

The Reagan Tax Cuts: Lessons for Tax Reform

During the summer of 1981 the central focus of policy debate was on the Economic Recovery Tax Act (ERTA) of 1981, the Reagan tax cuts. The core of this proposal was a version of the Kemp-Roth bill providing a 25 percent across-the-board cut in personal marginal tax rates. By reducing marginal tax rates and improving economic incentives, ERTA would increase the flow of resources into production, boosting economic growth. Opponents used static revenue projections to argue that ERTA would be a giveaway to the rich because their tax payments would fall.

The criticism that the tax payments of the rich would fall under ERTA was based on a static conception of human behavior. As a 1982 JEC study pointed out,^[1] similar across-the-board tax cuts had been implemented in the 1920s as the Mellon tax cuts, and in the 1960s as the Kennedy tax cuts. In both cases the reduction of high marginal tax rates actually increased tax payments by "the rich," also increasing their share of total individual income taxes paid. Unfortunately, estimates of ERTA by the Democrat-controlled CBO continued to show falling tax payment by upper income taxpayers, even after actual IRS data had become available showing a surge of income tax payments by affluent taxpayers.

Given the current interest in tax reform and tax relief, a review of the effects of the Reagan tax cuts on taxpayer behavior and tax burden provides useful information. During the 1980s ERTA had reduced personal tax rates by about 25 percent, while the Tax Reform Act of 1986 chopped them yet again.

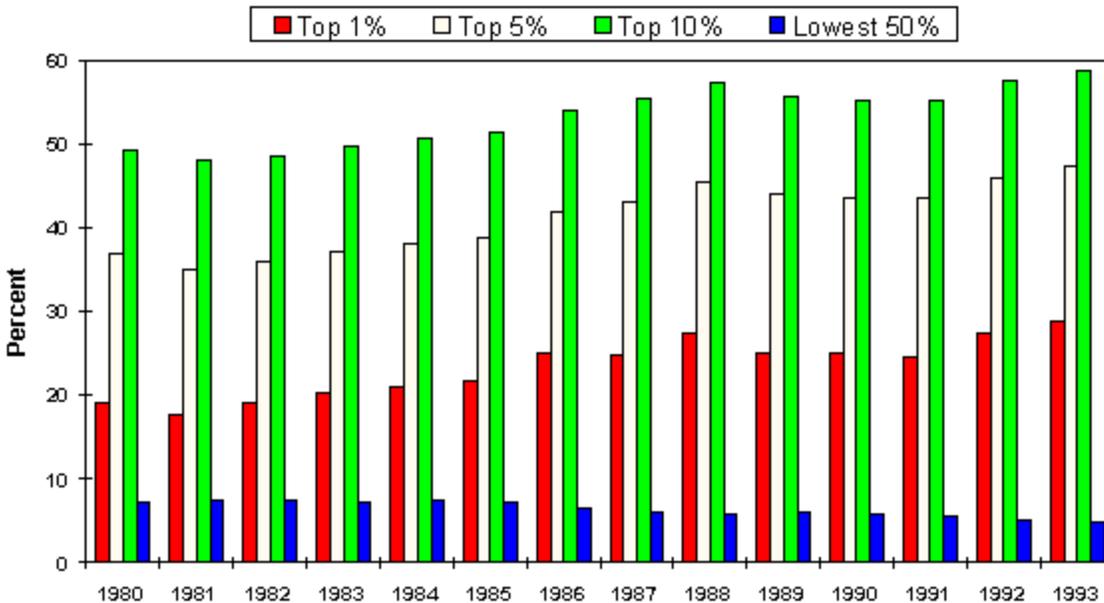
Tax Rates and Tax Revenues

High marginal tax rates discourage work effort, saving, and investment, and promote tax avoidance and tax evasion. A reduction in high marginal tax rates would boost long term economic growth, and reduce the attractiveness of tax shelters and other forms of tax avoidance. The economic benefits of ERTA were summarized by President Clinton's Council of Economic Advisers in 1994: "It is undeniable that the sharp reduction in taxes in the early 1980s was a strong impetus to economic growth." Unfortunately, the Council could not bring itself to acknowledge the counterproductive effects high marginal tax rates can have upon taxpayer behavior and tax avoidance activities.

