Gotta Raise Taxes? Maybe It Wont Work!

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You heard it here first: to pay for the extraordinary government programs in reference to COVID-19, the government is going to raise taxes. Some politicians have already been calling for increasing tax rates "on the rich" to levels not seen for decades. In January 2019, prominent politicians, such as Alexandria Ocasio-Cortez, proposed a 70 percent top Federal income tax rate, a rate not seen since 1981. The current top income tax bracket is 37% - not including state or local taxes.

Several years ago, we published an article, *Credit Hurricane Approaching!* (read it here) where we pointed out that the government debt has been climbing for many years and has to be addressed at some point. Things have gotten much worse since then. Even before COVID-19 hit the world, the U.S. deficit was running roughly $1 Trillion each year and U.S. government debt had grown to over $22 Trillion. In response to the economic problems triggered by COVID-19, the government has pumped an additional $3 Trillion into the economy. Since they were already negative, the only way to get additional money to spend is to borrow it, increasing the national debt even further.

The basic equation is simple: <u>revenue</u> minus <u>spending</u> equals <u>cash flow</u>. If you cannot reduce spending, then you need to increase the revenue to ease the cash flow. You are sure to hear raising the tax rate being proposed. After all, if the top rate for Federal income taxes is 37%, by raising that to 70%, you should bring in almost double the tax revenue, right?

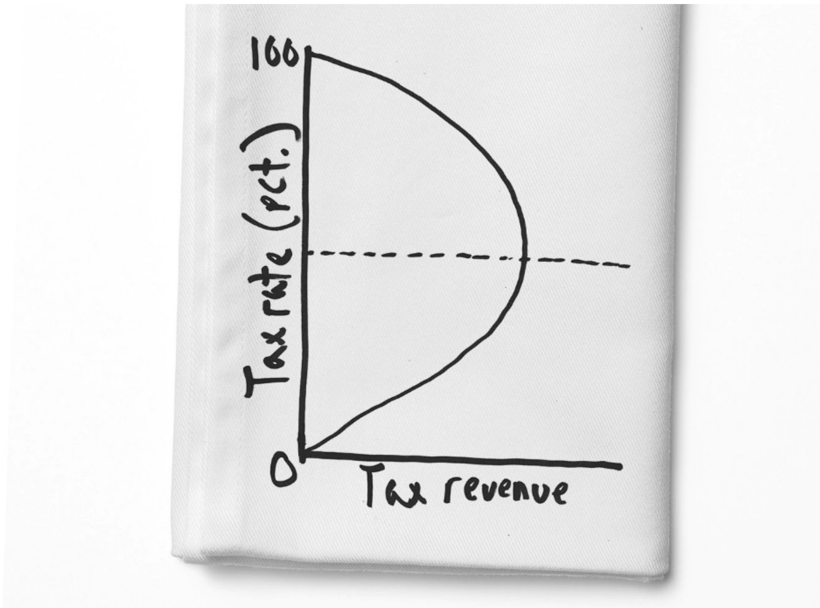
The difficulty is, tax revenue does not work that way. This has been tried before and it just does not work. The true goal of taxation is <u>not to raise the tax rate</u>, it is really to <u>maximize the revenue</u> coming into the government coffers. These two actions are NOT the same.

To understand this more fully, we borrow a concept from former chief economist at the Office of Management and Budget, Arthur Laffer. Art Laffer in 1974 illustrated this idea on a dinner napkin, the now famous Laffer Curve. While there have been many attempts to disparage this idea, the facts seem to demonstrate that it provides a valid explanation of reality.

Let's spend just a few minutes to review the concept.

As you can tell from our picture of the supposed napkin, there are two axis on the graph. The bottom axis (the X-axis from your high school days) is the amount of tax revenue received by the government.

On the vertical axis (the Y-axis), we vary the tax rate from zero to 100% and then draw a curve of the results.



The end points are pretty easy to plot. If the tax rate is zero, no one needs to pay taxes, so the government revenue is zero. Same thing if the rate is 100%. Who would declare any income if the government just took it all? This is not so fondly referred to as slavery and is an evil thing whether it is the government or a person taking everything that you work for.

As you work up from the bottom, or down from the top, the government starts to make <u>some</u> money. This results in the curve moving from the zero end points out to where the government is able to bring in revenue. At some point the bulge is the furthest out and revenues coming into the government are at their maximum. At this point, the maximum revenue point is reached – the point where the curve is at its farthest point to the right. From this point, whether the government <u>increases</u> the income tax rate or <u>decreases</u> it, any change in tax rates means that the government receives less revenue.

