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# The tax-rate dilemma

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Economic advisers to presidential candidates face a dilemma when it comes to tax reform. In order to maximize revenue, there must be low tax rates on the poor and the rich, because the poor lack the money, and the rich can always find ways around high rates. At the same time, the middle class will understandably not stand for being taxed more than the rich.

Warren Buffett, the country's second-richest man, recently wrote an article saying his average income tax rate was only 17.7 percent, while his secretary paid a rate of 30 percent. In the 2004 election, it was revealed that John Kerry (the richest man ever to run for president) and his wife only paid an average income tax rate of 12 percent, far less than most middle-class Americans.

Many politicians of the left and their lackeys in the "drive-by-media" engage in the rant that the rich should pay more. Yet, when you look at their proposals "for increasing taxes on rich," you most always find their plans involve increasing taxes on those who are trying to become rich, while barely touching the already rich, like the Kerrys and Kennedys. To test the sincerity of any politician's proposal to increase "taxes on the rich," I use the Kerry test, whereby I go back and look at the Kerrys' tax returns to see if it will have meaningful impact on them. (Note: The top 1 percent of income earners pays 37 percent of all income taxes.)

The political case for pro-growth tax policy, as opposed to redistributionist tax policy, is simple. Surveys over the last few decades have consistently shown most Americans believe no one should have to pay more than 25 percent of income to the government.

The reasons for this finding are that most Americans believe it is not fair for the government to take more than one-quarter of anyone's income, and many Americans who are not rich think they may become rich — by building a business, being a sports or entertainment success, or even by winning the lottery. Most Americans (unlike many Europeans) do not resent rich people; they admire them and want to be one of them. Hence, pro-growth candidates tend to do better at the polls than pro-redistribution candidates.

If you are advising a Republican candidate, you should note that most Republican primary voters do not care about taxing the rich more; they care about reducing the taxes they pay and reining in the Internal Revenue Service tyranny. In the general election, a few may vote for a candidate just because he or she promises to make the rich pay more, but almost certainly such voters will vote for the Democrat anyway. The Republican is unlikely to pick up any votes by playing the class-warfare game and would most certainly undermine his or her base.

The economic case for not raising tax rates on the rich is even more compelling. High tax rates can destroy wealth creation, and they won't make the rich pay more. One advantage of being very rich is that you tend to have a choice about the form in which you receive your income, where you earn it, and where you are taxed. Many rich Swedes and Frenchmen have become tax exiles from their own countries. When a rich person leaves, his government gets nothing. When tax rates are perceived to be too high, people tend to choose leisure over work, and consumption over saving and investment, resulting in less revenue for government.

Economists have been trying to figure out the optimum tax rate for each income group. If you believe the rich should pay a higher portion of their income than the poor, you confront a problem. As tax rates increase, the incentive to find legal or illegal ways to avoid them grows exponentially; yet the richer one is, the easier it becomes to avoid paying the tax. Hence, if the goal is to maximize tax revenue over the long run, the government would have low rates on low income people, higher rates on the middle class, and then lower rates on the very rich.

The reason for this is when the rich are taxed at high rates they either do not save or move their savings away from the high tax jurisdiction. Saving and its productive investment cause an increase in what economists call capital formation, and higher rates of capital formation translate into more jobs and higher pay. Thus, if a country imposes very high tax rates on the rich, it will have slower economic growth, fewer new jobs, and lower paying jobs.

It is politically unacceptable to have an explicitly higher tax rate for middle-income taxpayers than for the truly rich, and economically destructive to have very high rates on the rich. The only way out of the dilemma is to move to a modest flat rate or consumption tax system, with exemptions or rebates for low income people. Wise presidential candidates will propose such policies — demigods will not.

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