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TIME FOR LOWER INCOME TAX RATES: THE HISTORICAL CASE FOR SUPPLY-SIDE ECONOMICS

DANIEL J. MITCHELL

By every possible measure, the tax burden on Americans today is excessive and tax rates are too high. As the following statistics indicate, the time has come for across-the-board reductions in tax rates:

- Federal tax revenues this year are projected to consume 20.5 percent of the economy's output. This is the highest peacetime level of taxation the United States ever has experienced, exceeded only in 1944 at the height of World War II.
- The federal government is expected to collect $1.722 trillion from taxes this year, more than $13,500 for every worker in the country. This is nearly 50 percent more than the government took in as recently as 1993 and more than twice the level collected in 1987.
- According to the Tax Foundation, taxes at all levels now consume nearly 38 percent of the average dual-income family's income. Medieval serfs, by contrast, had to give the lord of the manor only one-third of their output.
- Indeed, this typical family will pay more than $22,500 in taxes to all levels of government. This is more than the family will spend on food, clothing, shelter, and transportation combined.

LOOKING AT HISTORY'S LESSONS

There is a distinct pattern throughout U.S. history: 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. This evidence demonstrates that:

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

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The tax cuts of the 1920s: Revenues from personal income taxes increased substantially during the 1920s despite a reduction in rates. Revenues rose from $719 million in 1921 to $1.164 billion in 1928, an increase of more than 61 percent (this was a period of virtually no inflation).

The Kennedy tax cuts (1960s): Tax revenues climbed from $94 billion in 1961 to $153 billion in 1968, an increase of 62 percent (33 percent after adjusting for inflation).

The Reagan tax cuts (1980s): Total tax revenues climbed by 99.4 percent during the 1980s, but 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—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 fell. 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.

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 earning more than $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.

The Reagan tax cuts: 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 its share of the income tax bill climb even more dramatically, from 17.6 percent in 1981 to 27.5 percent in 1988.

CLASS WARFARE MYTHS

A major argument against pro-growth tax policies is that the "rich" benefit at the expense of the poor. But consider the following:

Fact #1: According to data from the Internal Revenue Service, the top 1 percent of income earners pays more than 30 percent of the total income tax burden; the top 10 percent pay more than 60 percent; and the top 25 percent pay more than 80 percent. The bottom 50 percent of income earners, on the other hand, pay less than 5 percent of the total income tax burden.

Fact #2: President John F. Kennedy was right: A rising tide does lift all boats. Census Bureau data show that earnings for all income classes tend to rise and fall in unison. In other words, economic policy either generates positive results, in which case all income classes benefit, or causes stagnation and decline, in which case all groups suffer. The high-tax policies of the late 1970s and early 1990s are associated with weak economic performance, while the low tax rates of the 1980s are correlated with rising incomes for all quintiles.

Fact #3: President Bill Clinton's own Council of Economic Advisers reported in 1997 that "studies indicate a reasonably high degree of [income] mobility over time" and that "almost two thirds of households change income quintiles over 10 years." A Treasury Department study of those filing tax returns finds that, over a 10-year period, the poorest 20 percent were more likely to have climbed to the top 20 percent of taxpayers than to have remained in the bottom 20 percent.

High tax rates and a tax code that punishes working, saving, and investing do not comprise a recipe for long-term prosperity. History shows clearly that lower tax rates are an integral part of a reform package to maximize freedom and prosperity. A flat tax is the best way to ensure that all income is taxed at a single, low rate. The movement to implement across-the-board tax rate reductions also is a positive step in this direction.

—Daniel J. Mitchell is McKenna Senior Fellow in Political Economy for The Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

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TIME FOR LOWER INCOME TAX RATES: THE HISTORICAL CASE FOR SUPPLY-SIDE ECONOMICS

DANIEL J. MITCHELL

Proposals to lower income tax rates are receiving a great deal of attention from policymakers. These plans range from across-the-board reductions in rates to fundamental reforms like a flat tax that seek to address other problems in the tax code as well. The reasons for seeking lower rates are varied. Some legislators believe lower rates will ensure continued economic growth. Others see them as the fairest way of dealing with projected budget surpluses. Regardless of how or why, lower tax rates are a sound idea.

High tax rates diminish individual freedom and reduce the economy's long-term performance. And even though tax rates in the United States are significantly lower than they were 20 years ago, tax increases in 1990 and 1993 have set back some of the economic progress made in the 1980s. Combined with the fact that a growing number of Americans are being pushed into higher tax brackets by real income growth, this means the ladder of upward mobility is becoming more difficult to climb.

It should come as no surprise, therefore, that Americans are paying a record share of their income to the federal government. According to President Bill Clinton's recently released budget, federal tax revenues are consuming more than one-fifth of U.S. economic output this year, a peacetime record. Perhaps most shocking, tax revenues have doubled since 1987.

Lowering the rates of taxation is the fairest way to reduce this record tax burden. Rate reductions are desirable not only because all taxpayers get to keep more of their money, but also because lower rates will increase incentives to work, save, invest, and take risks. Ideally, lawmakers should scrap the entire tax code and replace it with a simple and fair flat tax. A flat tax would tax all income, but only one time and at one low rate. To the extent that a flat tax is not immediately achievable, across-the-board rate reductions offer the most economic promise.

