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THE HISTORICAL LESSONS OF LOWER TAX RATES

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INTRODUCTION

The 1996 presidential campaign has rekindled the debate over tax reductions. Among the proposals being considered are an across-the-board reduction in tax rates, the repeal of rate increases imposed in 1990 and 1993, the deductibility of payroll taxes, and a modified flat tax. But regardless of the particular features of each change under consideration, the argument is the same. Proponents argue that lower tax rates will spur economic growth by reducing the penalty on working, saving, and investing. Opponents disagree, claiming that the economy is doing fine and that tax rate reductions, if enacted, will help the rich disproportionately while widening the deficit.

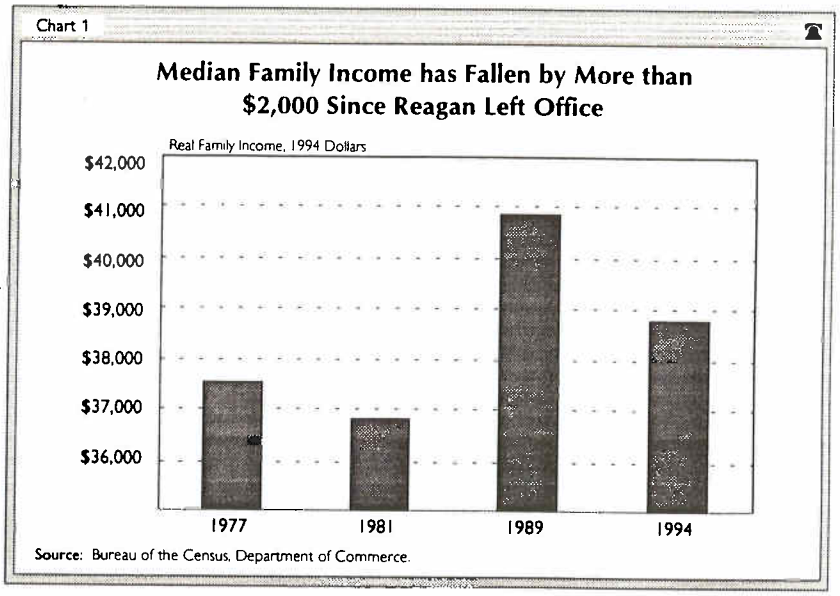
Fortunately, there is a way to judge the desirability of lower tax rates. The United States has had three major episodes of tax rate reductions—the 1920s, 1960s, and 1980s. By looking at how the economy performed during these periods, and by examining what happened to the deficit and the degree to which different income classes were affected, it is possible to gain useful evidence about the desirability of tax rate reductions today.

The evidence provides strong support for those who believe the economy is weak and favor reductions in tax rates. Recent history is especially compelling. Tax rate increases in 1990 and 1993 boosted the top rate to 39.6 percent (and over 42 percent including the Medicare payroll tax). This means a 50 percent increase in the tax burden on work, saving, investment, and entrepreneurship when compared with the 28 percent rate in effect when Ronald Reagan left office. The effect has been dismal:

✗ During the post-Reagan era, the economy has experienced its worst seven-year performance since the end of World War II.

✗ Real median family income, the best measure of living standards for the average American, has fallen by more than $2,000 since Reagan left office.

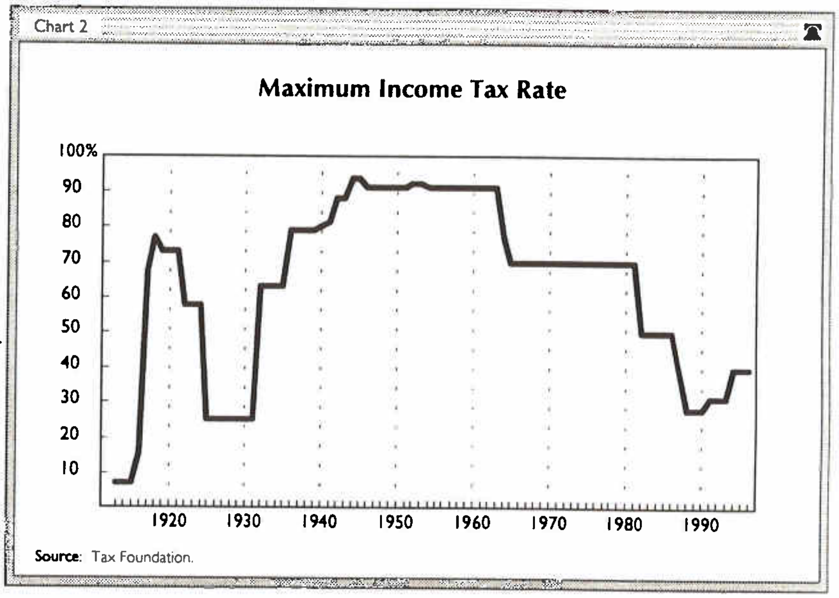
✗ Assuming there is no change in policy, the Congressional Budget Office estimates that economic growth for the next ten years will average less than 2.1 percent annually.[1] This is well below the post-World War II average of 3.2 percent.



