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HOW THE BUSH TAX CUT COMPARES IN SIZE TO THE REAGAN TAX CUTS

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The National Taxpayers Union (NTU) recently released a report arguing that President Bush's proposed tax cut is far smaller than the 1981 Reagan tax cut and other historical tax cuts.[1] Some Administration officials and Members of Congress have echoed these claims and suggested this shows the proposed tax cut is of a responsible size. Careful examination, however, shows the arguments in the NTU paper reflect apples-to-oranges comparisons.

If the cost of the Reagan tax cut is adjusted for the impact of inflation and the subsequent 1982 tax increase (which scaled back the 1981 tax cut), the net tax cut is moderately larger as a share of the economy (2.1 percent of GDP) than the proposed Bush tax cut would be (1.5 percent of GDP), rather than being several times the size of the Bush tax cut as the NTU has claimed. Furthermore, the Reagan tax cut occurred when marginal tax rates were higher than today. A reduction in marginal tax rates is therefore not as significant today as in 1981. Finally, the Reagan tax cut was a major factor in generating large budget deficits, from which the nation took more than decade and a half to recover.

The NTU comparisons are inappropriate for several reasons, as this paper explains. They should not serve as a basis for claiming the Bush tax plan is of a responsible size.

Inflation and the Revenue Baseline

Before 1985, frequent tax cuts were necessary just to prevent large tax increases over time because the tax code was not indexed to inflation. The result was a natural upward "creep" in tax collections over time, as ongoing inflation pushed individuals into higher tax brackets. To see how this worked, assume that the current tax code was not indexed to inflation. If a taxpayer's income merely kept pace with inflation, his or her purchasing power and standard of living would not increase. The taxpayers' tax liability *would* increase, however, because the standard deduction, the personal exemption, and other features of the tax code would not be adjusted for inflation. The taxpayer's tax liability would rise over time for a second reason as well — the tax rate brackets would not be adjusted for inflation, so a taxpayer could be pushed into a higher tax bracket if his or her wages simply remained even with inflation. For these reasons, under a tax code that is not indexed, taxpayers pay a higher percentage of income in taxes with each passing year even when their income gains merely keep them even with inflation or lag behind inflation.

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[1] Eric V. Schlecht, "History vs. Hysteria: Correcting the Hyperbole Surrounding the Bush Tax Cut Plan," National Taxpayers Union, NTU Issue Brief 111, January 24, 2001.

By contrast, when the tax code is indexed — as it is today — taxpayers' tax liabilities do not increase unless their incomes rise faster than inflation.

The lack of indexing in the tax code before 1985 consequently produced an automatic upward creep in tax collections over time. As a 1998 Treasury Department paper noted, "Without indexation, bracket creep occurs, which increases federal revenue as a percentage of GDP without any legislative action....In fact, when inflation is relatively high and bracket creep is particularly intense, as it was through much of the 1970's, policy makers have to cut taxes repeatedly to maintain the desired level of taxes."[2] In other words, regular tax cuts were necessary just to keep taxes steady as a percentage of taxpayers' incomes and to avert tax increases over time.

During this period, current law thus contained built-in tax increases at any point in time. Policymakers cut taxes every few years to offset much or all of the tax increases that otherwise would occur, but the Congressional Budget Office was forced in constructing its revenue baseline to assume that taxes would rise over time as a share of taxpayers' incomes, because the baseline reflected current law. Under this system, CBO "scored" legislation that merely kept tax burdens steady as a tax cut, even though families would feel no benefit from it: Their taxes would not change as a share of their income. The baseline against which the Reagan tax cut (the Economic Recovery Tax Act of 1981) and other tax cuts were measured thus was an artificially inflated baseline as a result of the lack of indexing in the tax code.

The size of the Reagan tax cut was measured by using this inflated baseline. That increased the apparent size of the tax cut, since the tax cut was measured relative to a baseline that assumed significant tax increases. As the Congressional Budget Office noted when the Reagan tax cut was first proposed, "While the Administration proposal would reduce revenues by large amounts in those years, it is important to keep in mind that, without a tax cut, income taxes rise continually because of the effects of inflation on the graduated income tax rate schedule...*a large share of the Administration's proposed tax cut would simply offset these tax increases* [emphasis

Table 1

Year	Percentage of ERTA Revenue Reduction Due Solely to Effect of Inflation after October 1, 1981 on Baseline
1982	28%
1984	32%
1987	45%

Source: Congressional Budget Office, *Baseline Budget Projections for Fiscal Years 1983-1987*, February 1982, Tables 11and 12, Figure 5, and author's calculations.