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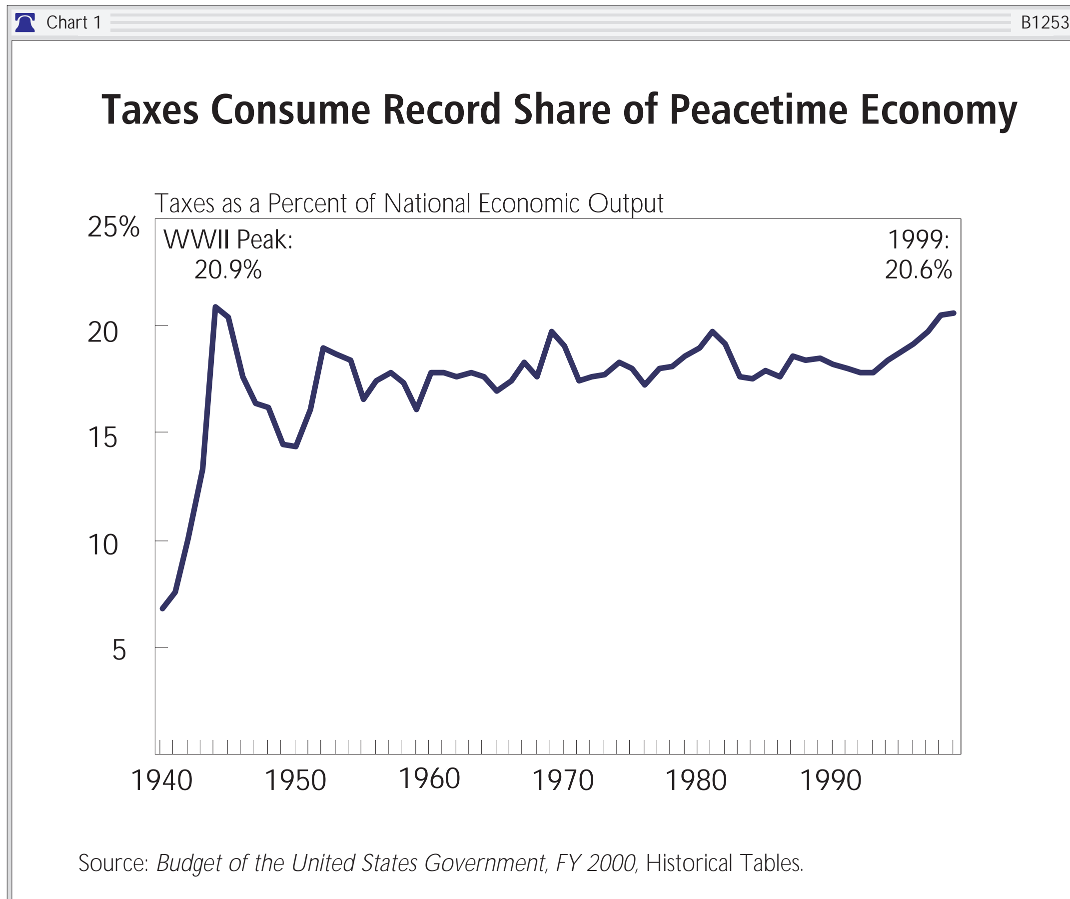
History demonstrates that lower tax rates are good for the economy. Tax rate reductions in the 1920s, 1960s, and 1980s all resulted in faster



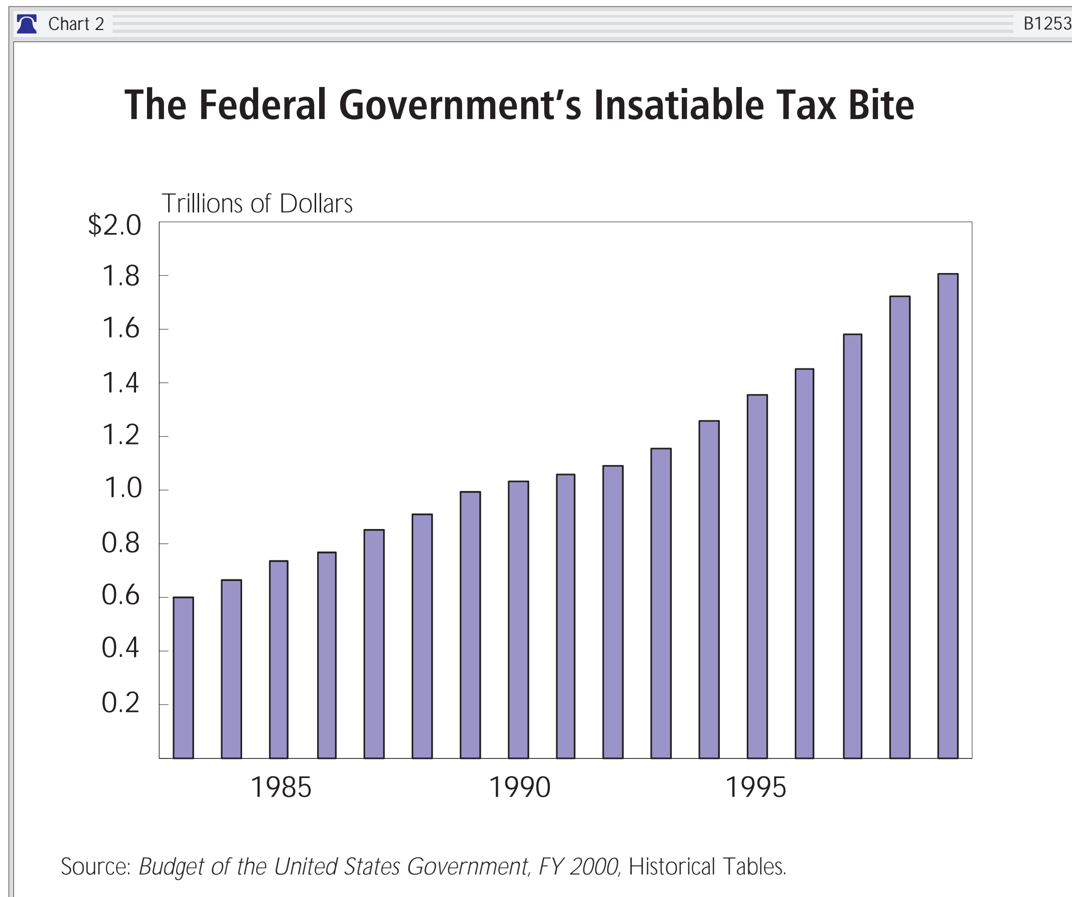
growth, rising incomes, and more job creation. And even though critics complained that these tax rate reductions would allow the "rich" to keep too much of their money, the rich actually wound up paying a greater share of the tax burden in all three decades. The reason: Lower tax rates reduced incentives to hide, shelter, and under-report income.

