IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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IMPORTANT TAX ANNIVERSARIES: ERTA'S 25th AND INDEXING'S 20th

August 13 marks the twenty-fifth anniversary of President Reagan's signing of the Economic Recovery Tax Act of 1981 (ERTA). That Act reduced marginal personal income tax rates across the board, phased in over four calendar years, to increase incentives to work, save, and invest. ERTA also introduced tax indexing, the practice of adjusting personal exemptions, the standard deduction, and the tax brackets for inflation each year to keep inflation-driven income increases from pushing taxpayers into higher tax brackets. That provision was effective in 1985. When people filed their tax forms in April 2006, it was the twentieth time that they received the protection that indexing offers against "bracket creep". ERTA's rate cuts and indexing were part of the Reagan economic policy that brought an end to the stagflation of the 1970s, and led to a seven-year expansion that created some eighteen million jobs. Many tax rate changes have been enacted since, some for the better, others not. The indexing feature is the last remaining, largely unchanged, major piece of the original 1981 tax cut, and one of the most important for economic growth and job creation.

The 1970s Problem: Stagflation

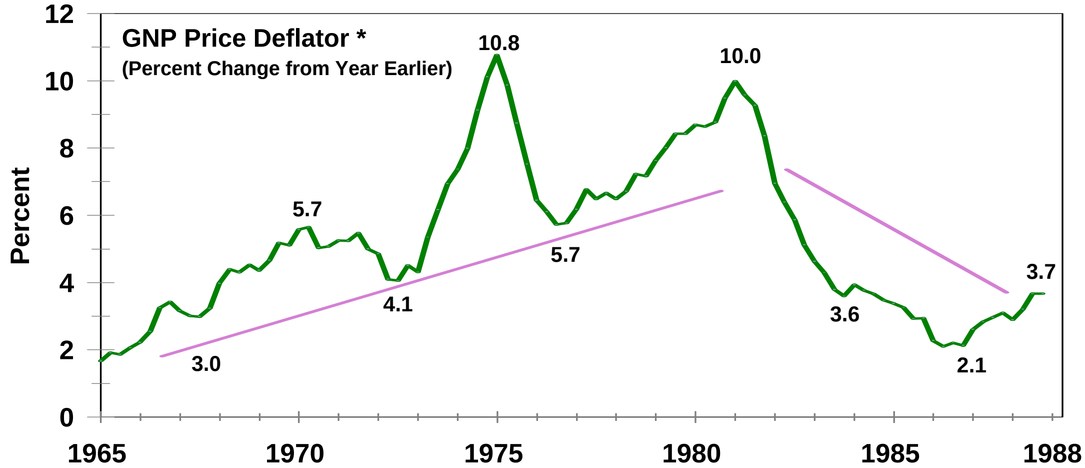
During the 1970s and the start of the 1980s, the United States experienced a period of stagflation, which is slow economic growth combined with inflation. Four recessions marked the era. Unemployment trended up. Inflation and interest rates soared well into double digits. Real after-tax wages were falling. Each business cycle through 1980 seemed to leave us worse off. (See chart 1.)