[2] Jerry Tempalski, "Revenue Effects of Major Tax Bills," U.S. Department of the Treasury, OTA Working Paper 81, December 1998, page 4.

added]."[3] Table 1 shows the percentage of the Reagan tax cut's cost that was due solely to measuring the tax cut against a revenue baseline that assumed future tax increases as a result of the effects of inflation.[4]

Since 1985, the tax code has been indexed to inflation, and the baseline consequently no longer includes large, automatic tax increases over time.[5] In other words, ongoing inflation no longer causes a large upward movement in taxes over time in the baseline. Under the current baseline, any tax cut that reduces tax burdens on families by a given amount would be scored as costing less than the tax cut would cost if it were measured against a baseline that did not include indexing.

Comparing the Bush tax cut to the Reagan tax cut thus is misleading: A large component of the Reagan tax cut merely prevented an increase in taxes that would have otherwise occurred because of the lack of indexing in the tax code.

The 1982 Tax Increase

The 1981 tax cut was excessive, a conclusion to which David Stockman and others in the Reagan administration came not long after its enactment. As a result, the Reagan administration worked to scale back the tax cut one year later. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) increased revenue by closing some loopholes broadened in the 1981 act, altering depreciation deductions, tightening safe harbor leasing rules, and making several other changes. As CBO noted, these "tax increases partly offset the revenue effects of ERTA [the 1981 act] by offsetting almost two-thirds of the ERTA corporate income tax reductions and about 10 percent of the ERTA individual income tax reductions."[6] The net cost of ERTA and TEFRA is a more appropriate measure of the Reagan tax cuts than the cost of ERTA alone.

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[3] Congressional Budget Office, "An Analysis of President Reagan's Budget Revisions for Fiscal Year 1982," March 1981, page 19.

[4] A previous version of this paper showed larger percentages for 1982-1984. Those larger percentages applied to the percentage of the individual income tax reductions in the 1981 package that reflected the effects of inflation on the revenue baseline. The individual income tax reductions, however, were only a part of the overall 1981 package. The percentages now shown in the table apply to the entire 1981 tax package.

[5] The indexation of the tax code, effective in 1985, was a component of the 1981 act.

[6] Congressional Budget Office, "Baseline Budget Projections for Fiscal Years 1984-1988," February 1983, page 27.

Comparing the Net Size of the Reagan Tax Cuts and the Proposed Bush Tax Cut

Various estimates are available of the size of the Reagan tax cuts as a share of the economy. The National Taxpayers Union, for example, cites the cost of ERTA as 3.3 percent of GDP. The Treasury Department paper cited above estimates a cost for ERTA four years after enactment of 4.15 percent of GDP.[7] The Congressional Budget Office, in 1983, estimated the cost of ERTA would be 5.6 percent of GDP in 1988.[8] We use the CBO estimate as a basis for comparison with the proposed Bush tax cut.

As explained, these figures should be adjusted for the impact of inflation on the revenue baseline and for the partial reversal of the 1981 tax cuts enacted in 1982. Table 1 indicates that the share of the revenue cost due solely to inflation in the baseline was 45 percent in 1987. To be conservative, we assume that 40 percent of the cost of ERTA was due to the impact of inflation on the revenue baseline and that 60 percent thus was a true tax cut.[9] Also, according to CBO, the revenue increase from TEFRA amounted to about 1.2 percent of GDP.[10] Table 2 displays these adjustments to the cost estimates. The net result is that the adjusted cost of the Reagan tax cuts amounted to 2.1 percent of GDP.

Cost of Tax Cuts as a Percentage of GDP

According to estimates from the Joint Committee on Taxation and CBO, the Bush tax cut is projected to amount to 1.5 percent of GDP in 2010.[11] These figures should be compared to an adjusted Reagan tax cut of 2.1 percent of GDP.

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[7] Tempalski, op. cit., Table 2.

[8] Congressional Budget Office, "Baseline Budget Projections for Fiscal Years 1984-1988," February 1983, Table 11.

[9] It is worth noting that the CBO analysis dividing the cost of the tax cut between the effect of inflation on the baseline and the remainder after taking such inflation into account was based on expected inflation as of the early 1980's. Actual inflation turned out to be somewhat lower than expected, which would affect the division of the total cost of the tax cuts into the two components. Analysis using actual inflation instead of expected inflation, however, is unavailable. In addition, the analysis using expected inflation reflects what policy-makers had expected as of passage of the legislation. That perspective may be the most relevant for evaluating the relative size of the Reagan and proposed Bush tax cuts.

[10] In 1983, one component of TEFRA 1982 was reversed: the withholding of tax from interest and dividends was repealed in the Interest and Dividend Tax Compliance Act of 1983. The cost of that act (0.04 percent of GDP) is subtracted from the TEFRA 1982 cost estimate in the figures in the text. Note also that correcting for the effect of inflation on the baseline would, if anything, *raise* the revenue gain due to TEFRA.

[11] This figure compares last year's Joint Committee on Taxation revenue estimate of the Bush plan to the projected GDP that was used in producing those estimates. Since then, the CBO has revised upward its estimate of projected GDP in 2010. The CBO revisions, however, also affect the cost of the proposed Bush tax plan. Analysis by the Center on Budget and Policy Priorities suggests that the revised revenue figure as a percentage of the revised GDP figure would be slightly higher (1.6 percent) than the figure based on last year's revenue and GDP projections (1.5 percent). The increase reflects the fact that projected revenues (and therefore projected revenue losses from a tax cut) are higher as a percentage of GDP in 2010 under the new baseline than under last year's baseline.