TAX RATES ARE TOO HIGH

A fundamental precept of all economic theories is that higher prices will reduce the amount of a product that is purchased. Taxes are the "price" that people pay for engaging in productive behavior. When marginal tax rates rise (the marginal tax rate is the amount of each additional dollar of income that government takes), the price of working, saving, investing, and taking risks rises as well. This means some people will forgo additional income; they will choose not to work overtime; they will decide not to take a second job; they will consume their income instead of saving and investing; and they will decide that some risks are not worth taking when the government seizes so much of the reward.

By every possible measure, the tax burden in the United States is excessive and tax rates are too high. As the following statistics indicate, the time has come for across-the-board reductions in the rate of taxation.

- Federal tax revenues this year are projected to consume 20.5 percent of U.S. economic output. This is the highest level of peacetime taxation the United States ever has experienced, exceeded only in 1944 at the height of World War II (see Chart 1).[1]
- The federal government is expected to collect $1.722 trillion from taxes this year, more than $13,500 for every worker in the country. This is nearly 50 percent more than it took in as



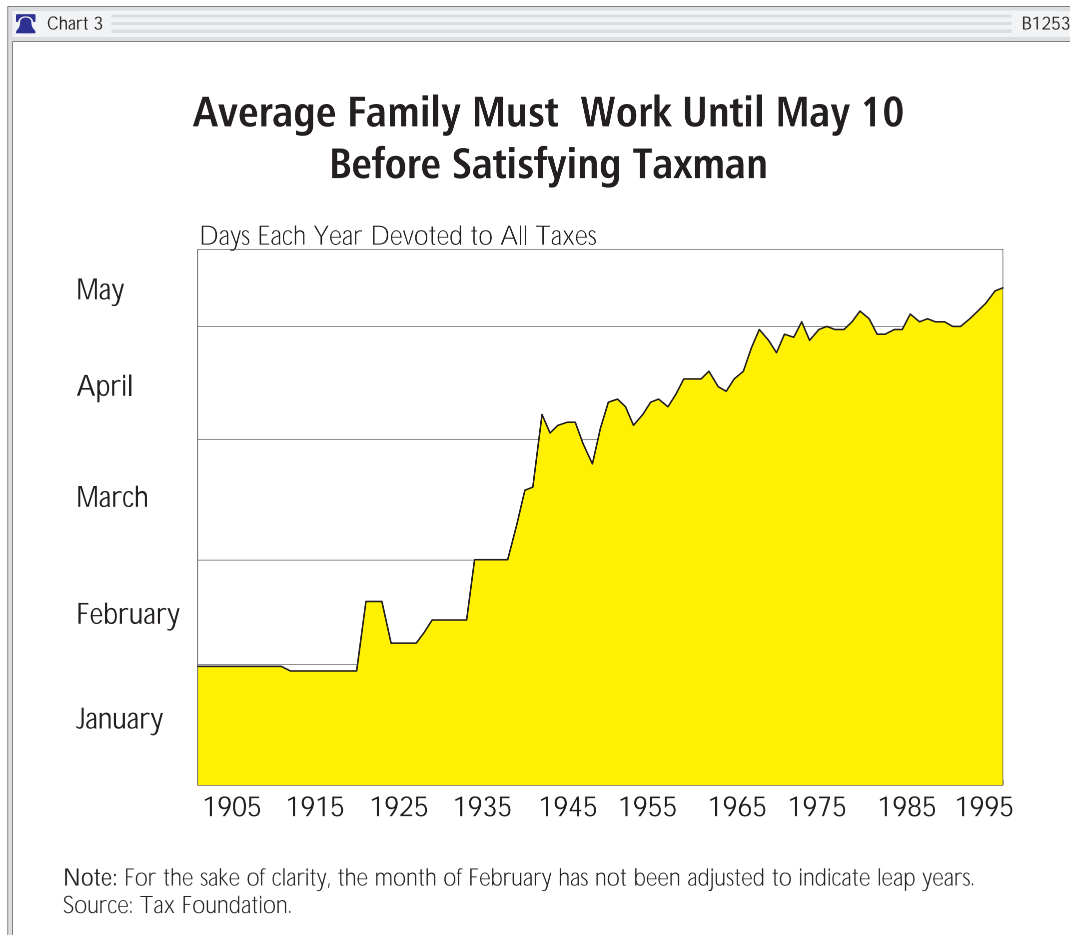
recently as 1993 and more than twice the level collected in 1987 (see Chart 2).[2]

- According to the Tax Foundation, taxes at all levels now consume nearly 38 percent of the average dual-income family's income. Medieval serfs, by contrast, had to give the lord of the manor only one-third of their output.[3]
- Indeed, this typical family will pay more than $22,500 in taxes to all levels of government, and will have to work until May 10 to meet its tax bill (see Chart 3). This is more than the family will spend on food, clothing, shelter, and transportation combined.[4]

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 squandering the surplus.

