Joint Economic Committee Republicans
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Taxes and Long-Term Economic Growth

Executive Summary

The 1960s and 1980s were periods of sustained high growth rates in the economy. The major reason for this growth is the tax cuts enacted in the beginning of each decade. President Kennedy's and President Reagan's tax cuts resulted in higher investment, lower unemployment, and improved overall economic performance.

Since March 1991, the U.S. economy has been expanding, though at a slower rate than previous post-war expansions. Productivity growth has been weak and must be improved. A tax cut that improves incentives to work, save, and invest is necessary to provide a framework for prosperity. As President Kennedy said, "A rising tide lifts all boats."

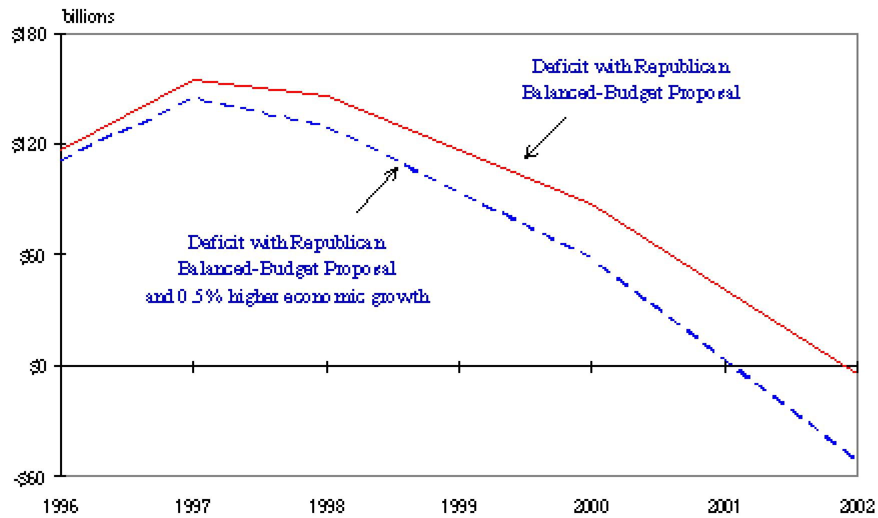
Taxes and Long-Term Economic Growth

Introduction

The current economic expansion that begin in 1991 is now almost six years old. This cyclical upswing has been associated with a lower unemployment rate, and improvement in other cyclical indicators. Though the pace of economic growth is below the post-war average, the long-term slowdown in labor force growth may be part of the explanation. However, productivity growth has been weak.[1] Productivity growth must be improved. In order to enact policies that foster economic growth, it is important to understand how various policies impact economic growth.

Why is economic growth important? Consider the family budget. Economic growth, specifically productivity growth, is vital to improve the well being of the American family. Small differences in economic growth will have large impacts on the family budget over time. If the economy grew one percentage point faster, per capita GDP in 40 years would be 50 percent higher, an economic improvement of nearly $30,000 for every American (Figure 1).

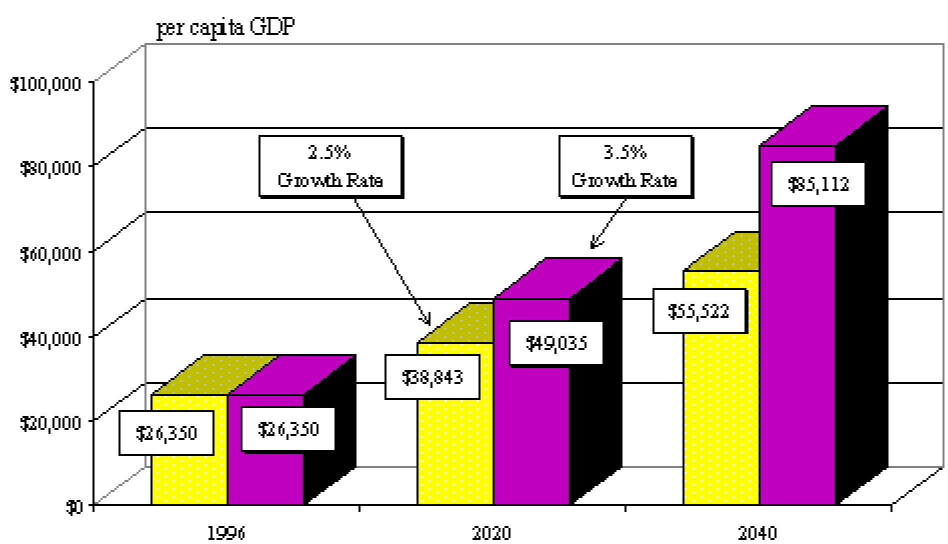
Economic Growth Lowers Budget Deficits



Source: CBO, 1996 and JEC Staff Calculations

Economic growth makes addressing many of the problems of the economic policy easier. Higher economic growth could help meet the needs of entitlement programs, and assist in achieving a balanced budget. If the government enacted pro-growth strategies, the impact on the budget would be impressive. Pro-growth policies could shorten the time until a balanced budget is achieved. If the pro-growth policies raised economic growth only 0.5 percent, a balanced budget could be realized one year earlier than the current balanced-budget proposal (Figure 2).