The Bush tax cut thus is not that much smaller than the adjusted Reagan tax cut. The Bush tax cut would cost 1.5 percent of GDP in 2010; the adjusted Reagan tax cuts cost about 2.1 percent of GDP. The Bush tax cut appears to be only modestly smaller than the Reagan tax cuts, amounting to more than 70 percent of the cost of the adjusted Reagan tax cut, rather than being a small fraction of the Reagan tax cut.

Table 2

	Percentage of GDP
ERTA 1981	5.6%
Minus: 40 percent adjustment for impact of inflation on baseline	2.2%
Equals: ERTA cost against indexed baseline	3.4%
Minus: TEFRA 1982 increase	1.2%
Equals: Net cost of Reagan tax cuts (as % of GDP)	**2.1%**

The Legacy of the Reagan Tax Cut

Even if the Bush tax cut represented only a modest proportion of the properly measured Reagan tax cut, the NTU argument would be problematic. The Reagan tax cut does not represent a valid basis for evaluating what size tax cut is fiscally responsible.

Even with the subsequent tax increase in 1982, the 1981 tax cut imposed a damaging fiscal legacy on the nation. The unified budget deficit rose from $74 billion in 1980 to $221 billion in 1986 and a peak of $290 billion in 1992. As a percentage of GDP, the deficit (adjusted for the economy's business cycle) rose from 0.7 percent in 1980 to a peak of 4.8 percent in 1986.

Some advocates for the Bush tax proposal have argued that the Reagan tax cuts were not a cause of the large budget deficits during the 1980s. Rather, they argue, the problem arose because of large spending increases. This argument is not supported by the evidence. CBO produces estimates of revenues and outlays that adjust for the state of the business cycle. These figures indicate that, adjusted for the state of the business cycle, revenue fell from 19.4 percent of GDP in 1981 to 16.9 percent of GDP in 1986 and 17.3 percent in 1987. Outlays rose from 19.9 percent of GDP in 1981 to 21.7 percent in 1986 and 20.6 percent in 1987. Between 1981 and 1987, revenues fell three times as much as a percentage of GDP as spending increased. (Revenues declines by 2.1 percent of GDP while outlays increased by 0.7 percent of GDP.) These data indicate that the Reagan tax cuts contributed to the budget deficits of the 1980s and early 1990s.

The result of these deficits was that the federal government was forced to borrow massively, and debt held by the public rose from 25.7 percent of GDP at the end of 1980 to 49.5 percent at the end of 1993. Federal debt per household was more than $15,000 higher in 1993 than if debt had remained at the same level (relative to the size of the economy) as it was in 1980. Interest payments on the debt (in constant dollars) were more than $9,000 higher per household in total between 1981 and 1993 than if debt had remained at its 1980 level as a share of the economy. The test of fiscal responsibility today should not be this historical record of deficits and debt that was partly engendered by the Reagan tax cuts.

The Level of Marginal Tax Rates

Marginal tax rates were higher in 1981 than they are today. In 1981, the maximum marginal income tax rate was 70 percent on unearned income and 50 percent on wage and salary income. Today, the maximum statutory marginal income tax rate is 39.6 percent.[12] A reduction in marginal tax rates is therefore less critical today than in 1981.

Conclusion

The National Taxpayers Union's argument is dubious: It is based on a way of measuring the size of the Reagan tax cuts under which simply keeping taxes from rising counts as a large tax cut. The NTU approach also overlooks the 1982 tax increase and implicitly ignores the fiscal problems to which the Reagan tax cuts were a significant contributor. After adjustment is made for the impact of inflation on the revenue baseline before 1985 and for action that scaled back the 1981 tax cut just one year later, the Reagan tax cut is seen to be only modestly larger than the proposed Bush tax cut.

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[12] In practice, the effective marginal tax rate differential may be modestly smaller than this difference in statutory rates. In particular, the 2.9 percent payroll tax that funds the Hospital Insurance component of Medicare now applies to an unlimited amount of earnings; before 1993, it applied only up to a given threshold of earnings. In addition, the phase-out of itemized deductions (which applies to married taxpayers with adjusted gross income of more than $128,950 in 2000) and of personal exemptions (which applies to married taxpayers with adjusted gross income of more than $193,400 in 2000) may raise the effective marginal income tax rate above 39.6 percent for some taxpayers, depending on their level of deductions. It is worth noting that the personal exemption phase-out ends at an adjusted gross income of $315,900. The 39.6 percent bracket begins at a *taxable* income level of $288,350. This makes it unlikely that many taxpayers in the 39.6 percent bracket are affected by the phase-out of the personal exemptions.