The economy's sub-standard performance in recent years should come as no surprise. As seen below, major changes in tax policy inevitably affect growth.

✔ Across-the-board tax rate reductions in the 1920s reduced the top rate from 71 percent to 24 percent. The economy boomed, growing by 59 percent between 1921 and 1929.

✗ In 1930, Herbert Hoover raised tax rates from 25 percent to a maximum of 63 percent, and Franklin Roosevelt boosted them to 79 percent later in the decade. The 1930s, to put it mildly, are not remembered as one of the American economy's better decades.[2]



✔ Across-the-board tax rate reductions introduced by President John F. Kennedy reduced the top rate from 91 percent to 70 percent. These lower rates, along with substantially lower taxes on savings and investment, are associated with the longest economic expansion in American history.[3]

1 Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1997-2006*, May 1996.

2 It is important to note that tax policy is just one of the many ways government can influence the economy and should receive neither full credit nor full blame for how well the economy performs. In the 1930s, for instance, contractionary monetary policy and protectionist trade policy also contributed to the economy's poor performance.

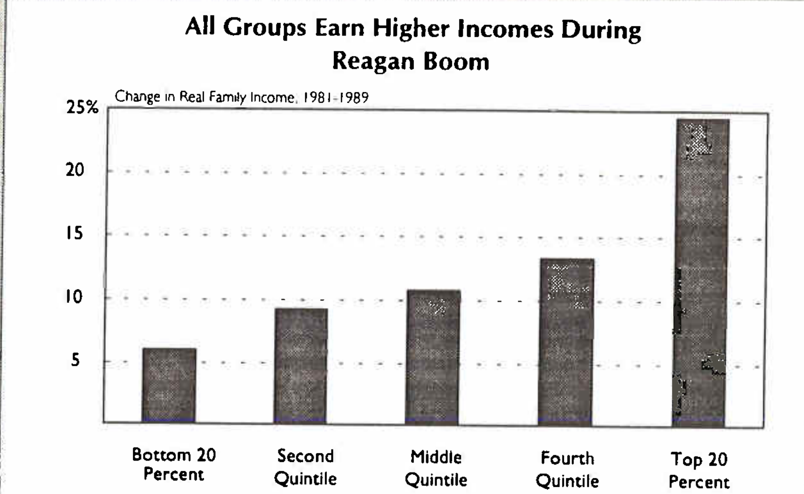
3 The lower tax rates were phased in between 1964 and 1965. The lower taxes on capital went into effect in 1962.

✗ The Johnson surtax, enacted in 1968 during the administration of President Lyndon Johnson, combined with the inflation-induced bracket creep of the 1970s (subjecting taxpayers to higher rates even though their real incomes had not changed), resulted in a decade of stagflation.

✔ Reagan's across-the-board tax cuts ushered in America's longest peacetime expansion, helping to create 20 million new jobs and pushing incomes and living standards to record highs.

✗ The tax rate increases imposed under George Bush and Bill Clinton, as outlined below, are associated with the slowest growing economy in 50 years and a decline of more than $2,000 in the average family's income.

Chart 3



Source: Bureau of the Census, Department of Commerce.

If legislators want to unleash stronger growth and more prosperity, the best tax policy would be the flat tax. Under that proposal, all three major problems of the current tax code—high rates, anti-capital bias, and complexity—would be minimized. To the extent that politicians are reluctant to adopt a flat tax, however, any change that moved in the right direction would be helpful. If history is any guide, any tax rate reduction, whether a 15 percent across-the-board cut, a repeal of the Bush and Clinton tax hikes, or some other reform, would boost the economy and raise living standards.

