Tax Cuts and Revenue: What We Learned in the 1980s

By Richard W. Rahn

There will be no gain in long-term tax revenue from increasing tax rates on those making more than $200,000 per year, despite claims by President Obama's Office of Management and Budget, and the Congressional Joint Committee on Taxation, which studied the administration's tax proposals. The current debate over the expiring Bush tax cuts is a replay of the debate about the Reagan tax-rate reductions of three decades ago. We know the outcome of that debate. Lower tax rates, particularly on labor and capital, lead to higher levels of employment and economic growth.

Those of us who argued in the late 1970s and early 1980s for lower tax rates were often characterized as "radical supply-siders" and criticized for claiming that all tax-rate reductions lead to higher tax revenues. This was untrue; none of the principal advocates of Reagan's 1981 tax cuts made this claim.

The Reagan tax cuts reduced rates for all income classes, even though it was well understood that cutting the lower rates would result in substantial revenue losses. Low tax rates (below 20%) do not cause much of a disincentive for working, saving or investing, and hence there is little supply-side effect. We did argue, however, that reducing the high marginal rates (up to 70% on high-income earners) would cause little, if any, revenue loss, because of the large, positive supply-side effects. Were we right?

Since most of the Reagan tax cuts applied to lower- and middle-income earners, there was close to a dollar lost in tax revenue for each "dollar" of tax cut for these groups. Still, CBO figures show that total tax revenue only fell from 19.2% of gross domestic product (GDP) in 1982, before most of Reagan's tax-rate reductions were put in place, to 18.4% of GDP in 1989, the year he left office. This happened because the U.S. economy grew by more than one-third in real terms (34.3%), much faster than the 24.3% rate expected even by economists within the Reagan administration. Thus, by the time President Reagan left office, the economy was generating more tax revenue at a maximum 28% rate than many on the left forecast it to generate at a maximum 70% rate.

> Supply-siders never argued that all tax cuts pay for themselves. But the evidence is clear that lower rates on high earners do produce more revenue over time.

The Reagan tax-rate reductions did, in fact, pay for themselves—but it took about seven years.

The Obama administration wants to extend the Bush tax cuts only for those making less than $200,000 a year. This will significantly reduce federal revenues. But the rate cuts it does not want to extend would be more likely to increase tax revenues.

The reason is simple: Those who earn more than $200,000 annually are among the ones who create most of the new jobs and fund new investment—the engines of economic growth. Without these jobs and new investment, the economy will be smaller and throw off less tax revenue.

Recently, the liberal blogger Dylan Matthews asked several economists, "What is the revenue maximizing income tax rate?" Estimates ranged from 19% to 70%. The problem with the question was that no time period was specified.

If Congress decides to increase tax rates to 70% next week on this year's income, tax revenues will increase for this year because most people will not be able to respond. People will go to great lengths to avoid paying high tax rates, including reducing work effort and taxable savings and investments, or even finding illegal means to avoid the tax collector. But it takes time for them to do so. A big tax increase on the job-creating and investing class this year will almost certainly kill economic growth and job creation next year, resulting in less tax revenue.

In the 30-year period from 1970 to 2000, the maximum tax rate on individual income ranged from 28% to 70%, yet individual tax revenue as a percentage of GDP ranged from a low of 7.6% (when the maximum rate was 70%) to a high of 9.6%. Total tax revenues ranged from a low of 17.1% of GDP to a high of 19.8% during that same 30 years. Over the long run (seven years or more), individual federal tax rates not exceeding 25% or so would probably maximize federal tax revenues (remember that state and local income tax rates must be added to the federal rate so many people would still face marginal tax rates of well over 30%).

The Obama administration also ignores the fact that many upper-income people obtain significant portions of their income from capital gains and dividends. The capital gains tax is going to increase to 20% from 15% in 2011 and, thanks to ObamaCare, to 23.8% in 2013. The tax on dividends is going to increase to a maximum rate of 39.6% in 2011 and once again, thanks to ObamaCare, to 43.4% by 2013.

These rates are self-defeating. The nonpartisan Institute for Research on the Economics of Taxation, headed by a former senior U.S. Treasury economist, Steve Entin, has recently published studies on the effects of the Obama administration's tax increases on capital gains. Their analyses show that increasing the capital-gains tax rate would result in lower tax revenue and higher deficits. The studies are also congruent with the historical experience of the last 40 years.

The official government tax revenue and economic forecast models are still largely Keynesian static models, rather than dynamic; they do not capture most of the incentive and long-term effects of tax-rate changes. As a result, they give the wrong answers. These models missed the revenue gains from the 1978 and 1997 capital-gains rate cuts. They missed the economic gains from the Reagan-era tax cuts. Most recently, they spectacularly failed in their employment, tax revenue and economic growth forecasts from the Obama "stimulus" program.

The current administration has ignored historical evidence that high tax rates on saving and investment over time erode the growth of productive capital, leading to lower economic growth and job creation. It also has stubbornly relied on outdated Keynesian economic models. Hence it continues in a fantasy that higher tax rates on upper-income earners will generate significant revenue. The job hopes of many are too important to be nailed to the cross of this economic ideology.

Mr. Rahn, a senior fellow at the Cato Institute, was vice president and chief economist of the U.S. Chamber of Commerce during the Reagan administration.