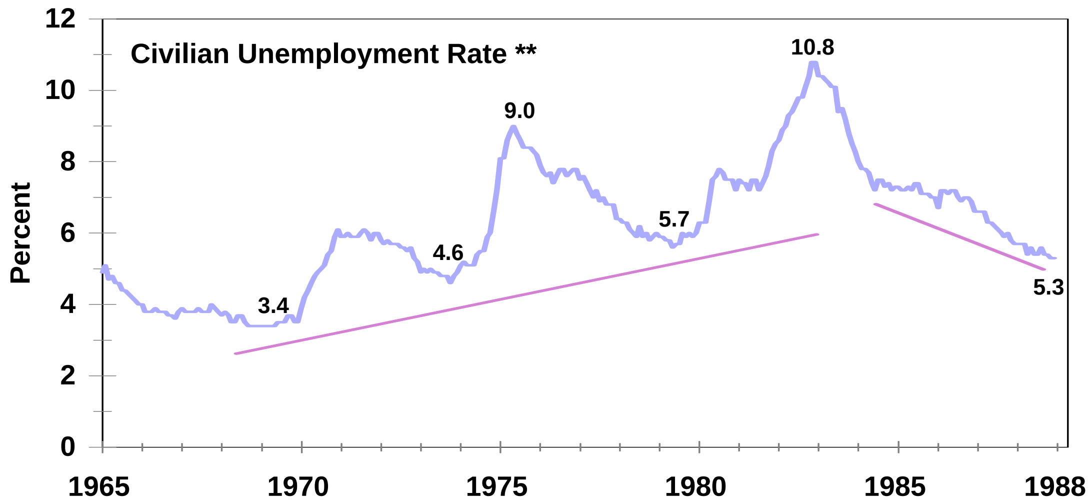
The Keynesian economic theory of the time could not offer a solution. It viewed all economic policies as working by increasing or decreasing "aggregate demand". To fight inflation, government would raise taxes, cut its spending, and slow the growth of the money supply, all policies set on "stop" to reduce private or public sector spending on goods and services. GDP would be expected to slow and unemployment to rise in the process, until inflationary expectations were wrung out of the system. To fight unemployment, the government would cut taxes, increase its spending, and create money at a faster pace, all policy tools set on "go". Inflation would be expected to increase, lowering real wages to encourage hiring. This trade-off, that there had to be more inflation to get lower unemployment, was known as the Phillips Curve, which helped put the "dismal" in the Dismal Science.

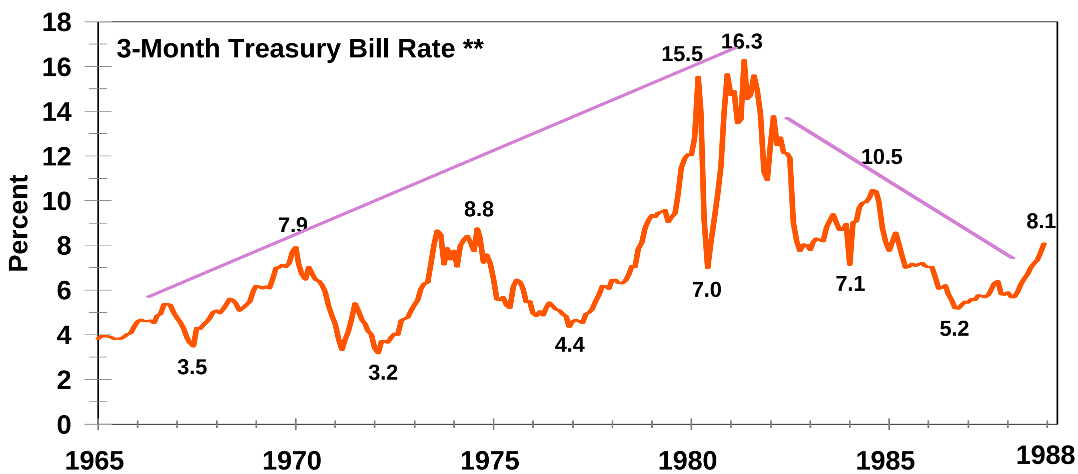
The Insight: Inflation-Driven Tax Rates Were Strangling Hiring and Investment

At the time, there were fifteen taxable brackets for a married couple, with tax rates ranging from 14 percent to 70 percent (capped at 50 percent on wages). The dollar amounts that separated one tax bracket from another were not adjusted for inflation. Neither were the personal exemption and the standard deduction. The brackets were not very wide in percentage terms, especially compared with double digit inflation. With inflation and a cost of living increase, more of a worker's income was subject to tax, and the taxable portion spilled over into higher tax rate brackets. Average and marginal tax rates rose.

Chart 1 Inflation, Unemployment, and Interest Rates







* Quarterly data from 1965-I to 1988-IV.

** Monthly data from January 1965 to December 1988.

For each 10 percent rise in prices and nominal income, government revenues rose about 16 percent. That is, revenues rose about 6 percent in real terms, giving the government an incentive to continue to inflate. A lot of the extra money was spent. The rest was returned to the taxpayers, but not in a manner conducive to growth. There had been about a dozen increases in the personal exemption and the standard deduction in various 1970s tax bills. Although they reduced taxes on the first dollars earned, they kept the last dollars of inflated wages and salaries stuck in the higher brackets into which they had been pushed. About half the revenue from bracket creep was returned in this way, but the increases in the marginal tax rates, and the corresponding economic disincentives, were not offset.

