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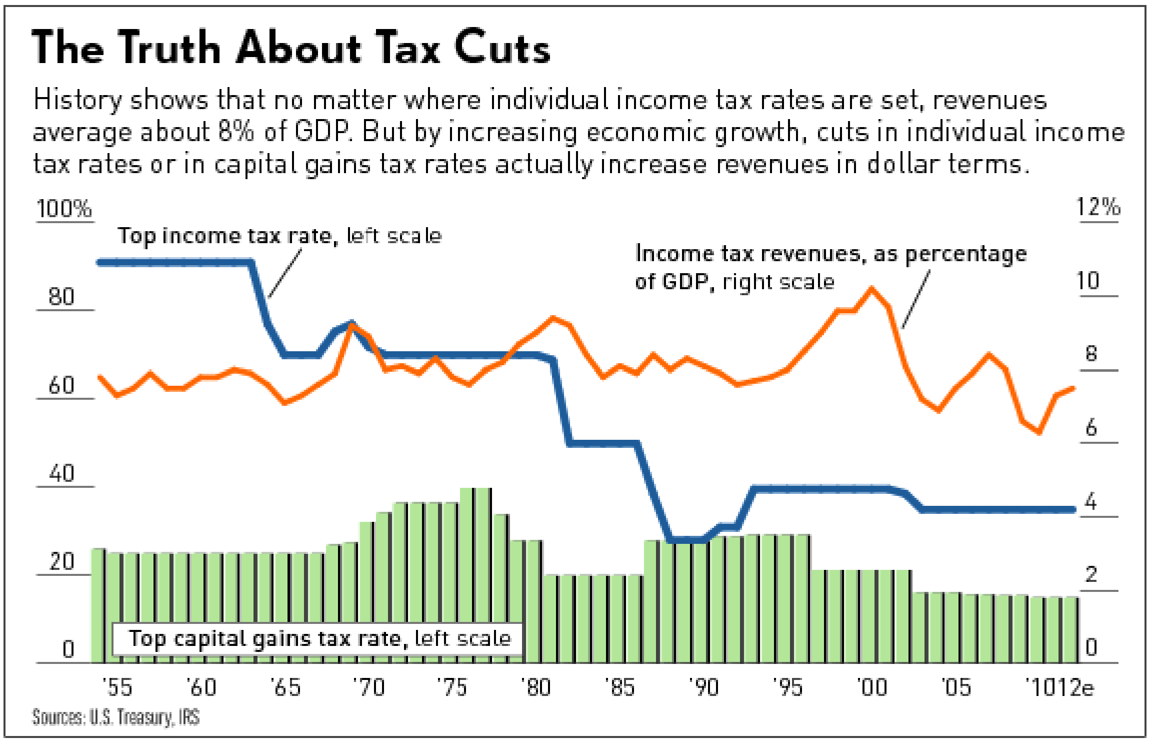
Romney, As Reagan Did, Has It Right On Cutting Taxes

By: ALAN REYNOLDS – November 5th, 2012



Presidential candidate Mitt Romney wants to cut all marginal tax rates by 20%. Vice President Joe Biden, in the debate with Paul Ryan, emphatically repeated that, "it has never been done before."

Yet President Kennedy cut all tax rates by 22% in 1964, and President Reagan cut them by another 19% to 22% by mid-1983. The 1986 Tax Reform Act then cut the top rate to 28% in 1988-90.

What happened to tax revenues? Take a look at the graph above.

It compares top federal tax rates on individual income and capital gains with the amount of revenue raised by the individual income tax as a share of GDP. That ratio of revenues to GDP provides no clue that tax rates were cut by more than 20% in 1964 and 1983, or that tax rates higher than 28% were eliminated by 1988.

Aside from booms and busts, the individual income tax always brought in about 8% of GDP regardless whether the top tax rate was 91% or 28%. Revenue spiked above 9% of GDP with the 1969 surtax, but recession soon erased that gain. Revenue spiked in 1980-82, partly because GDP (the denominator) fell. Recession soon ended the Treasury's windfall from inflation.

Revenues from the individual income tax averaged only 7.7% of GDP from 1951 to 1963 with tax rates of 20% to 91%, but rose to 8.1% from 1988 to 1990 with tax rates of 15% to 28%. This did not happen because of "closing loopholes."

The 1986 Tax Reform Act (TRA) eliminated some itemized deductions but all the savings were used to increase standard deductions. The result? Total deductions averaged 22.8% of adjusted gross income (AGI) from 1988 to 2010 — exactly the same as they did from 1970 to 1986.

The reason individual tax revenues remained above 8% of GDP as top tax rates fell from 91% to 28% is that high-income taxpayers earn and report more income when marginal tax rates come down. Economists call this the "elasticity of taxable income," and the response is powerful in high tax brackets.

Looking at the revenue line, it is hard to detect two increases in top tax rates in 1991 and 1993.

Revenues were 8.3% of GDP in 1989 when the top tax rate was 28%, but dropped to 7.6% of GDP in 1992 after Bush 41 phased-out deductions and exemptions for high-income tax payers. Revenues were still just 8% of GDP in 1995 — two years after President Clinton raised marginal tax rates by 16% to 28% on joint returns above $140,000.

Individual income tax revenues did rise significantly until 1997 when the top tax rate on long-term capital gains was reduced to 20% (a 29% cut). Realized capital gains accounted for 9% of individual income tax revenue from 1997 to 2002 — up from 6.9% in 1987-96, when the capital gains tax was 28%.

Revenues also increased after 2003, largely because more dividends and capital gains were reported.

Since individual income-tax revenues have long been a nearly-constant 8% of GDP, long-term growth of real revenues depends almost entirely on growth of real GDP. Federal revenue grew by 4.5% a year in real terms from 1984 to 1989 because real GDP grew by 4.3% a year.

Can lower marginal tax rates "jump start" economic growth? Ask countries such as Brazil, India, Russia and Singapore that slashed their top income-tax rates 13% to 30%.

By no coincidence, the U.S. economy grew by 6.2% a year from 1964 to 1966 with the Kennedy tax-rate cuts, and by 5.3% a year from 1983 to 1985 when the Reagan cuts took effect. Growth of real revenues depends on growth of the real economy, which is the crucial goal of tax policy.

Unlike previous U.S. tax-rate reductions, the Romney tax plan would also cap deductions, which currently leave taxable income nearly a fourth smaller than income before deductions (AGI). Previous tax-rate reductions left total deductions unchanged.

With that added fillip, Romney's proposed reductions in marginal tax rates would probably raise more than the usual 8% of GDP, particularly if (1) rate reductions were not foolishly phased in as in 1981 and 2001, and (2) the lowest rate was no lower than 12% as the Simpson-Bowles commission proposed.

Under Romney's plan to bring spending back down to 20% of GDP in four years — the other half of his "20 Percent Solution" — federal spending would wind up $4.1 trillion smaller over 10 years than the spending in President Obama's moribund 2013 Budget.

No tax reform or spending plan is perfect, and none remains untouched by Congress, but Romney surely has the direction right.

• *Reynolds, a senior fellow with the Cato Institute, is the author a new Cato Working Paper "The Misuse of Top 1 Percent Income Shares as a Measure of Inequality."*