

Title:

The Tax Policy Charade

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705

Summary:

Is political discussion about tax policy meant to achieve a rational tax system? Or is it just to garner votes? Is there science that gets lost in the debate?

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tax policy, taxes, ideas

Article Body:

Tax policy discussions are meant to do what? Arrive at a rational policy, or garner votes. I think it is the latter. What is lost in all the debate over tax increases versus tax cuts, is science. Contrary to what most people may think, there is some scientific study of taxation.

Applying The Laffer Curve To Tax Policy

Invented by Arthur Laffer, the Laffer curve shows the relationship between tax rates and tax revenue collected. It demonstrates a simple principle that very few people understand, but one that is crucial to proper governance. It is the idea that as you raise taxes, you reach some point where actual revenues collected begin to drop.

This is perfectly logical, and you can understand it at the extremes. If the government took 95% of your income in taxes after the first \$10,000, would you work much after that? Do they get any more taxes if you don't work more? No. More money will actually be collected if they take a lower percentage, right?

Now add to this the fact that every dollar the government takes can't be invested into new businesses or the expansion of existing businesses. New business investment means new income, and therefore more taxes. This isn't hypothetical - you can't invest what has been taken away from you. A friend of mine put off hiring employees and expanding his business for a long time because of a state business tax that would dramatically increase his taxes if he hired help.

That was a truly perverse tax policy, but any raising of taxes has to at some

point cause a lowering of profits to the point where less is actually collected in taxes. There obviously has to be a point of diminishing returns. Where is it?

The science isn't that exact yet, but the principle is clear. The top of the curve seems to be somewhere around 15% to 25% as a total tax burden (federal, state and local). What this means is that if tax rates go higher than that 15% to 25%, the curve goes down; the government actually collects less money.

This isn't a republican or democratic issue. When Kennedy lowered tax rates and when Reagan did so (from a high of 70%!), tax revenues soared. The fact that under Reagan the government spent even faster than the rising revenues is another issue, but the lesson was clear: the Laffer Curve is an accurate description of tax rates and tax revenue.

In other words even if a political party or a society wants all sorts of social welfare programs, they have to realize that there is an ideal rate of taxation to get the most money to pay for these programs. Tax more heavily, and you get less, not more. This is the reality, whether people like it or not.

The Politics Of Tax Policy

Quite often, people don't like this reality, and politics trumps science. For example, wealthy people are often taxed at rates that have them spending more time looking for loopholes than ways to make more taxable income. This lowers production, and so lowers the potential taxes collected. If your friends don't get it when you explain this, point out that 20% of a million is more than 50% of three hundred thousand, so production matters - not just higher tax rates.

What happens if we recognize this? Will a politician explain that the government can collect more taxes from the wealthy if the rates are lowered? When they try, they lose votes. Long term there is real hope, because the principle is actually easy to understand. Short term it is politically difficult to say you want to lower taxes on the wealthy to a scientifically determined rate of greatest efficiency.

Many people want to believe that the rich can be taxed enough to pay for anything we want. The reality is that if most of the income of the wealthy was taken it would fund government for only a few weeks. There are more middle class than wealthy people, and more total income there, so that is where most taxes have to come from. Voter's don't know this or don't like this, and politicians tell them what they want to hear. Hence the tax policy charade.