Between 1965 and 1981, the average family of four went from the 17 percent tax bracket to the 24 percent tax bracket, and took home seven percent less after taxes out of every extra dollar earned. A professional earning twice the average income went from the 22 percent bracket to the 43 percent bracket, and took home 21 percent less after taxes of each extra dollar of income. Incentives suffered.

Taxes were about 10 percent of a typical worker's income, so for each 10 percent increase in prices and wages, the tax burden rose by about 16 percent, or 1.6 percent of income, and workers had to ask for an 11.6 percent pay raise to keep their after-tax incomes from falling. But their employers were only seeing their revenues rise by 10 percent, and productivity gains in the late 1970s were nearly nil or negative. The resulting rise in the tax wedge on labor drove a bargaining wedge between labor and management. The result was an epidemic of major strikes in many industries, such as steel, automobiles, farm equipment, and coal. In 1976, the coal workers stuck for a 30 percent hike in wages and benefits over three years, and the country was shocked. But after taxes and inflation, the workers would barely have broken even.

Savers were hard hit. In 1965, a saver in the 25 percent tax bracket could get 4 percent interest at a time of 2 percent inflation. After losing 1 percentage point to taxes and 2 percentage points to inflation, the saver retained a 1 percent real after-tax reward for saving. In 1980, the same saver would have been in the 32 percent tax bracket and could have earned 15 percent interest on a Treasury bill. Taxes would have taken 5 percentage points, and inflation 13 percentage points. The after-tax return was a negative 3 percent. Saving was depressed, and interest rates were driven higher as inflation and rising tax burdens caused people to demand higher returns.

Inflation also reduced the value of the cost recovery allowances for business investment. The worse inflation got, the more that profit was overstated and over-taxed, and the fewer were the investments that could pay their own way and be undertaken. Many firms were reporting taxable income even though, on a replacement cost basis, they were losing money. The result was a smaller capital stock than otherwise, and lower productivity, wages, and employment.

In such a situation, the harder the Federal Reserve tried to boost the economy by easing monetary policy, the more prices and wages rose, causing tax rates to rise even further on labor and capital income. The higher the tax rates rose, the less people were willing to work or to hire, and to save or to invest in new plant and equipment. As nominal demand rose, real supply shrank, and inflation and unemployment just got worse.

The Cure: A New Policy Mix

Monetarist economists, led by Professor Milton Friedman, had long since debunked the notion that tax cuts and spending increases increase disposable income or aggregate demand. Unless the resulting budget deficits (or reduced surpluses) were matched by new money creation by the Federal Reserve (a change in monetary policy), the tax cut would be borrowed back by the government, or added borrowing would be needed to fund the spending. Either way, the demand effect would be canceled out. If the Fed created more money, the main result would be higher inflation, with only transitory effects on real output. The main role of monetary policy was to maintain zero inflation and a sound dollar.

As for fiscal policy, the new neo-classical or supply-side view of economics was that tax changes would promote growth if and only if they raised rewards, at the margin, to work, saving, and investment. This required marginal tax rate cuts, such as the Kennedy proposals of the 1960s (passed under Lyndon Johnson), which did seem to promote a burst of real growth. Kennedy had earlier signed into law an investment tax credit and a reduction in the corporate tax rate.