Small Changes in Economic Growth Have A Large Impact



Source: Economic Report of the President, 1996 and JEC Staff Calculations

Many prerequisites for economic growth, such as property rights, rule of law, freedom from political corruption and instability are guaranteed by the Constitution. The impact of other policies, such as fiscal and monetary policy, are the subject of often-heated debate. One area that has been scrutinized for several decades is the impact of taxes on long-term economic growth. The factual evidence is persuasive that high taxes are a major impediment to faster economic growth.

Taxes and Economic Growth

From one point of view, it is not apparent that higher taxes should harm economic growth. A tax increase would simply move the spending decision from the private- to the public-sector.[2] In this view, it does not matter who has control of economic resources. The main thing that matters is that there would be sufficient total demand to prevent recessions. However, this view of taxation is very narrow. This view does not recognize the fundamental axiom of taxation. **Taxing an activity, any activity, will reduce the level of that activity**. For example, raising the taxes on cigarettes will reduce cigarette consumption. Raising the tax on home ownership will reduce home ownership. Basic economic theories of supply and demand show that when anything rises in price, as occurs with a tax increase, less is demanded. Although economists recognize that impact varies among goods and services, the fundamental axiom still holds.

This fundamental axiom of taxation applies in the same manner with income taxes. Income taxes reduce the incentives to engage in activities that generate income, such as work, savings, and investment. Consider the simple example of a firm that is considering investment options. Suppose the firm decides that it will only consider investments that are expected to produce a 10 percent rate of return. If the government imposes a 50 percent tax rate on investment income, the firm will forego many formerly worthy projects. Now only projects that are expected to produce a 20 percent pre-tax rate of return will be considered. However, the firm will have fewer opportunities to invest when the rate of return must be 20 percent. Many formerly sound investments will no longer be sound for the simple reason that taxes are too burdensome. The same decision-making process is made when individuals determine how much to work and save.

Economic theory makes it clear that tax increases harm economic growth. However, like many economic questions, it is important to look at the historical record to confirm the theory. Economists have looked at tax reduction throughout the world. In the United States, there were two significant post-World War II periods of tax reduction: the Kennedy tax cuts of the 1960s and the Reagan tax cuts of the 1980s. A look at these episodes demonstrates that cutting taxes unleashes the creative forces of the American economy and provides incentives to work, save and invest.

The Kennedy Tax Cuts

"We Democrats believe that our economy can and must grow at an average rate of five percent annually, almost twice as fast as our average annual rate since 1953. We pledge ourselves to policies that will achieve this goal without inflation."

