Tax Hikes Reveal Congress' Economic Ignorance

by Richard W. Rahn

Why do almost all airliners cruise at approximately 550 Mph, the same speed they did 65 years ago? Faster planes can be built. The Concorde (1976-2003) flew at over twice the speed of the latest Boeing-787, and the fastest planes ever built (first flight in 1964), the SR-71 "Blackbird" flew at more than 2,000 Mph, or about four times as fast as a Boeing-737.

Fuel efficiency in airplanes falls rapidly as they approach the speed of sound (761 mph at sea level), and few people are willing to pay the very high ticket prices required (and in a smaller seat) to get from New York to London three hours faster. In sum, it makes little economic sense – at the present level of technology – to build high-speed aircraft for mass civilian travel. Engineering economics 101.

As one who has spent decades trying to teach Tax Economics 101 to students, members of the media, and the political class, it is painful to acknowledge that the current crop of "leaders" seems to have learned nothing. Back in the early 1980s, during the Reagan presidency, many of us were under the illusion that we were rolling back economic illiteracy. Mr. Reagan explained the basics with great clarity (he had a degree in economics), and most of his economic team were unusually talented with excellent communication skills.

Currently, the U.S. Congress is considering passing several tax increases that make no economic sense – but do display their economic ignorance and lack of historical knowledge. A few extremists even argue that Congress should raise the maximum federal income tax rate of about 37% to more than 90% "to tax the rich to pay for the programs for the poor." That experiment has been run before – in the U.S. and many other countries. From WWII until the "Kennedy" tax cuts of 1963, the maximum tax rate was over 90%.

Almost no one paid such high rates because they had figured how to avoid it, and hence it brought in very little revenue to the government – but it did cause a misallocation of resources and slower growth. Under Mr. Kennedy, the maximum tax rate was lowered to 70% and eventually to 28% under Mr. Reagan. In both cases, the economy grew rapidly, and within a few years, tax revenues (inflation-adjusted) were higher, not lower. Many other countries tried the same experiment with the same result.

Every tax has a revenue-maximizing rate and an economic wealth-maximizing rate. Art Laffer, Larry Kudlow, and many other economists have been repeating this fundamental – and true – maxim almost daily for decades on many TV and radio programs. Art Laffer drew the diagram and said it so many times that others labeled it the "Laffer Curve" even though, as Art will be first to point out, the ancient Greeks even understood the concept.

There are many empirical and theoretical studies showing that most taxes on labor and capital are well above the revenue and growth-maximizing rates – yet the members of the Biden Administration and Congress keep telling us they are going to fund trillions of dollars in new spending by taxing the rich – (even though the top 1% already pay 40% of all tax revenue). The evidence is they are likely to receive less, not more, revenue from these tax increases over the long run. The tax and economic models Congress uses to justify the tax increases are almost useless. In 1983-1984, the economic establishment (and their models) claimed the economy could not grow more than 3.0% with the Reagan tax cuts. Yet, the economy grew twice as fast as they predicted – oh well! More recently, the economic establishment and their allies in Congress and media claimed that it was not possible to reduce the level of black and Hispanic unemployment achieved before the pandemic under President Donald Trump.

In the very short run (days or weeks before people have a chance to adjust their behavior), big tax increases result in a windfall in tax revenue. Still, as people adapt to the new rates (by working and investing less, and finding endless ways, both legal and illegal, to avoid the high rates), the revenue gain will slowly disappear. It will then become a loss as the economy grows more slowly because fewer are working and investing. The models that Congress and most media use for doing their tax revenue estimates do not fully capture all the behavioral effects of tax rate increases or decreases and have too short time horizons (10 years).

The benefits of the Reagan tax cuts carried on for a couple of decades as the capital stock was permanently raised, and the disincentives for productive employment had been reduced.

The big increases in government spending being proposed will greatly damage the economy by misallocating resources and providing the wrong incentives over the long run and should not be enacted. Tabling the spending proposals would have the added benefit of taking away the phony excuse for increasing taxes – a win-win for the economy. Clear thinkers should not accept the false proposition that raising tax rates will produce more revenue and lead to more prosperity over the long run but attempt, like Mr. Reagan, to educate the economic know-nothings among the political class and media.

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