Since 1984 the JEC has provided factual information about the impact of the tax cuts of the 1980s. For example, for many years the JEC has published IRS data on federal tax payments of the top 1 percent, top 5 percent, top 10 percent, and other taxpayers. These data show that after the high marginal tax rates of 1981 were cut, tax payments and the share of the tax burden borne by the top 1 percent climbed sharply. For example, in 1981 the top 1 percent paid 17.6 percent of all personal income taxes, but by 1988 their share had jumped to 27.5 percent, a 10 percentage point increase. The graph below illustrates changes in the tax burden during this period.

Income Tax Burden Shifted Towards Wealthy

Share of Total Income Taxes Paid By Income Groups



Source: IRS and JEC Staff calculations

The share of the income tax burden borne by the top 10 percent of taxpayers increased from 48.0 percent in 1981 to 57.2 percent in 1988. Meanwhile, the share of income taxes paid by the bottom 50 percent of taxpayers dropped from 7.5 percent in 1981 to 5.7 percent in 1988.

A middle class of taxpayers can be defined as those between the 50th percentile and the 95th percentile (those earning between \$18,367 and \$72,735 in 1988). Between 1981 and 1988, the income tax burden of the middle class declined from 57.5 percent in 1981 to 48.7 percent in 1988. This 8.8 percentage point decline in middle class tax burden is entirely accounted for by the increase borne by the top one percent.

Several conclusions follow from these data. First of all, reduction in high marginal tax rates can induce taxpayers to lessen their reliance on tax shelters and tax avoidance, and expose more of their income to taxation. The result in this case was a 51 percent increase in real tax payments by the top one percent. Meanwhile, the tax rate reduction reduced the tax payments of middle class and poor taxpayers. The net effect was a marked shift in the tax burden toward the top 1 percent amounting to about 10 percentage points. Lower top marginal tax rates had encouraged these taxpayers to generate more taxable income.

The 1993 Clinton tax increase appears to having the opposite effect on the willingness of wealthy taxpayers to expose income to taxation. According to IRS data, the income generated by the top one percent of income earners actually declined in 1993. This decline is especially significant since the retroactivity of the Clinton tax increase in that year limited the ability of taxpayers to deploy tax avoidance strategies, temporarily resulting in an increase in their tax burden. Moreover, according to the FY 1997 Clinton budget submission, individual income tax

revenues as a share of GDP will be lower during the first four years of the Clinton tax increase, which include the effects of the 1990 tax increase, than under the last four years of the Reagan tax changes (FY 1986-89). Furthermore, according to a study published by the National Bureau for Economic Research,^[2] the Clinton tax hike is failing to collect over 40 percent of the projected revenue increases.

Incidentally, the claim that unrealistic supply side Reagan Administration revenue projections caused large budget deficits during the 1980s is false. Nonetheless, this false allegation is often used against current tax reform proposals. The official Reagan revenue projections immediately following enactment of ERTA did not assume huge revenue increases, and were actually quite close to the CBO revenue projections. Even the Democrat-controlled CBO projected that deficits would fall after the enactment of the Reagan tax cuts. The real problem was a recession that neither CBO nor OMB could foresee. Even so, individual income tax revenues rose from \$244 billion in 1980 to \$446 billion in 1989.

Conclusion

The Reagan tax cuts, like similar measures enacted in the 1920s and 1960s, showed that reducing excessive tax rates stimulates growth, reduces tax avoidance, and can increase the amount and share of tax payments generated by the rich. High top tax rates can induce counterproductive behavior and suppress revenues, factors that are usually missed or understated in government static revenue analysis. Furthermore, the key assumption of static revenue analysis that economic growth is not affected by tax changes is disproved by the experience of previous tax reduction programs. There is little reason to expect static revenue analysis to evaluate the economic or distributional effects of current tax reform proposals much better than it evaluated the Reagan tax program 15 years ago.

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Endnotes:

1. Joint Economic Committee, *The Mellon and Kennedy Tax Cuts: A Review and Analysis*, 1982.
2. Feldstein, Martin and Daniel Feenberg, *The Effect of Increased Tax Rates on Taxable Income and Economic Efficiency: A Preliminary Analysis of the 1993 Tax Rate Increases*, NBER, 1995.

Other JEC Reports that deal with this issue:

1. JEC Annual Report: 1988 through 1994.
2. Latest Data Show Higher Income Tax Rates Reduce Taxes Paid by the Rich, JEC Report: December 1993.