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 the ways in which the economy performed during these periods, and by examining what happened to the deficit and the degree to which different

1. Office of Management and Budget, *Budget of the United States Government, FY 2000,* Historical Tables (Washington, DC: U.S. Government Printing Office, 1999).
2. *Ibid.*
3. *http://www.taxfoundation.org/prtaxclaims.html*
4. *Ibid.*



income classes were affected, it is possible to gain useful evidence about the desirability of tax rate reductions today.

LOOKING AT CASE HISTORIES

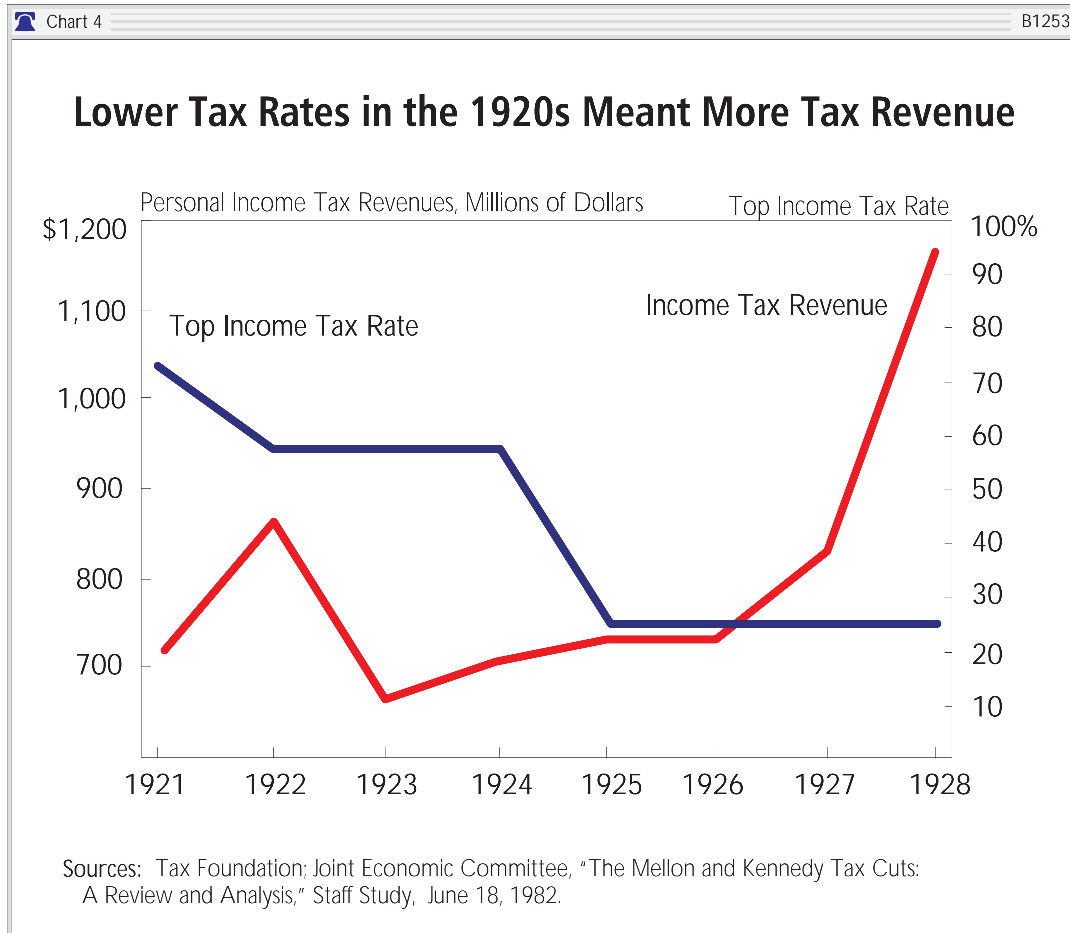
The effect of tax rates on economic activity should not be overstated. The economy, after all, can be affected significantly by trade policy, regulatory policy, and monetary policy, as well as by many other government actions. Even within the context of fiscal policy, tax rates are not the only critical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

Keeping all these caveats in mind, there nevertheless is a distinct pattern throughout U.S. 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 Secretary of the Treasury 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.

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.