In theory, applying some policy tools to the fight against inflation and others to promoting real economic growth could yield the desirable outcome of more growth with less inflation. Monetary policy was the only real cause, and hence the only cure, for continuing inflation. Tax policy clearly affected the costs of production and the incentives to produce, both real output effects. Government spending coopted real resources. By devoting monetary policy to fighting inflation, and tax and spending policy to promote private sector growth, it would be possible to contain nominal demand while spurring real output.[1]

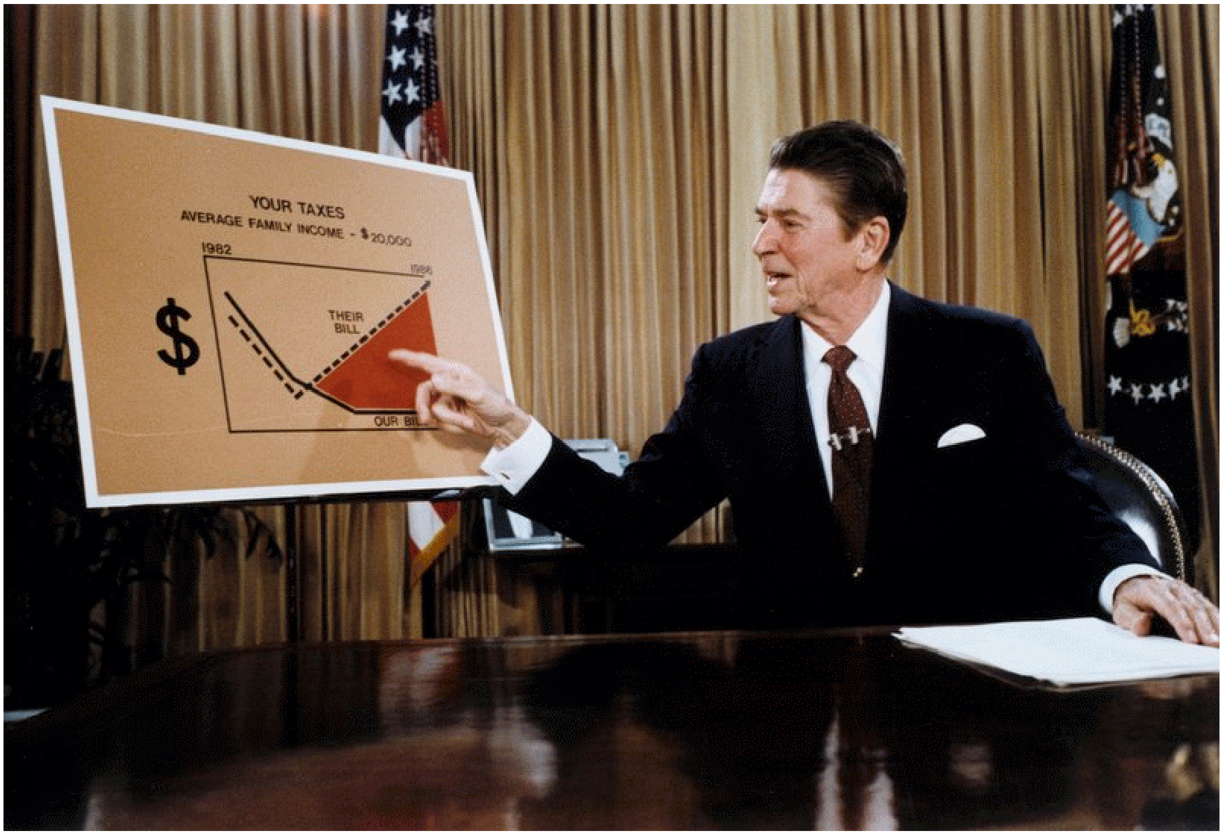
The Reagan Administration adopted this world-view, and implemented a four part program to fight stagflation: lower tax rates on individual income and on business investment; real cuts in government spending to transfer resources to the private sector and to pay for the tax reductions; slower growth of the money supply to reign in inflation; and reduced regulation to lower the cost of production.

The Reagan tax plan consisted of a 25 percent across-the-board reduction in marginal tax rates to restore incentives to work, save, and invest: 5 percent on October 1, 1981; 10 percent on July 1, 1982; and 10 percent on July 1, 1983.[2] Indexing would follow in 1985 to keep the rates from rising again. The marginal tax rate structure was reduced from a range of 14 percent to 70 percent down to a range of 11 percent to 50 percent. The top tax rate on capital gains fell to 20 percent. The plan included an enhanced ITC, and, on a deferred basis, faster and therefore more complete recovery of the cost of plant and equipment, phased in between 1984 and 1985. (The original Reagan campaign proposal was for a 30 percent tax cut, 10 percent each year on January first, 1981-1983, but the size was scaled back and the timing delayed because of Congressional fears about the deficit. The business cuts were deferred for the same reason.)