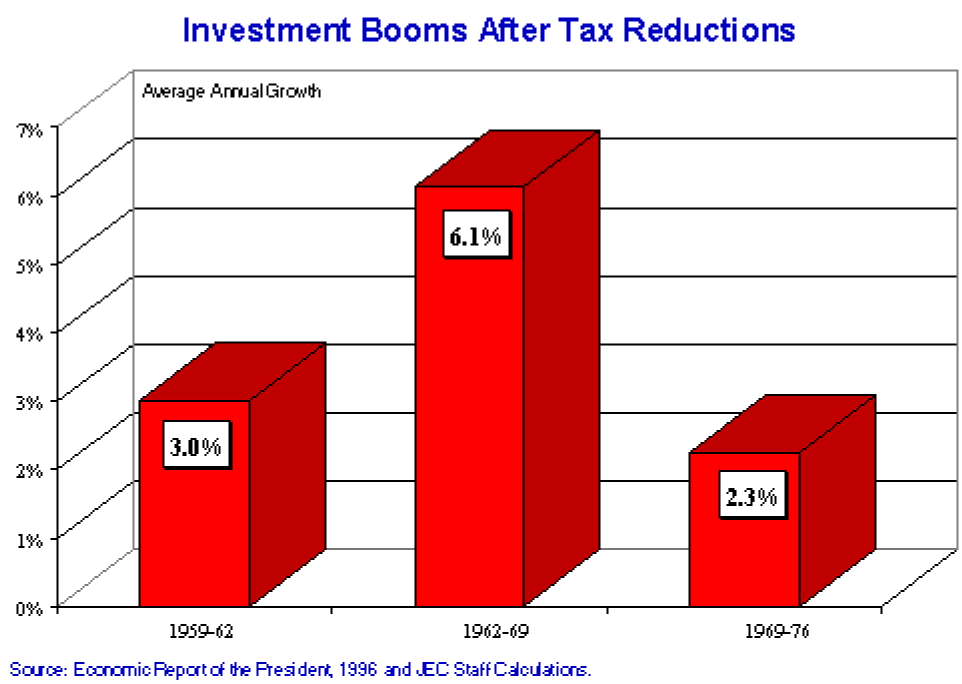
1960 Democrat Platform

"It is a question of the growth of our country, of the jobs, and security of our people."

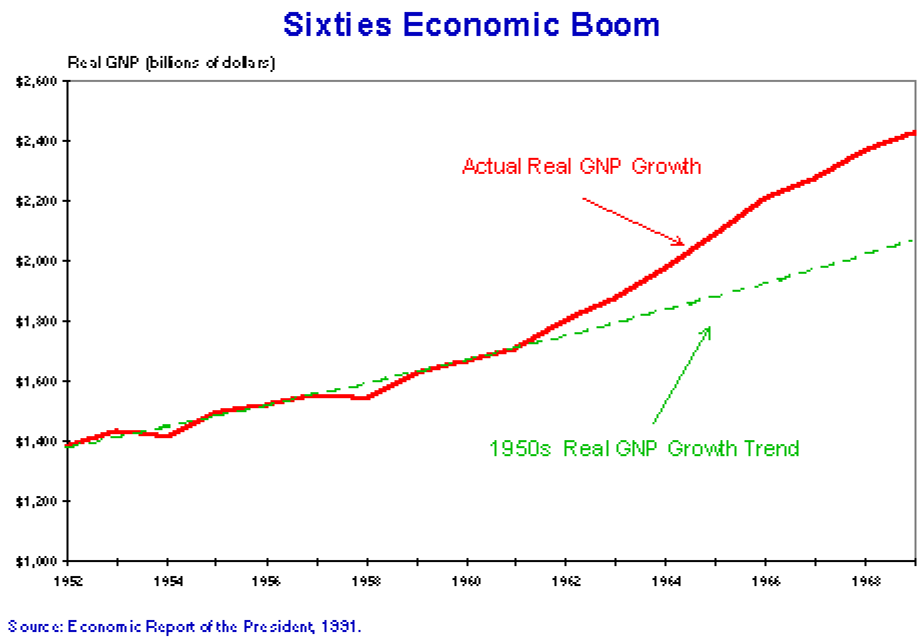
John F. Kennedy, September 18, 1963

The presidential election in 1960 took place in a stagnating economy. A recession that began in April did not end until February of the next year. The Democrat platform stressed the importance of increasing economic growth. Fortunately, the Democrats were prevented in their attempt to increase economic growth through higher government spending.

The Administration, eventually in July 1962, resorted to a series of tax reductions.[3] This first cut was through a restructuring of depreciation allowances. In October 1962, an investment tax credit was enacted that also encouraged investment. By allowing businesses to more rapidly write-off investments, the change in the depreciation rules dramatically lowered the cost of capital. The lower cost of capital and the investment tax credit initiated a boom in investment (Figure 3). Between 1962 and 1969, investment grew at a annual rate of 6.1 percent. This period's annual rate of growth of private investment was much better than the 3 percent annual growth rate of investment for the period 1959-62 and the 2.3 percent annual growth rate of investment for the years, 1969-76, after the Kennedy tax reforms were repealed.

