

LAFFER ASSOCIATES

 Supply-Side Investment Research

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**January xx, 2003**

January xx, 2002xx

10-yr T-Note: 2.18% DJIA: 17,924.06 NASDAQ: 4,945.54 S&P 500: 2,088.00 S&P 500 Undervalued: 131.4%

###### THROUGH THE LAFFER LENS: REVISITING THE REAGAN TAX CUTS

*By Arthur B. Laffer*

*Jimmy Pethokoukis, a columnist and blogger at the American Enterprise Institute, recently appeared on my friend Bill Bennett’s radio show. Based on his comments on Bill’s show, Jimmy wrote an article entitled “The right needs to get real on Reaganomics,”[[1]](#footnote-1) claiming that the Reagan tax cuts didn’t pay for themselves. Bill Bennett asked for my take on the issue, and here is my response:*

Jimmy “P” is correct that “federal income taxes” as a percentage of GDP went from 9.1% in 1981 to 8.0% in 1989. And what does this prove for Jimmy “P”?—“Reagan tax cuts didn’t pay for themselves.” Q.E.D.

Let’s imagine we cut all income tax rates across the board to a true flat rate tax such that the static average tax rate drops from 9.1% of GDP starting in 1981 to 8.0% of GDP, and, as a result of this tax rate cut, GDP doubles. While the tax cut was designed to be static revenue neutral (i.e. given no change in the size of the economy, total tax receipts would be the same), the size of the economy grew dramatically, causing taxes as a share of GDP to fall as the denominator grew faster than the numerator. In others words, even though GDP doubled and tax revenues went up by 75%—both because of the tax cut—tax revenues as a percent of GDP fell to 8.0% from 9.1%. So much for Jimmy “P”’s proof.

What else happened? Income tax revenues from the top 1% of income earners rose like mad as a share of GDP. In 1981, the top 1% of income tax filers paid total income taxes equal to 1.5% of GDP. In 1989, the top 1% paid a full 2% of GDP in income taxes. From 1981 to 1989, the highest marginal income tax rate, which is the rate paid by the highest income earners, fell from 70% to 28%.

Think about it. The highest income tax rate paid by the top 1% of income earners fell by 60% (from 70% to 28%), and yet the top 1% of income earners paid 33% more in income taxes as a share of GDP. And yet Jimmy “P” writes disparagingly, “Republicans sometimes misuse Reaganomics to justify fantastical tax plans that promise deep rate cuts for the rich.” Just what does Jimmy “P” mean?

Now let’s go on from here. From 1981 to 1989 (the years Jimmy “P” uses), employment as a share of adult population rose by 4 percentage points, which, in human terms, is an additional 7.4 million people employed above and beyond the number of people who would have been employed if employment as a share of population had remained at the 1981 level. These people got their jobs because employers and job creators found hiring them more attractive because of the tax cuts.

Now let’s see what this additional employment would do to payroll and income taxes. For payroll taxes alone, the higher employment would add $14 billion in taxes annually. For income taxes, there would be an equally as large number. These are huge increases in taxes because of the income tax cuts, but they don’t change taxes as a percentage of GDP because both tax revenues and GDP rise, yet they are real, real, real even if there isn’t a change in the percentage.

And then, of course, we’d have to add in increased tax revenues from sales taxes, excise taxes and state and local taxes resulting from so many more people working, spending and earning higher incomes. Let’s not forget that there was a lot more spending from the highest income earners as well. State and local tax revenue increases were huge during this period because tax rates changed little but GDP soared (Figure 1).

Figure 1

**State & Local Government Total Receipts**

(annual, 1978 to 1990, NIPA-basis, $ billions, deflated with GDP deflator to 1981 dollars)



And then, of course, we get the reduction in welfare subsidies, social security outlays and unemployment benefits, yada, yada, yada, all due to the tax cuts. These too aren’t anywhere to be found in Jimmy “P”’s numbers, but they are in reductions in government spending and increases in government tax revenues nonetheless, just not in income taxes alone. Well, I hope you get the idea. Jimmy “P” unfortunately weaves the tapestry of the big fabrication with threads of partial truths.

Jimmy “P” also writes, “What’s more, the Reagan tax cuts didn’t spur some crazy period of light-speed growth,” alluding to growth rates in the ‘80s being only one tenth of one percent higher than growth rates in the previous decade. Jimmy’s numbers may be correct for his chosen period, but he’s not looking at the correct period! Reagan, no matter how well-intentioned, made the mistake of phasing in his tax cuts. Instead of putting the lower rates into effect right away, he phased them in to take full effect starting on January 1, 1983. It’s amazing how tax cuts don’t work until they take effect!