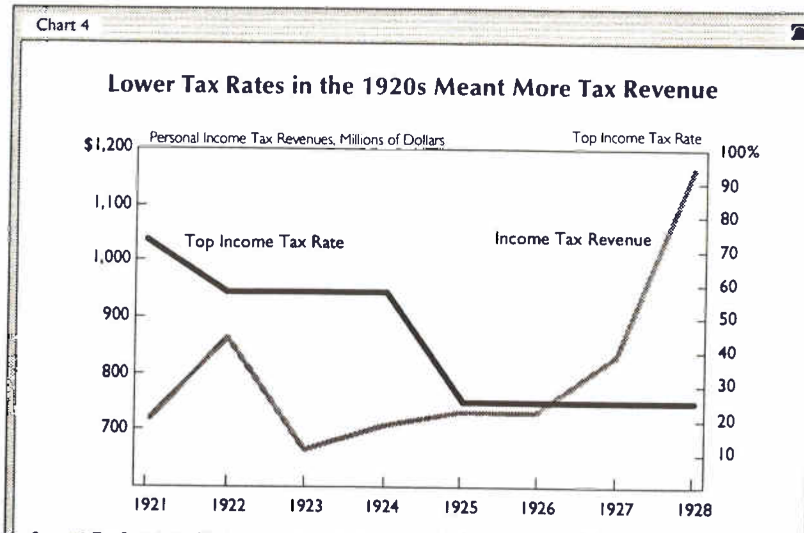
Looking at Case Histories

The effect of tax rates on economic activity should not be overstated. The economy, after all, can be affected significantly by trade policy, regulatory policy, monetary policy, and many other government actions. Even within the context of fiscal policy, tax rates are not the only critical issue. Both the level of government spending and where that money goes are very important. And even when looking only at tax policy, tax rates are just one piece of the puzzle. If certain types of income are subject to multiple layers of tax, as occurs in the current system, that problem cannot be solved by low rates. Similarly, a tax system with needless levels of complexity will impose heavy costs on the productive sector of the economy.

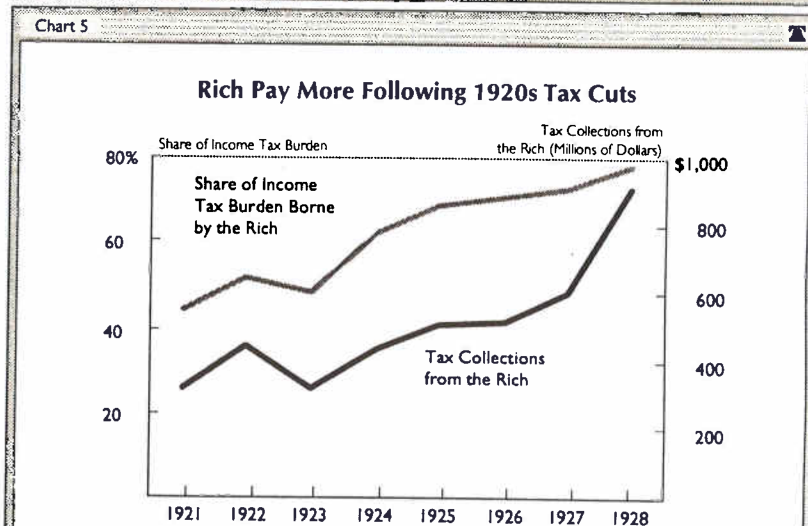
Keeping all these caveats in mind, there nonetheless is a distinct pattern throughout American history: Simply stated, when tax rates are reduced, the economy prospers, tax revenues grow, and lower-income citizens bear a lower share of the tax burden. Conversely, periods of higher tax rates are associated with subpar economic performance and stagnant tax revenues.

The 1920s

- ✔ Under the leadership of Treasury Secretary Andrew Mellon during the Administrations of Presidents Warren Harding and Calvin Coolidge, tax rates were slashed from the confiscatory levels they had reached in World War I. The Revenue Acts of 1921, 1924, and 1926 reduced the top rate from 73 percent to 25 percent.



Sources: Tax Foundation; "The Mellon and Kennedy Tax Cuts: A Review and Analysis," Staff Study, Joint Economic Committee, June 18, 1982.



Note: "The Rich" are defined as those with incomes above $50,000.
Source: "The Mellon and Kennedy Tax Cuts: A Review and Analysis," Staff Study, Joint Economic Committee, June 18, 1982.

- ✔ Spurred in part by lower tax rates, the economy expanded dramatically. In real terms, the economy grew 59 percent between 1921 and 1929, and annual economic growth averaged more than 6 percent.

- ✔ Notwithstanding (or perhaps because of) the dramatic reduction in tax rates, personal income tax revenues increased substantially during the 1920s, rising from $719 million in 1921 to $1,160 million in 1928, an increase of more than 61 percent (this was a period of no inflation).[4]

- ✔ The share of the tax burden borne by the rich rose dramatically. As seen in Chart 5, taxes paid by the rich (those making $50,000 and up in those days) climbed from 44.2 percent of the total tax burden in 1921 to 78.4 percent in 1928.

4 Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970, Part 1* (Washington, D.C.: U.S. Government Printing Office, 1976).

This surge in revenue was no surprise to Mellon:

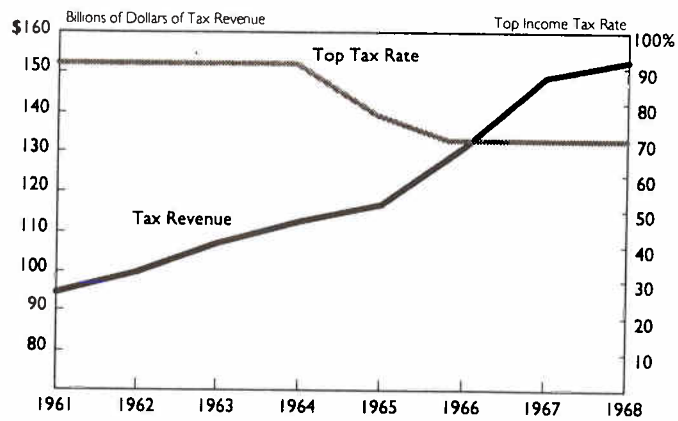
> The history of taxation shows that taxes which are inherently excessive are not paid. The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find other lawful methods of avoiding the realization of taxable income. The result is that the sources of taxation are drying up; wealth is failing to carry its share of the tax burden; and capital is being diverted into channels which yield neither revenue to the Government nor profit to the people.[5]