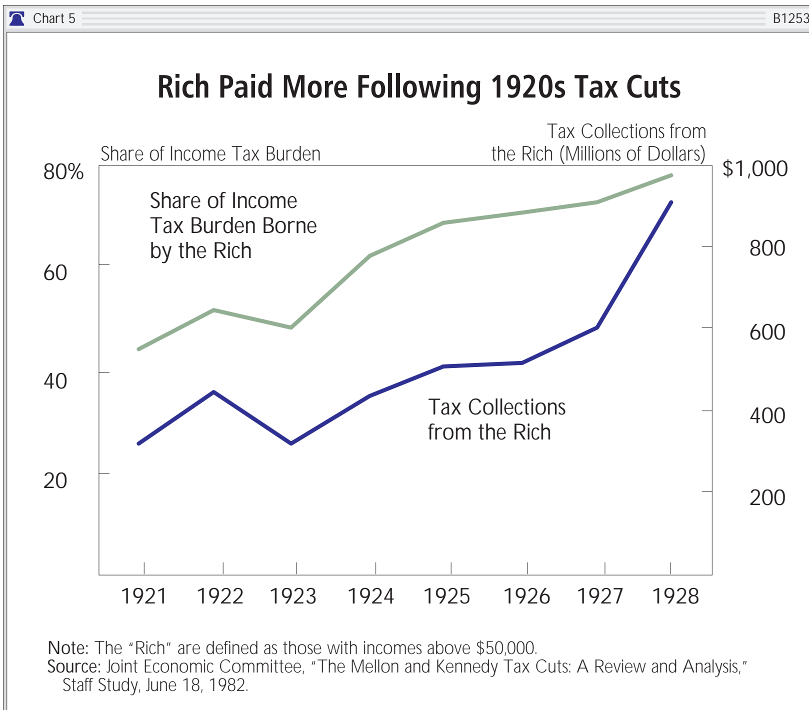
Notwithstanding (or perhaps because of) the dramatic reduction in tax rates, personal income tax revenues increased substantially during the 1920s, rising from $719 million in 1921 to $1.16 billion in 1928. As Chart 4 shows, the increase was more than 61 percent (this was a period of no inflation).[5]

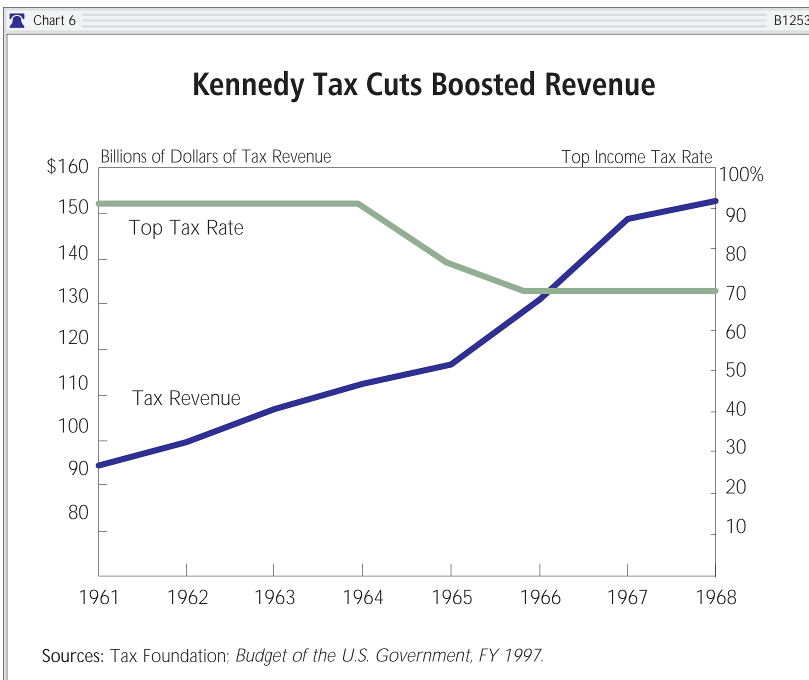
The share of the tax burden borne by the rich rose dramatically. As seen in Chart 5, taxes paid by the rich (those making $50,000 and up in those days) climbed from 44.2 percent of the total tax burden in 1921 to 78.4 percent in 1928.

This surge in revenue came as no surprise to Secretary 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.[6]

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





The 1960s

President John F. Kennedy proposed a series of tax rate reductions in 1963 that resulted in legislation the following year that dropped the top rate from 91 percent in 1963 to 70 percent by 1965.[7]

The Kennedy tax cuts helped to trigger the longest economic expansion in the history of the United States. 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.

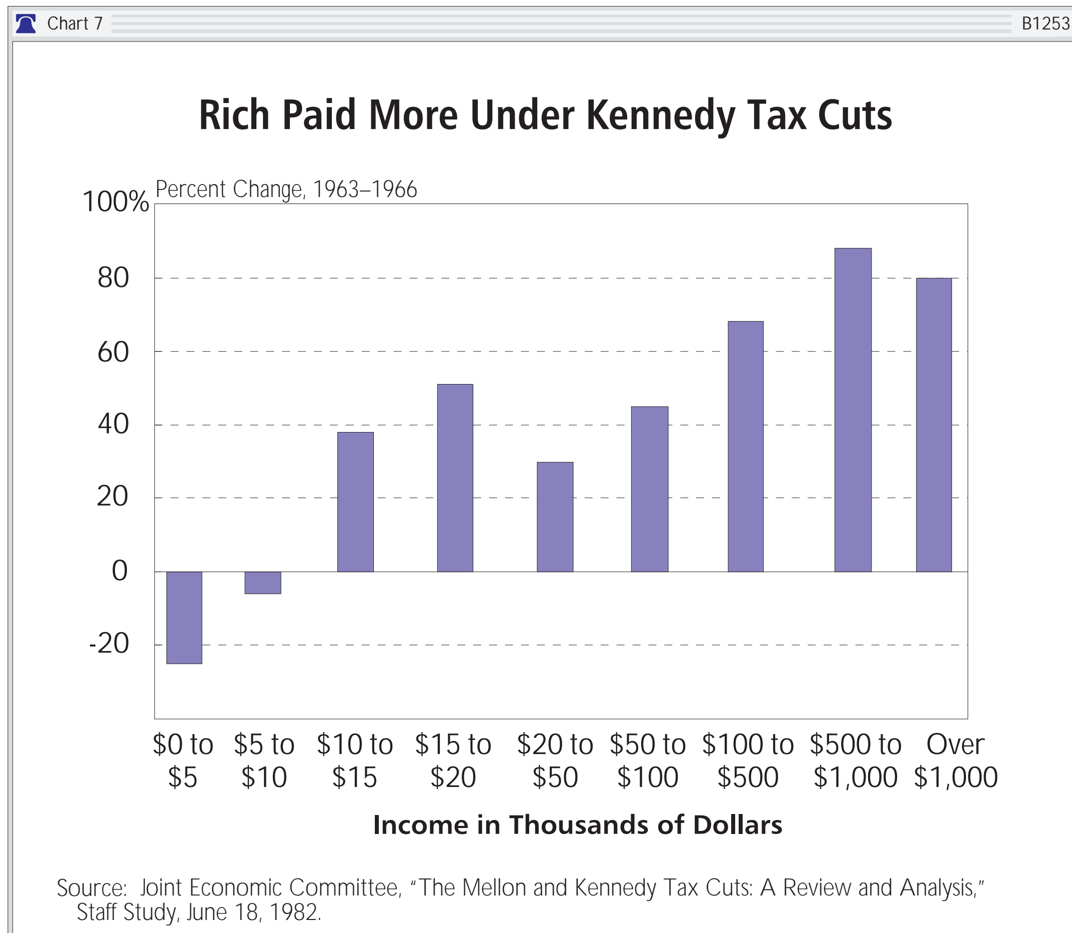
Tax revenues grew strongly, rising by 62 percent between 1961 and 1968. Adjusted for inflation, they rose by one-third (see Chart 6).