Our experience confirms this. With high tax rates, many of our most productive workers simply stopped working: why work so hard just to see so much of your effort be sucked away by taxes? In a high tax rate environment, we as financial planners, along with attorneys, accountants, and other business professionals, were spending a LOT of time figuring out ways to get tax advantages. After all, if the tax savings provided an instant 70% return on investment, that was probably better than we could get by normal means on a typical investment.

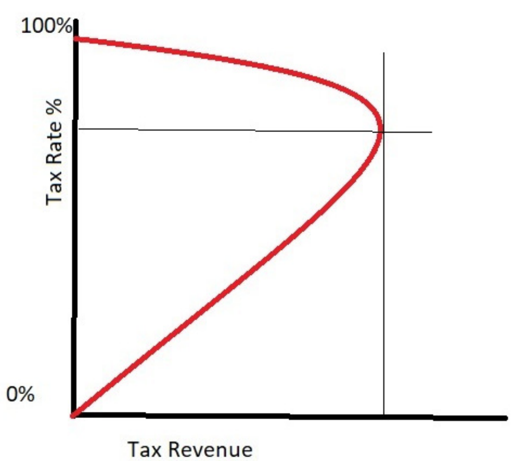
Once tax rates were low enough, it stopped becoming worth all that effort or expense to set up special tax shelter programs. Workers and investors found it much more effective to just pay the tax and spend their time doing more. Productivity soared! And more important to policymakers – revenue soared as well.

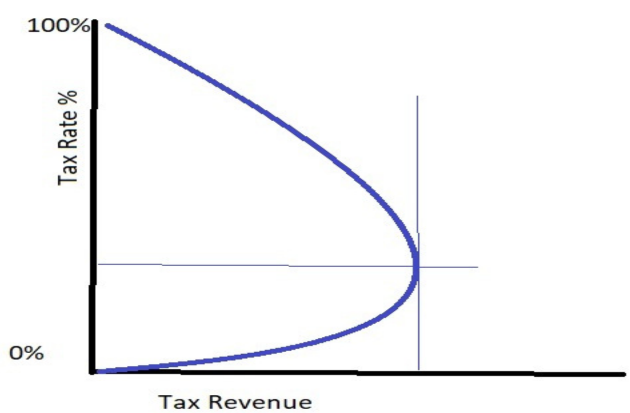
There are numerous examples of this tax effect in action, but let's address just one painfully obvious case. In 1990, the U.S. Congress decided that rich people were not paying their "fair share" of taxes. Looking around, they found two items that typically only rich people can buy, yachts and airplanes. It seemed like a no-brainer: have the rich pay a “small” 10 percent luxury tax on yachts priced at more than $100,000 and on private planes that cost more than $250,000. Proponents of the new tax expected to raise an additional $9 Billion of revenue over the next 5 years.

You can probably guess the actual results: According to iGeek.com, “*what actually happened is:*

- *Sales dropped 56% in the first month, and got worse from there -- the larger tax package cooled the economy and contributed to a mini-recession*
- *≈25,000 workers in American Yacht Building lost their jobs, 75,000 more jobs were lost from companies supplying parts and materials to those yacht companies*
- *There was also another thousands more lost in small aircraft, and other jobs*
- *The government not only didn't come close to target, they had to pay out billions in unemployment and lost income taxes instead*
- *We went from net exporter to importer, as the rich just bought their boats made in other countries, and listed their livery in the Bahamas, to get around the taxes: and the industry has never recovered.”*

The important question with the Laffer Curve is “What is the shape of the curve?” Proponents for higher tax rates believe that the curve bulges at the top and then begins a slow slide towards the zero mark. Looking at the red curve (the one on the left) below shows that in this case, the maximum revenue is achieved at a HIGHER tax rate percentage. Proponents of lower tax rates believe the curve bulges near the bottom, as illustrated by the blue curve on the right below. A curve with this shape provides that the maximum revenue would be achieved by a LOWER tax rate.





So which is it? History seems to teach us that the lower tax rate proponents appear to have it right. When Democratic President John F. Kennedy lowered tax rates to the 70% level, his move seemed to trigger the “go-go” 60’s. After Republican President Ronald R. Reagan lowered tax rates even more in 1981, his move seemed to trigger the next 20 years of a booming economy.

Our point here is not to say what that optimal tax rate level might be. It IS to say that simply raising tax rates, especially to a very high level, is likely to be counterproductive and may actually LOWER tax revenues. As we like to say, "Proceed with Caution."

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