The 1960s

- ✔ President Kennedy proposed a series of tax rate reductions in 1963 that resulted in legislation the following year dropping the top rate from 91 percent in 1963 to 70 percent by 1965.[6]
- ✔ The Kennedy tax cuts helped trigger the longest economic expansion in America's history. Between 1961 and 1968, the inflation-adjusted economy expanded by more than 42 percent. On a yearly basis, economic growth averaged more than 5 percent.
- ✔ Tax revenues grew strongly, rising by 62 percent between 1961 and 1968. Adjusted for inflation, they rose by one-third.

Chart 6

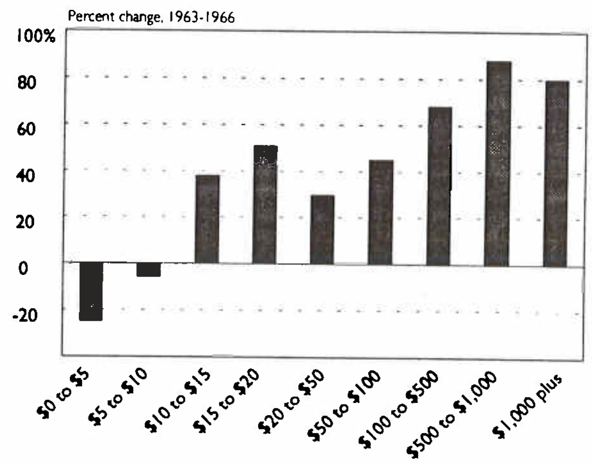
Kennedy Tax Cuts Boosted Revenue



Sources: Tax Foundation; *Budget of the U.S. Government, FY 1997*, Office of Management and Budget.

Chart 7

Rich Pay More Under Kennedy Tax Cuts



Source: "The Mellon and Kennedy Tax Cuts: A Review and Analysis," Staff Study, Joint Economic Committee, June 18, 1982.

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5 Andrew Mellon, *Taxation: The People's Business* (New York: Macmillan, 1924).

6 The Kennedy boom also was helped along by reductions, occurring in 1962, in the tax burden on investment and capital gains.

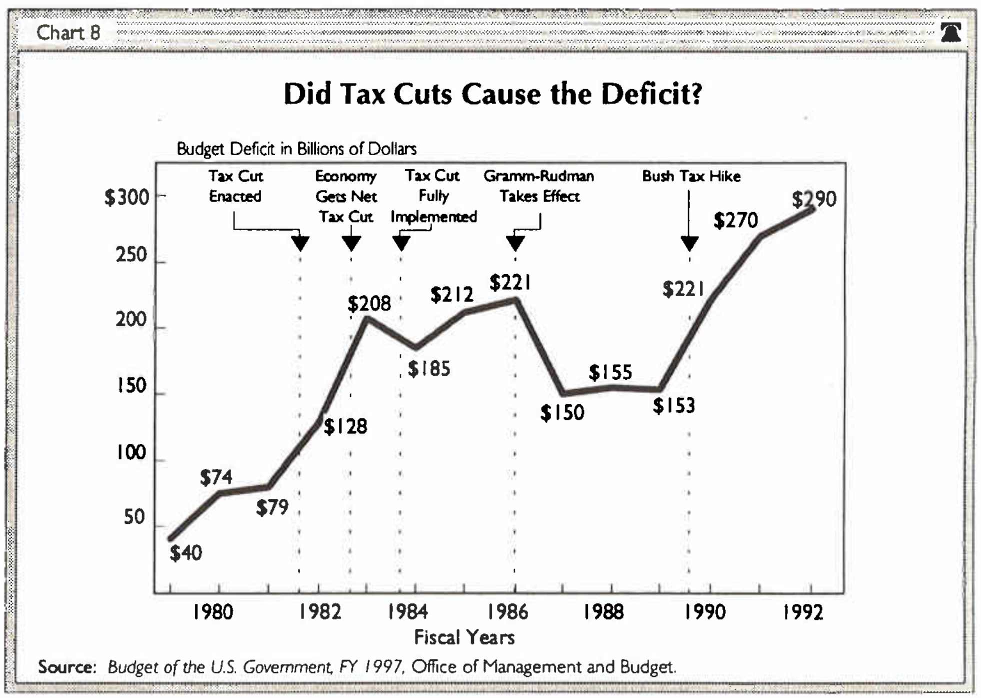
✔ Just as in the 1920s, the share of the income tax burden borne by the rich increased. Tax collections from those making over $50,000 per year climbed by 57 percent between 1963 and 1966, while tax collections from those earning below $50,000 rose 11 percent. As a result, the rich saw their portion of the income tax burden climb from 11.6 percent to 15.1 percent.[7]