Just as in the 1920s, the share of the income tax burden borne by the rich increased. As Chart 7 shows, 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.[8]

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

6. Andrew Mellon, *Taxation: The People's Business* (New York, NY: Macmillan, 1924).
7. The Kennedy boom also was helped along by reductions, occurring in 1962, in the tax burden on investment and capital gains.
8. Joint Economic Committee, "The Mellon and Kennedy Tax Cuts: A Review and Analysis," June 18, 1982.



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.[9]

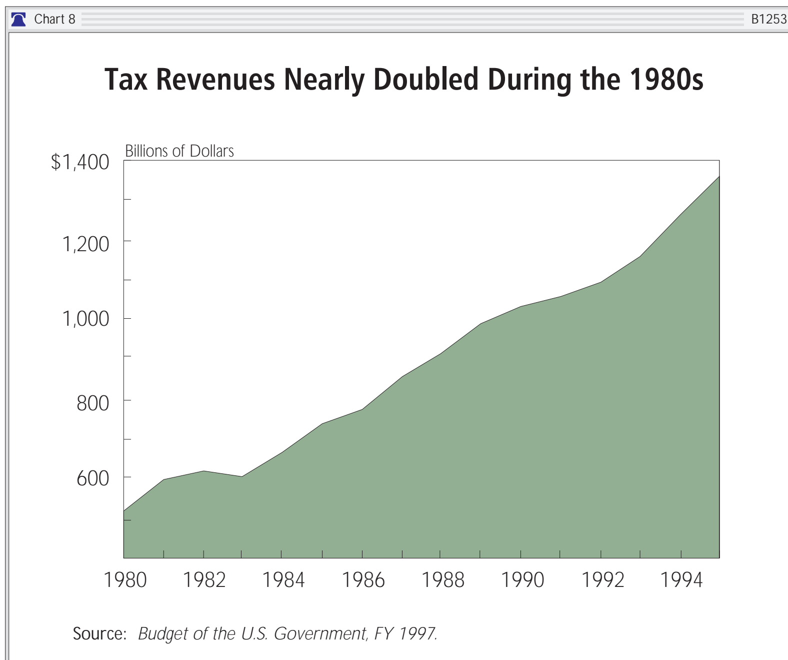
The 1980s

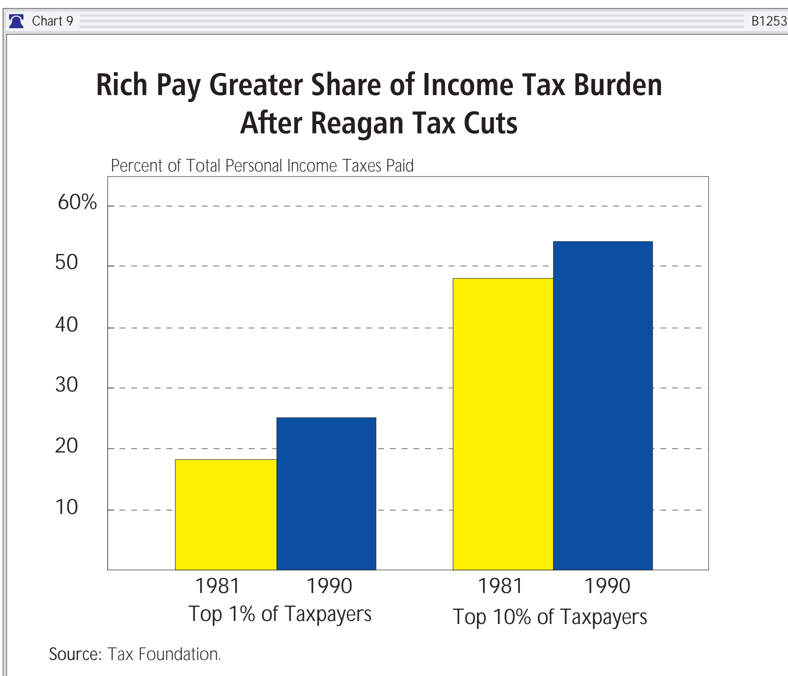
President Ronald Reagan presided over two major pieces of tax legislation that, together, reduced the top tax rate from 70 percent in 1980 to 28 percent by 1988.