The Vote

The House Majority leadership attempted to forestall the full tax reductions with a smaller alternative. Ways and Means Chairman Dan Rostenkowski and Speaker Tip O'Neill offered a two-step tax cut. The Ways and Means Committee bill would have lowered marginal tax rates a bit more than the President's bipartisan plan in the first two years. It contained no inflation protection, and tax rates would have resumed their upward climb in year three, generating more stagflation in the decade ahead.

President Reagan went on national television in prime time on July 27, 1981, two days before the House vote on the tax bill. He explained why the full three step tax cut was needed, and that, with tax indexing, the tax rates would come down and stay down. Pointing at a chart of the competing tax reductions, he told the public that the House leadership plan was a better plan, "if you are only planning to live two more years". (See picture.[3]) He explained indexing in very simple terms: that, in spite of many recent tax cuts, people's taxes kept going up because of the effect of inflation on the tax rates. Indexing would stop that, he said, by



adjusting the tax system for inflation. He urged the public, "If you want a permanent tax cut, call your Congressman."

People did. The Congressional switchboard was jammed, and the White House got over two hundred thousand calls in the next two days. Congressman Rostenkowski, who had listened to the speech from his House office, told the New York Times that as soon as President Reagan finished speaking, he could hear the phones begin to ring in his (Rostenkowski's) outer office (at 9:30 at night!). Speaker O'Neill told the Times that he had never seen such a phone blitz. The next morning, the Georgia delegation told Rostenkowski that they were defecting to the President's plan. Forty-eight Democrats joined the Republican House minority to give the President's proposals a bipartisan majority of 238 to 195, on July 29th. After a quick reconciliation with the Senate-passed version, ERTA passed the Congress on August 4, and President Reagan signed it into law on August 13.

Implementation

Implementation of the program was not well coordinated. The Federal Reserve had moved quickly to curb money supply growth, starting the day after the 1980 election, and continuing through 1981. It feared, groundlessly, that the cost-cutting, supply-enhancing tax cuts would be inflationary.

The tax reductions, unfortunately, were delayed by deficit concerns until late in 1981, by which time the monetary squeeze had triggered a recession. The tax cuts did not catch up with the rising tax rates due to bracket creep until 1983, at which point the economy took off in a seven year expansion. The reduced tax burdens on labor gave workers a real wage hike without having to ask their employers for a nominal pay hike. Over eighteen million additional jobs were created during the rest of the decade. (In the same period, employment growth in Europe and Japan totaled zero.)

The monetary tightening and reduced tax rates on interest led to a rapid decline in inflation expectations and interest rates. Inflation fell from double digits to 3.8 percent a year by 1982 (Dec. to Dec.), much faster than expected. Although Congress had voted to trim spending growth, it had budgeted for 6 to 8 percent inflation over the period, much higher than actually occurred, so real outlays rose. This collapse in inflation, and the resulting surge in real outlays, plus the recession, were the main sources of the subsequent deficit. At least, the episode proved that real growth and non-monetized tax cuts are not inflationary.

Changes Since: Some Good, Some Bad

In 1982, Congress responded to the recession-related deficit by enacting the Deficit Reduction Act (DEFRA), which rescinded most of the tax reductions planned for equipment under ERTA, before most of the incentives ever became effective. DEFRA caused a sufficient collapse in the orders for new equipment, especially on leased equipment, to completely explain the second half of the 1981-1982 downturn. Taxes were raised on investment in structures in the Tax Equity and Fiscal Responsibility Act of 1984.

The Tax Reform Act of 1986 (TRA) lowered personal tax rates further, with a new top rate of 28 percent (a good supply-enhancing move), but it paid for the cuts by raising taxes on investment even higher. It eliminated the differential tax rate on capital gains, ended the ITC, lengthened capital cost recovery periods, curtailed access to IRAs for middle- and upper-income taxpayers, and penalized investment in real estate partnerships. In 1988 and 1990, two payroll tax hikes raised labor costs.