According to President Kennedy:

> Our true choice is not between tax reduction, on the one hand, and the avoidance of large Federal deficits on the other. It is increasingly clear that no matter what party is in power, so long as our national security needs keep rising, an economy hampered by restrictive tax rates will never produce enough revenues to balance our budget just as it will never produce enough jobs or enough profits. Surely the lesson of the last decade is that budget deficits are not caused by wild-eyed spenders but by slow economic growth and periodic recessions and any new recession would break all deficit records. In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now.[8]

The 1980s

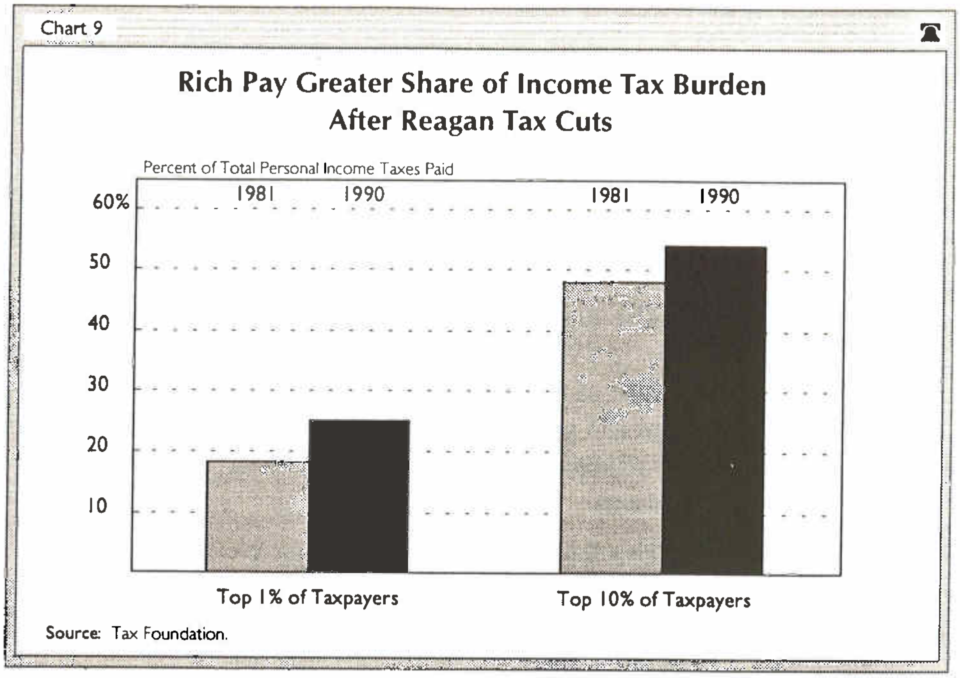
President Reagan presided over two major pieces of tax legislation which together reduced the top tax rate from 70 percent in 1980 to 28 percent by 1988.



The economic effects of the Reagan tax cuts were dramatic. When Reagan took office in 1981, the economy was being choked by high inflation and was in the middle of a double-dip recession (1980 and 1982). The tax cuts helped pull the economy out of the doldrums and ushered in the long-

7 Joint Economic Committee, "The Mellon and Kennedy Tax Cuts: A Review and Analysis," June 18, 1962.
8 John F. Kennedy, speech to Economic Club of New York, December 14, 1962.

est period of peacetime economic growth in America's history. During the seven-year Reagan boom, economic growth averaged almost 4 percent.



Critics charge that the tax cuts caused higher deficits, but they misread the evidence. The Reagan tax cut, though approved in 1981, was phased in over several years. As a result, bracket creep (indexing was not implemented until 1985) and payroll tax increases completely swamped Reagan's 1.25 percent tax cut in 1981 and effectively canceled out the portion of the tax cut which went into effect in 1982. The economy received an unambiguous tax cut only as of January 1983. Thereafter, personal income tax revenues climbed dramatically, increasing by more than 54 percent by 1989 (28 percent after adjusting for inflation).

