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Tax rates vs. revenues

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The U.S. Treasury has just released some new data that will bring cheer to the advocates of lower tax rates and heartburn to those who advocate higher tax rates.

By way of background, for the last three decades, there has been a fierce debate about which tax rates maximize tax revenue. Economist Art Laffer drew a curve that merely illustrated the well-known concept that at some point a tax rate becomes so high people will find legal or illegal ways of avoiding the tax, and tax revenue actually will fall.

Mr. Laffer was derided by high-tax advocates, who misrepresented his and fellow supply-siders' statements as implying all tax cuts would immediately increase revenues.

In fact, we supply-siders said some tax rates were above their revenue-maximizing point. Cutting these tax rates, would cause the economy to grow faster by stimulating work, saving and investment. There would be less tax avoidance and evasion. Thus, over the long run, tax revenues actually would increase.

The prime example of a tax rate too high to maximize revenue was the capital-gains rate. The capital-gains tax is somewhat unique as many people have discretion whether to sell a particular asset, such as a corporate stock or real estate property. If the tax rate is seen as too high, many people will delay selling an asset they wish to dispose of, in order to avoid the tax. This is known as the lock-in effect.

In the 1970s, Congress increased the capital-gains tax rates a couple of times until the maximum rate was almost 40 percent (precisely 39.875 percent). The combination of high capital-gains tax rates, along with high inflation in the late 1970s, was almost lethal to new investment: Capital gains were not adjusted for inflation, so the effective tax rate on assets sales often exceeded 100 percent.

In 1978, Rep. Bill Steiger introduced a bill, over the objection of President Carter, to reduce the maximum capital- gains rate to 28 percent. Many of us who supported the Steiger bill argued the rate cut should increase revenue. Many in the liberal economic establishment ridiculed us. But after the bill passed, capital-gains tax revenues immediately rose about 30 percent.

Under President Reagan, the capital-gains tax rate was cut again in 1981 to a maximum of 20 percent, then increased in 1986 to 28 percent, with a small additional increase in the early 1990s to 29.19 percent. In 1997, as a result of the Clinton-Gingrich compromise, the rate was cut to 21.19 percent. In 2003 the rate was cut to a 15 percent maximum.

Treasury has now released the data through 2002. As result of the frequent rate changes, we have considerable evidence who was right and who was wrong. When the capital gains tax rate was at its maximum in the late 1970s, capital-gains tax receipts averaged slightly under $8 billion annually.

From 1998 to 2002, the maximum capital-gains tax rate was approximately half the rate of the late 1970s, yet capital-gains tax revenues averaged 11 times higher ($88.6 billion per year), though the economy (nominally) was only 4 times larger.

I have summarized some of the new Treasury data in the following table that clearly indicates how sensitive capital-gains realizations are to tax rates.

Long-Term Capital Gains and Tax Rates, 1977-2002

Average Realized Gains as a Percent of GDP	Maximum Tax Rate (percent) on Long-Term Capital Gains
1.57	39.88
2.24	28.00
4.10	20.00
2.31	28.00 to 29.19
4.32	21.19

It is notable that official government tax forecasting agencies have consistently underestimated gains from rate cuts and incorrectly projected revenue gains from rate increases. I am willing to bet that several years from now, when the data is in on the Bush capital gains tax cut, the critics who opposed the rate cut will again be proved wrong.

If liberals and their media allies would ever take time to look at the data, they would see supply-siders are batting 100 percent [1.000]. But I won't hold my breath waiting for their contrition.

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