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Tax cut revenue rewards

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Many in the Washington establishment were shocked Aug. 17, when the Congressional Budget Office reported a surge of "unanticipated tax receipts" that will sharply push down this year's deficit. Those who had been proclaiming the Bush tax rate cuts would result in a big reduction in tax revenues tried to hide their disappointment. It was tough being proved wrong again after having said the same thing when Ronald Reagan cut tax rates in the early 1980s.

We have now had three major experiments with tax rate reduction in the last half-century, and each time both economic growth and tax revenues have surged, despite the fears and cries of the anti-tax-cut crowd. How much more evidence will they need to understand the difference between tax rates and tax revenues? Most everyone, including most members of Congress, can understand that properly structured tax rate reduction, by decreasing the impediments to working, saving and investing, will lead to a higher rate of economic growth. Why then is it so difficult to understand that a bigger economic pie can lead to more tax revenue rather than less?

Tax Cuts	Increase in Tax Revenues	
	Total	Average per Year
Kennedy 1963-67	39.6%	9.9%
Reagan 1981-89	65.4%	8.2%
Bush 2002-06	29.7%	7.4%

The table shows the average annual change in tax revenue from the year before the tax cut to the end of the experiment (or in Mr. Bush's case to the present).

President Kennedy proposed major tax reduction before he was assassinated in 1963. Congress passed and President Johnson signed the tax cuts in the summer of 1964. Rates for all income groups were cut and the top rate was reduced from 91 percent to 70 percent. Economic growth averaged more than 5 percent a year for the three years after the tax cut, with very low inflation. President Johnson and the Democratic Congress raised taxes in 1968, ending the Kennedy experiment.

When Ronald Reagan took office in 1981, the economy was experiencing no growth and high inflation. As part of the solution, Reagan proposed a 30 percent reduction in tax rates. His critics claimed this would increase inflation and lead to economic disaster. Twenty five years ago this month, Congress passed a slightly watered-down version of

the Reagan proposals, which reduced tax rates by about 25 percent over three years, and brought the top rate down to 50 percent.

In retrospect, the entire tax rate reduction should have been made in 1981, rather than dragging it out to 1983, which had the short-run effect of reducing growth by giving people an incentive to delay income realization. However, once enacted, the results were spectacular. Real economic growth averaged more than 4 percent per year, and inflation fell from double digits and averaged roughly 4 percent.

During the Reagan years, several other tax changes were made, both increasing and lowering some rates; but at the end of his term, the maximum marginal rate was only 28 percent. The first President Bush and Congress increased tax rates in 1990, thus ending the Reagan experiment.

The latest major tax rate reductions were enacted in 2003, and the first three-year results are now in. The increase in tax revenues, as in the previous two experiments, has far outstripped inflation, and the economy is close to full employment. The economy was already falling into recession when George W. Bush took office, and he made the mistake then of giving small tax rebates (which had no positive economic effects) rather than cutting marginal tax rates on labor and capital as he did in the bigger tax cut of 2003.

The question is always asked, did the "tax cuts pay for themselves?" If, by "paying for themselves," one means more tax revenue was produced for the government after several years than otherwise would have occurred, we can provide a reasonably certain answer. As noted above, the Kennedy tax cuts led to a very high rate of economic growth and no reduction in tax revenue as a percent of gross domestic product (GDP) over the period (average of 17.6 percent). Therefore, with a very high degree of confidence, we can say the Kennedy rate cuts paid for themselves in three years.

The Reagan tax cut program also led to higher GDP growth than would have been expected; in fact, the U.S. economy grew in real terms by almost one-third during the Reagan years. Tax revenues as a percent of GDP fell slightly from 19.6 percent of GDP at the beginning of his administration to 18.3 percent at the end, but total tax revenues were almost certainly far higher -- actually, the tax cuts probably "paid for themselves" within four years. This is because the tax base was at least 15 percent larger than would have been expected without the rate reduction program.

The Bush tax cuts also appear to be well on their way to "paying for themselves," despite the dire warnings of his critics.

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