The TRA tax increase on capital income and the payroll tax hikes were enough between them to trigger the 1991 recession, which was exacerbated by the 1991 tax rate increase in the top tax bracket to 31 percent under President George H. W. Bush. Marginal tax rates were raised again in the 1993 Tax Act under President Clinton, with new top rates of 36 percent and 39.6 percent, but some of that damage to incentives was offset by the restoration of a capital gains differential.

Nonetheless, the individual rate reductions and the retention of tax indexing, which meant that inflation would not boost taxes on workers in the years ahead, or on interest income on long term bonds, worked wonders. Job growth remained strong, and interest rates remained low. The Federal Reserve brought inflation to very low levels in the mid-1990s. The further reduction in inflation allowed businesses to recover more of the real cost of their investments by strengthening the capital consumption allowances. The economy was back on a path of significant real growth with low inflation that lasted until the 2001 recession.[4]

In recent years, further individual marginal tax rate reductions, and caps on taxation of dividends and capital gains, have encouraged additional employment and capital formation. The tax rate cuts proposed by President George W. Bush in 2001 were originally intended to be phased in over several years, and they initially did little to spur recovery from the 2001 recession. It was not until 2003, when the rate cuts were brought forward and the dividend and capital gains caps (and a temporary enhancement of depreciation allowances) were enacted, that the economic recovery from the 2001 recession really took off. These cuts should be made permanent. They should be paid for through spending restraint.

The Alternative Minimum Tax (AMT) remains a problem. DEFRA expanded the tax base for the AMT in 1982, and established exempt amounts that were not indexed for inflation. It seems that as soon as Congress voted to deny itself a windfall from inflation under the ordinary income tax, it had to enact a new inflation windfall under the AMT. The exempt amount was raised slightly and permanently in 1993. Another, temporary increase was enacted in 2001, and has had to be renewed in successive years. In the 1980s and early 1990s, the expanded AMT affected only a few upper income taxpayers. Today, however, after nearly 25 years of real income gains and modest inflation, the tax is hitting a large number of middle income households, and Congress is addicted to the revenue. The situation would not have arisen had the exempt amount been indexed in the first place. In addition, taxpayers who are caught in the phase-out range of the AMT face rather high marginal tax rates, even on capital gains and dividends. The AMT is eating into the incentives that recent tax reductions have provided.

Lessons To Be Learned

Tax changes affect the economy by changing incentives, not by manipulating "demand".

An appropriate mix of pro-growth tax cuts and non-inflationary monetary policy can boost real output without inflation. Further efforts along these lines would pay handsome dividends.

Restraint of government spending facilitates private sector growth. Government spending does not add to GDP; rather, it requires taxes that retard total output.

Phasing-in tax rate reductions is bad policy. It encourages people to defer economic activity, and delays the economic benefits. If tax rates are to be cut, or other incentives to invest are to be enacted, do so at once.

It is vital to adjust tax parameters for inflation. Otherwise, bad things happen, like making investment sensitive to inflation, or trapping more people in the Alternative Minimum Tax.

Stephen J. Entin
President and Executive Director

Endnotes

1. This innovative policy mix was the brain-child of several neo-classical economists, including Robert Mundell, Norman B. Ture, Arthur Laffer, and Paul Craig Roberts. Dr. Ture was the founder of IRET, and served in the Reagan Treasury as Under Secretary for Tax and Economic Affairs.

2. On a calendar year basis, these cuts amounted to a 1.25 percentage point tax rate reduction for 1981, a 10 percentage point rate cut for 1982, a 20 percentage point cut for 1983, and a 25 percentage point cut for 1984. The 1981 and 1982 cuts were more than offset by bracket creep and rising payroll taxes. Only in 1983 was there finally a net marginal tax rate reduction.

3. The President's diagram was designed by your author, who was then Deputy Assistant Secretary for Economic Policy at the Treasury Department. Indexing had already been included in the Senate version of the tax reduction, thanks to the efforts of Senator Bill Armstrong.

4. That downturn followed a monetary disturbance related to the Y2K panic. A surge in money creation and a brief upturn in inflation was followed by a sharp Fed reversal.

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.