Contrary to conventional wisdom, it was the "rich" who paid the additional taxes. The share of income taxes paid by the top 10 percent of earners jumped significantly, climbing from 48.0 percent in 1981 to 57.2 percent in 1988. The top 1 percent saw their share of the income tax bill climb even more dramatically, from 17.6 percent in 1981 to 27.5 percent in 1988.[9]

One of the chief architects of the Reagan tax cuts was then-U.S. Representative Jack Kemp (R-NY). According to Kemp:

> At some point, additional taxes so discourage the activity being taxed, such as working or investing, that they yield less revenue rather than more. There are, after all, two rates that yield the same amount of revenue: high tax rates on low production, or low rates on high production.[10]

9 Joint Economic Committee, *Annual Report, 1992.*

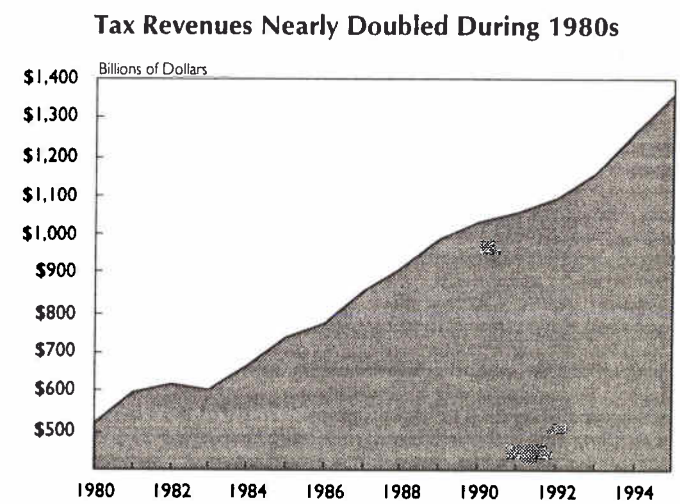
10 Jack Kemp, *An American Renaissance: A Strategy for the 1980s* (New York: Harper and Row, 1979).

1) Lower tax rates do not mean less tax revenue.

The tax cuts of the 1920s: Personal income tax revenues increased substantially during the 1920s, despite the reduction in rates. Revenues rose from $719 million in 1921 to $1164 million in 1928, an increase of more than 61 percent (this was a period of virtually no inflation).

The Kennedy tax cuts: Tax revenues climbed from $94 billion in 1961 to $153 billion in 1968, an increase of 62 percent (33 percent after adjusting for inflation).

Chart 10



Source: *Budget of the U.S. Government, FY 1997,* Office of Management and Budget.

The Reagan tax cuts: Total tax revenues climbed by 99.4 percent during the 1980s, and the results are even more impressive when looking at what happened to personal income tax revenues. Once the economy received an unambiguous tax cut in January 1983, income tax revenues climbed dramatically, increasing by more than 54 percent by 1989 (28 percent after adjusting for inflation).

2) The rich pay more when incentives to hide income are reduced.

The tax cuts of the 1920s: The share of the tax burden paid by the rich rose dramatically as tax rates were reduced. The share of the tax burden borne by the rich (those making $50,000 and up in those days) climbed from 44.2 percent in 1921 to 78.4 percent in 1928.[11]

The Kennedy tax cuts: Just as happened in the 1920s, the share of the income tax burden borne by the rich increased following the tax cuts. Tax collections from those making over $50,000 per year climbed by 57 percent between 1963 and 1966, while tax collections from those earning below $50,000 rose 11 percent. As a result, the rich saw their portion of the income tax burden climb from 11.6 percent to 15.1 percent.[12]

11 Joint Economic Committee, "The Mellon and Kennedy Tax Cuts."

12 *Ibid.*

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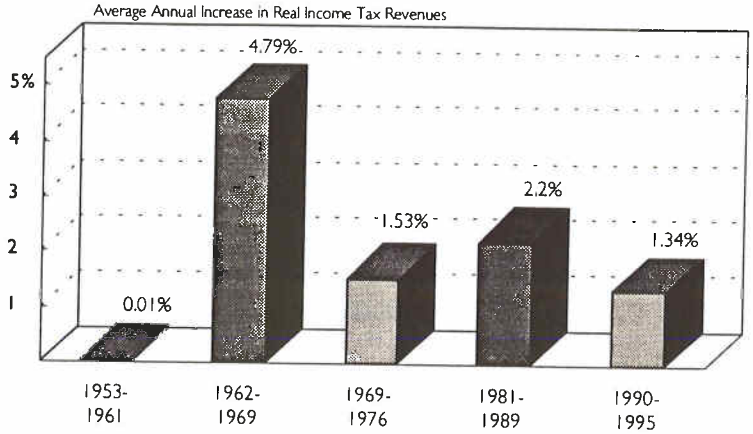
THE 1990S: IGNORING THE LESSONS OF THE PAST

Unlike reductions in tax rates, increases in tax rates have a history of failure. The Hoover and Roosevelt tax increases of the 1930s certainly contributed to the dismal economy during the Great Depression. Tax revenues fell during much of the period, and the deficit increased. And as Chart 11 shows, the high tax rates of the 1950s resulted in sluggish revenue growth. Ignoring history, both Democrats and Republicans at the time argued that tax rates reaching over 90 percent could not be cut for fear of revenue loss. Moreover, the 1970s, which began with the Johnson surtax and later were hit by bracket creep, triggered the tax revolt and the Reagan tax cuts.