The economic effects of the Reagan tax cuts were dramatic. When President 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 to pull the economy out of its doldrums and ushered in a period of record peacetime economic growth. 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

9. John F. Kennedy, speech to Economic Club of New York, December 14, 1962.





Reagan tax cut, although 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 that went into effect in 1982. The economy received an unambiguous tax cut only as of January 1983. As Chart 8 shows, revenues then climbed dramatically. Personal income tax revenues led the way, 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 its share of the income tax bill climb even more dramatically, from 17.6 percent in 1981 to 27.5 percent in 1988 (see Chart 9).[10]

One of the chief architects of the Reagan tax cuts was then U.S. Representative Jack Kemp (R–NY). According to Representative 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.[11]

THE LESSONS

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 $1.164

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

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

billion 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).

The Reagan tax cuts: Total tax revenues climbed by 99.4 percent during the 1980s. The results are even more impressive, however, when looking at what happened to personal income tax revenues. Once the economy received an unambiguous tax cut in January 1983, personal 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 fell. 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.[12]

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 earning more than $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.[13]

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CLASS WARFARE: MYTH AND REALITY

A major argument against pro-growth tax policies is that the "rich" will benefit disproportionately. This argument is used against across-the-board reductions in the tax rate; it is used against capital gains tax relief; and it is thrown up against fundamental reforms like a flat tax. No matter the policy, opponents charge that the result will be to make the tax code less fair.

A key element of this debate is the question of what constitutes fairness. Advocates of tax reduction and reform generally believe that fairness means treating all taxpayers equally before the law. As such, a wealthy person who makes 100 times more than another person should pay 100 times more in taxes. Others believe in equality of results rather than equality of opportunity. With this perspective, they want government to impose increasingly punitive tax rates on higher-income taxpayers to facilitate income redistribution.

Yet battles over tax policy involve more than the subjective meaning of fairness. Often, opponents of pro-growth tax policy make assertions that are at odds with easily verifiable numbers. Class warfare advocates frequently rely on the following three myths:

1. **Myth:** The rich don't pay their fair share.

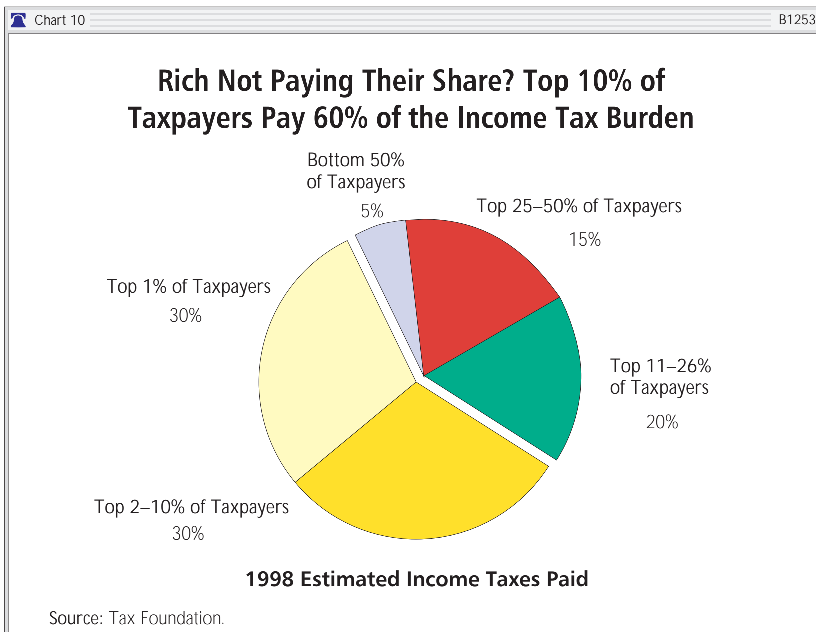
   Reality: According to data from the Internal Revenue Service,[15] the top 1 percent of earners pays more than 30 percent of the income tax burden; the top 10 percent pay more than 60 percent; and the top 25 percent pay more than 80 percent. The bottom 50 percent of income earners, on the other hand, pay less than 5 percent of income taxes (see Chart 10).

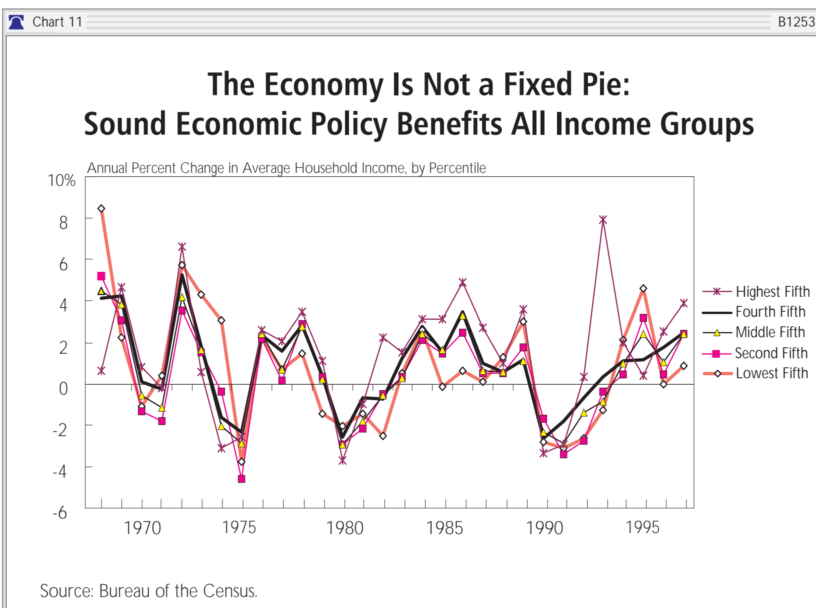
12. Joint Economic Committee, "The Mellon and Kennedy Tax Cuts."