Specifically, here’s how the phase-in occurred: Supposedly there was a 5% cut in income tax rates on October 1, 1981, 10% on July 1, 1982 and 10% on July 1, 1983. The real tax bracket extensions weren’t quite 25% because the extensions were based on the prior year’s number. Therefore, a 5% cut in October of 1981 was on the original tax rates whereas the 10% cut in July of 1982 was on the brackets after the 5% cut, i.e. 9.5% on the original tax brackets and the 10% cut in July of 1983 was on the 1982 brackets (8.55% on the original tax bracket), or a cumulative total cut of 23.05%—not 25%.

But in addition to the tax cuts being smaller than advertised, there is also no such thing as a mid-year tax cut. As every income tax filer knows, income is reported for a whole year without reference to which month that income was earned. All income, regardless of month earned, is taxed on the same tax table. For 1981, for example, withholding was changed on October 1, 1981, but instead of being a 5% cut for the final three months of 1981 the cut was prorated over the whole year of 1981 at 1.25% (3/12 x 5%). The cut included for 1982 the full 5% left over from 1981 plus half of the 10% cut scheduled for July 1, 1982, adding up to a full 10% cut for income earned in calendar 1982. For 1983—the full calendar year—the cut was 20%: the 5% from 1981, the 10% from 1982 and half the 10% for 1983.

Way back in 1981 in a front-page interview in *Barron’s*,[[2]](#footnote-2) I said:

**Q. Well, are you disappointed, so far, with Reaganomics?**

**A.** I am not surprised about what’s happening with the current Administration. But I’m disappointed, frankly, that Stockman had enough influence to convince the President to postpone the tax cuts.

**Q. Why?**

**A.** Let me answer this way: Suppose you have to go back to school and not earn income in one of the next two years. But you get to choose which year. Which year do you go back? This year, when tax rates are high, or next year, when tax rates are low? Which is the year you choose not to earn your income? That is what we are seeing happen.

Later on in the interview, the interviewer asked again about the timing of the tax cuts:

**Q. You said before, Arthur, that you think the timing of Reagan’s tax cuts is off. Are you satisfied, though, that once the full impact of the program is felt...**

**A.** Once we are in ’83 and ’84, we are going to be in a great economy.

**Q. You sound pretty definite about that.**

**A.** Oh, yeah, there is no question of that in my mind. I couldn’t be more certain of a proposition than I am of that, given the uncertainty of my profession. Everything I look at, the fastest-growing economies in the world—from the Ivory Coast to Hong Kong to whatever—all have low tax rates. High taxes reduce the incentive to profit, and you just don’t ex­pand really rapidly through government. Especially, not through redistribution policies.

The real start of the Reagan Era was 1983, not 1981. It’s just not right to blame Reagan’s tax cuts for all of Carter’s policies still in place in the beginning of Reagan’s term. Look at the charts below and see if you don’t think this is “some crazy period of light-speed growth.”

Figure 2

**Real GDP Growth: Qtr.-on-Qtr. Annualized % Change**

(quarterly, 1Q-1981 to 4Q-1990)

Figure 3

**Employment-to-Population Ratio**

(monthly, seasonally-adjusted, Jan-81 to Dec-90)

These two charts, which are very basic measures available to anyone who actually cares, paint the correct picture, not the one painted by Jimmy “P.” Figure 2 shows quarterly real economic growth rates that rocketed up as soon as the tax cuts went into effect. Average annual real GDP growth for the years 1983 through 1989 was 4.4%. Figure 3 shows the same story with employment, with the employment-to-population ratio cratering as the tax cuts went in effect before beginning a six percentage point climb through 1990. I think these two charts say it all.

Honestly, what do you think the U.S. economy would look like today if, for the whole period of 1980 through 2015, we had kept the highest marginal income tax rate at 70% starting at $108,300 of income, a capital gains tax rate on nominal capital gains at 45% and an income tax that started out at $2,300 with a rate of 14%?

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1. James Pethokoukis, “The right needs to get real on Reaganomics,” American Enterprise Institute’s *AEIdeas* blog, April 29, 2015. <http://www.aei.org/publication/the-right-needs-to-get-real-on-reaganomics/> [↑](#footnote-ref-1)
2. “No Shrinking Supply-Sider: Economist Arthur Laffer Keeps the Faith”, *Barron’s*, December 21, 1981. [↑](#footnote-ref-2)