Chart 11

Lower Tax Rates Work: Revenues Grew Faster Under Kennedy and Reagan



Source: *Budget of the U.S. Government, FY 1997,* Office of Management and Budget.

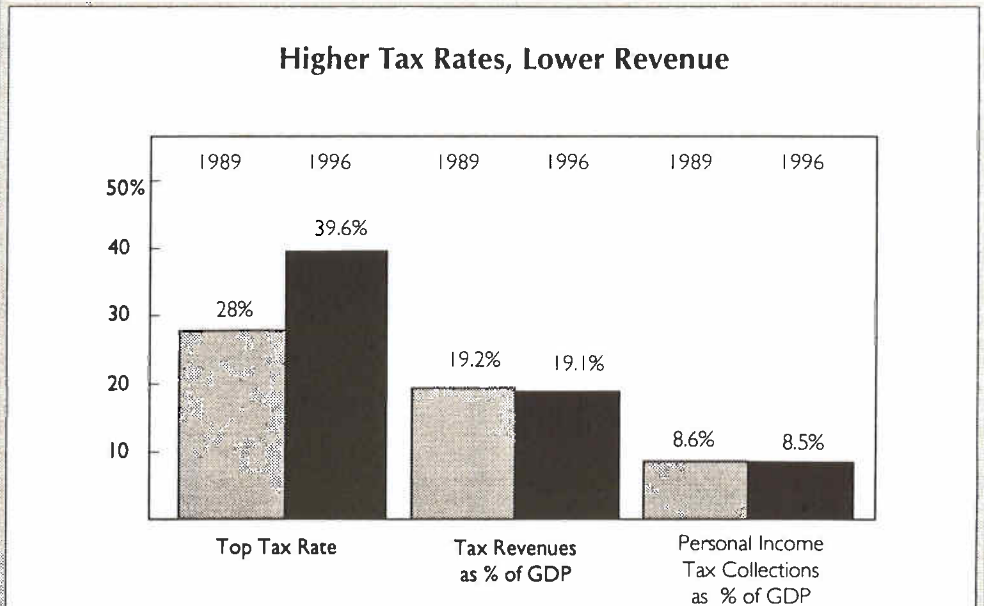
Bracket Creep — The Inflation Tax Did Raise Revenue

As Chart 11 shows, revenues do not grow quickly when tax rates are high. The one exception to this pattern occurred during the late 1970s when inflation pushed taxpayers into higher and higher tax brackets (there were more than 20 separate tax rates at the time). Ironically, the victims of bracket creep—the ones who paid the additional tax — were lower- and middle-income taxpayers. The rich already were in the high bracket and thus were not affected. Moreover, since those with lower earnings receive more than 80 percent of their income from wages and salaries, it was very difficult—at least in the short run — for them to make behavioral changes to escape the higher taxes. Rich taxpayers, on the other hand, receive the bulk of their earnings in the form of dividends, interest, capital gains, and business income. The timing and composition of these earnings can easily be altered to protect the taxpayer from confiscatory tax rates (which helps explain why higher tax rates aimed at the rich almost always fail to generate additional tax revenue). So politicians seeking higher revenues can claim some historical evidence on their side–but only if they are willing to take more money from the poor and middle class through the hidden tax of inflation.

13 Joint Economic Committee, *Annual Report, 1992*.

Perhaps more than any other decade, however, the 1990s make the best argument against higher tax rates. In both 1990 and 1993, the economy was subjected to record tax increases, the ostensible purpose of which was to raise revenue to reduce the budget deficit. As Chart 12 illustrates, however, these increases backfired. Total tax revenue, as a percent of economic output, is expected to be lower this year than it was when Reagan left office.[14]

Chart 12



Source: Bureau of the Census, Department of Commerce.

Significantly, the modest decline in revenues relative to gross domestic product (GDP) is due to the slower growth in personal income tax revenues. As shown in Chart 12, individual income tax revenues totaled 8.6 percent of economic output in 1989. By 1996—two large tax increases later—individual income tax revenues had fallen to 8.5 percent of economic output. In other words, the tax that was increased the most accounts for the drop in tax revenue as a share of national output.

High tax rates are bad for the economy. High tax rates that increase the deficit by reducing the growth of tax revenue are even worse. What makes recent history especially tragic is that the economic and budgetary losses could have been avoided if Bush and Clinton had simply kept Reagan's policies in place. In 1989, the Congressional Budget Office projected that the budget deficit, which then was $152 billion, would continue to fall for the next five years assuming no change in Reagan's policies. As of 1995—again, two large tax increases later—the budget deficit had risen to $164 billion, and it is projected by the CBO to reach more than $400 billion by 2006 if Clinton's policies are left in place.

