

You Can't Soak the Rich

By DAVID RANSON
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Kurt Hauser is a San Francisco investment economist who, 15 years ago, published fresh and eye-opening data about the federal tax system. His findings imply that there are draconian constraints on the ability of tax-rate increases to generate fresh revenues. I think his discovery deserves to be called Hauser's Law, because it is as central to the economics of taxation as Boyle's Law is to the physics of gases. Yet economists and policy makers are barely aware of it.

Like science, economics advances as verifiable patterns are recognized and codified. But economics is in a far earlier stage of evolution than physics. Unfortunately, it is often poisoned by political wishful thinking, just as medieval science was poisoned by religious doctrine. Taxation is an important example.

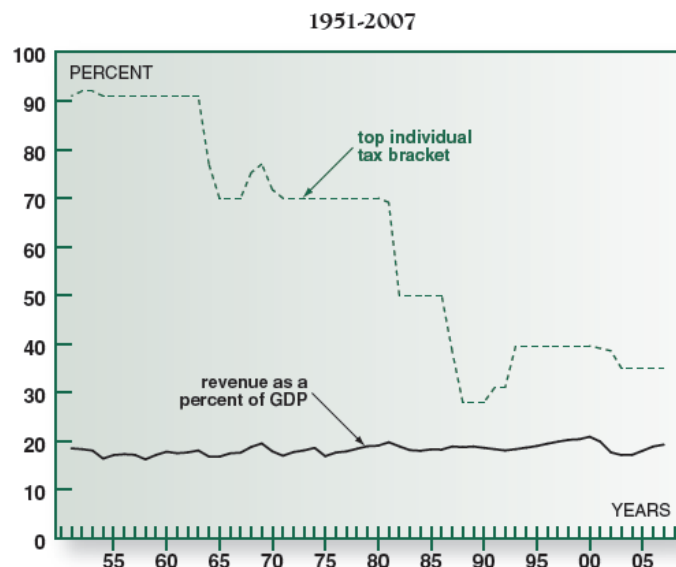
The interactions among the myriad participants in a tax system are as impossible to unravel as are those of the molecules in a gas, and the effects of tax policies are speculative and highly contentious. Will increasing tax rates on the rich increase revenues, as Barack Obama hopes, or hold back the economy, as John McCain fears? Or both?

Mr. Hauser uncovered the means to answer these questions definitively. On this page in 1993, he stated that "No matter what the tax rates have been, in postwar America tax revenues have remained at about 19.5% of GDP." What a pity that his discovery has not been more widely disseminated.

Federal Tax Revenue "Yield" and Marginal Tax Rates

The chart nearby, updating the evidence to 2007, confirms Hauser's Law. The federal tax "yield" (revenues divided by GDP) has remained close to 19.5%, even as the top tax bracket was brought down from 91% to the present 35%. This is what scientists call an "independence theorem," and it cuts the Gordian Knot of tax policy debate.

The data show that the tax yield has been independent of marginal tax rates over this period, but tax revenue is directly proportional to GDP. So if we want to increase tax revenue, we need to increase GDP.



What happens if we instead raise tax rates? Economists of all persuasions accept that a tax

rate hike will reduce GDP, in which case Hauser's Law says it will also *lower* tax revenue. That's a highly inconvenient truth for redistributive tax policy, and it flies in the face of deeply felt beliefs about social justice. It would surely be unpopular today with those presidential candidates who plan to raise tax rates on the rich – if they knew about it.

Although Hauser's Law sounds like a restatement of the Laffer Curve (and Mr. Hauser did cite Arthur Laffer in his original article), it has independent validity. Because Mr. Laffer's curve is a theoretical insight, theoreticians find it easy to quibble with. Test cases, where the economy responds to a tax change, always lend themselves to many alternative explanations. Conventional economists, despite immense publicity, have yet to swallow the Laffer Curve. When it is mentioned at all by critics, it is often as an object of scorn.

Because Mr. Hauser's horizontal straight line is a simple fact, it is ultimately far more compelling. It also presents a major opportunity. It seems likely that the tax system could maintain a 19.5% yield with a top bracket even lower than 35%.

What makes Hauser's Law work? For supply-siders there is no mystery. As Mr. Hauser said: "Raising taxes encourages taxpayers to shift, hide and underreport income. . . . Higher taxes reduce the incentives to work, produce, invest and save, thereby dampening overall economic activity and job creation."

Putting it a different way, capital migrates away from regimes in which it is treated harshly, and toward regimes in which it is free to be invested profitably and safely. In this regard, the capital controlled by our richest citizens is especially tax-intolerant.

The economics of taxation will be moribund until economists accept and explain Hauser's Law. For progress to be made, they will have to face up to it, reconcile it with other facts, and incorporate it within the body of accepted knowledge. And if this requires overturning existing doctrine, then so be it.

Presidential candidates, instead of disputing how much more tax to impose on whom, would be better advised to come up with plans for increasing GDP while ridding the tax system of its wearying complexity. That would be a formula for success.

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