13. *Ibid.*

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

15. *http://www.taxfoundation.org/prtopincomechart1.html*





2. **Myth:** Lower tax rates mean the rich get richer and the poor get poorer.

Reality: President Kennedy was right: A rising tide does lift all boats. Data from the Bureau of the Census show that earnings for all income classes tend to rise and fall in unison. In other words, economic policy either generates positive results, in which case all income classes benefit, or causes stagnation and decline, in which case all groups suffer. As Chart 11 illustrates, the high tax policies of the late 1970s and early 1990s are associated with weak economic performance, while the low tax rates of the 1980s are correlated with rising incomes for all quintiles.

3. **Myth:** The United States no longer is the land of opportunity. Those who work hard and play by the rules cannot climb the economic ladder.

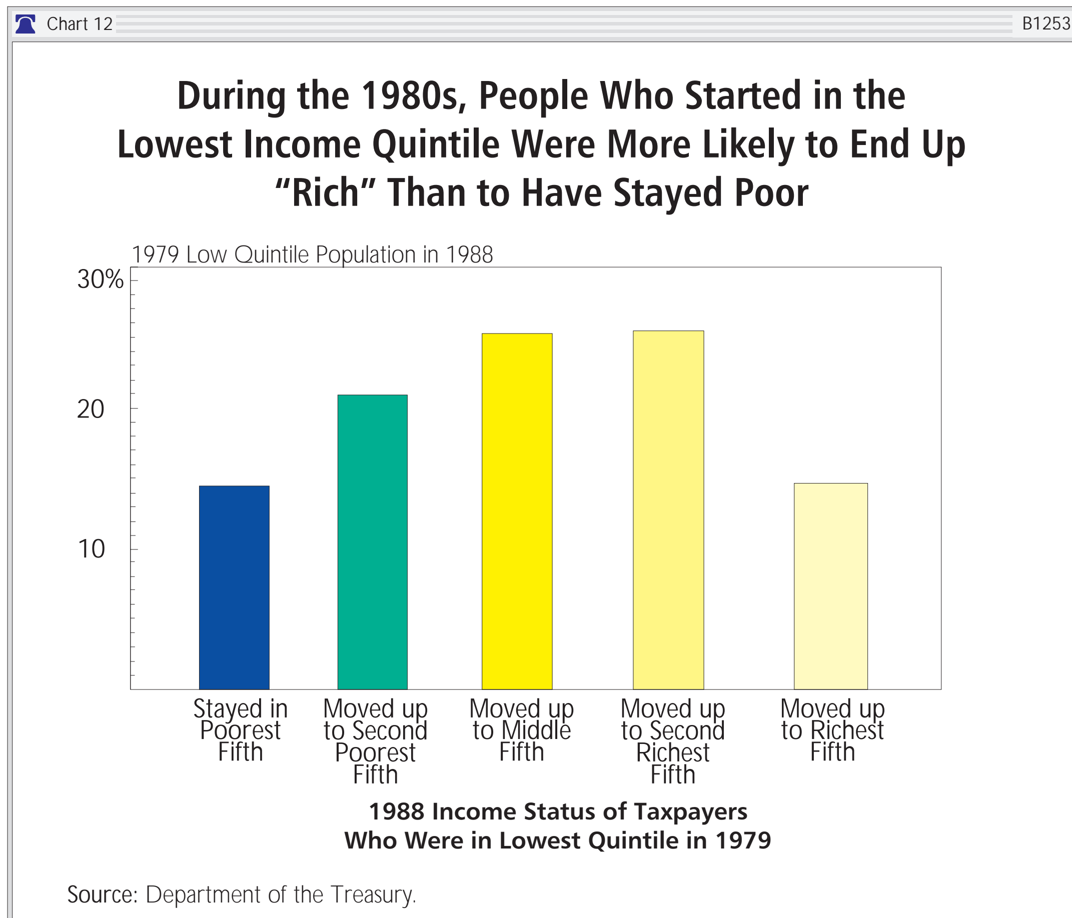
Reality: President Clinton's own Council of Economic Advisers reports that "studies indicate a reasonably high degree of [income] mobility over time" and that "almost two thirds of households change income quintiles over 10 years."[16] A study by the Department of the Treasury of those filing tax returns finds that, over a 10-year period, the poorest 20 percent were more likely to have climbed to the top 20 percent of taxpayers than to have remained in the bottom 20 percent (see Chart 12).[17]

CONCLUSION

High rates of taxation and a tax code that punishes working, saving, and investing do not comprise a recipe for long-term prosperity. History shows clearly that lower tax rates are an integral part of a reform package to maximize freedom and prosperity. A flat tax is the best way to ensure that all income is taxed at a single, low rate. The

16. *Economic Report of the President* (Washington, DC: U.S. Government Printing Office, February 1997).

17. Joint Economic Committee, "Income Mobility and Economic Opportunity," Staff Study, June 1992, available on the Internet at *http://www.house.gov/jec/middle/mobility/mobility.htm.*



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