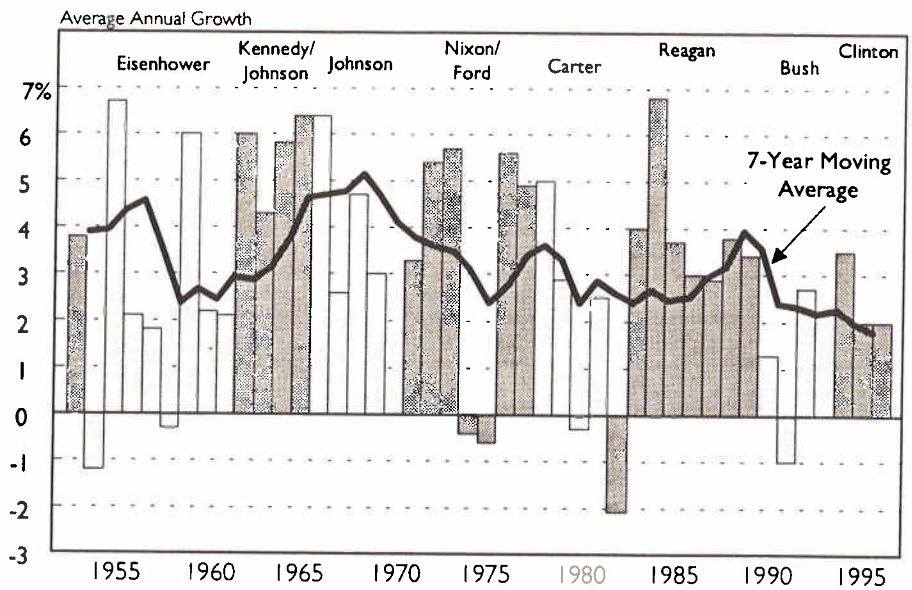
The dismal budget numbers, however, tell only part of the story. The economy has been the real victim of higher tax rates. As Chart 13 shows, the post-Reagan era has seen the slowest growth of any seven-year period since the end of World War II. As discussed earlier, this slow growth has left people with more than $2,000 less income when infla-

14 This is a particularly stunning statistic, since collections normally rise as a percentage of GDP over time in a system with graduated rates.

tion is taken into account. The biggest losers have been the poor. As Chart 14 illustrates, income for the bottom 20 percent has fallen the most during the Bush/Clinton era. The politicians who imposed the higher taxes, needless to say, argued that the rich would be the ones to suffer.

Chart 13

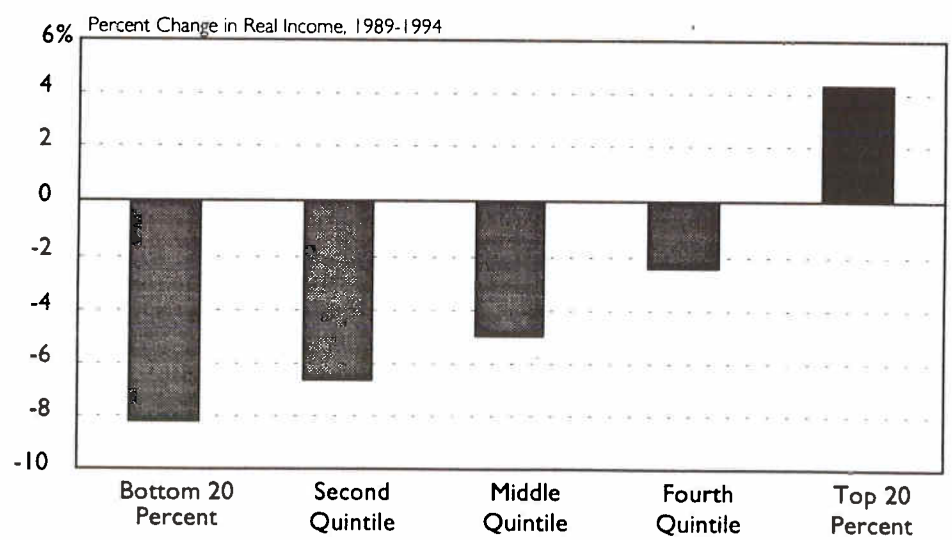
1.81 Percent Average Annual Growth Since Reagan Left Office is Worst Seven-Year Economic Performance Since End of World War II



Source: *Economic Report of the President*, Council of Economic Advisers, February 1996.

Chart 14

Lower and Middle Income Families Suffer Most During High Tax, Post-Reagan Era



Source: Bureau of the Census, Department of Commerce.

CONCLUSION

The economy is limping, incomes have been falling, tax revenues are stagnant, and it is projected that the deficit will more than double in the next ten years. This is the legacy of higher tax rates and a tax code that punishes working, saving, and investing. History shows clearly that the way to reverse this trend is to cut tax rates. Legislation to reduce rates would do this. Better still, Congress should scrap the current system as quickly as possible and replace it with a flat tax that treats all taxpayers equally and minimizes the burden on productive behavior.