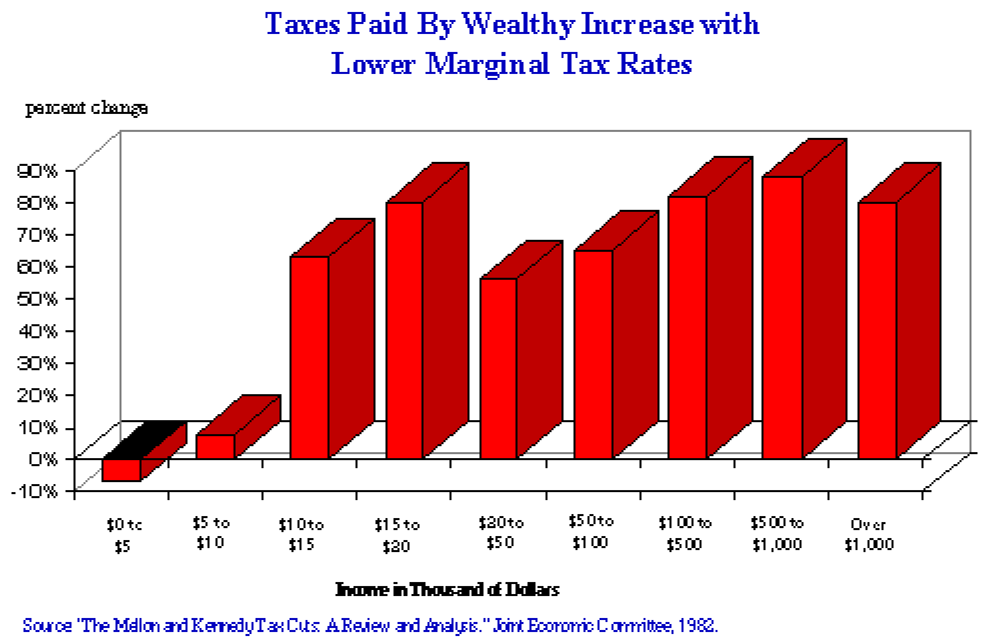


The Kennedy Administration's proposal to reduced taxes on business continued into 1964. In 1964, the corporate tax rate fell from 52 percent to 48 percent. Also, individual tax rates fell. The top marginal tax rate fell from 90 percent to 70 percent. The lowest marginal tax rate fell from 20 percent to 14 percent. The result was an expanding economy. Real GNP growth, which averaged only 2.4 percent from 1952 to 1960, rose to 4.5 percent in the sixties (Figure 4). When the expansion that started in February of 1961 ended nearly nine years later, it was, and still is, the longest expansion in the history of the United States.



A common concern among policy makers is that tax cuts will necessarily explode the deficit. Superficially, it seems obvious that by cutting taxes less revenue will flow into the government's coffers. However, that was not the case in the 1960s. Between 1962 and 1969, revenues increased 6.4 percent a year compared with a growth of only 1.2 percent between 1952 and 1959. After the tax cuts of 1962 and 1964, the deficit fell. The $7.1 billion deficit in 1962 fell to a deficit of $1.4 billion in 1965. As President Kennedy said in his address to the American people concerning his tax proposal, "Prosperity is the real way to balance our budget. ...By lowering tax rates, by increasing jobs and income, we can expand tax revenues and finally bring our budget into balance."[4] Walter Heller, the chairman of the Council of Economic Advisers during the Kennedy Administration, said, "Did it pay for itself in increased revenues? I think the evidence is very strong that it did."[5] High taxes mean lower economic growth which in turn depresses taxable income and lowers the growth of government revenues.

The impact of lower marginal rates is largest for the wealthy. Consider a wealthy citizen that is considering buying a work of art or buying a corporate bond that yields 10 percent. With a marginal tax rate of 90 percent, the return on the bond, after tax, would be 1 percent. With inflation of 1.7 percent in 1960, the wealthy investor would be poorer investing in corporate bonds than investing in tax shelters or buying a painting. There is no income foregone in purchasing the painting. The U.S. Treasury would lose in the bargain. The income that possibly could be generated from the bond is lost. The result of high tax rates engenders a variety of strategies to shelter income. Corporations paid CEOs with non-taxable benefits instead of taxable income. The income destroying nature of high marginal tax rates is apparent when one sees that the share of taxes paid by the wealthy rises when tax rates are reduced (Figure 5). The result of lower tax rates is a change in behavior of wealthy citizens to generate more income.



The Kennedy tax cuts demonstrate ably the benefits of lower tax rates. However, many of those lessons were lost in the effort to fight the Vietnam War and the inflation crisis of the 70s. To finance the Vietnam War, President Johnson and Congress eliminated the investment tax credit and further raised tax rates.

A greater problem for individual taxpayers over the next decade was the inflation-induced increase in taxes known as "bracket creep." Although Congress did not enact major tax increases, its refusal to index tax brackets for inflation resulted in a tax increase for millions of married families. Consider a married couple with a taxable income of $16,000 in 1965.[6] If their income rose only as quickly as inflation, they would have an income of $41,760 in 1980. To state it another way, their real income showed no increase between 1965 and 1980. They were not richer in 1980. But what happened to their tax burden? They went from the 28 percent marginal-tax-rate bracket to the 43 percent marginal-tax-rate bracket. This middle-class family was paying the same tax rates that were meant for richer families. Workers who receive cost of living increases saw their take-home pay decrease as the government gobbled up more of their resources. Against this backdrop, many policy makers recognized the need for a major tax cut. Ronald Reagan campaigned for a tax cut if elected in 1980.

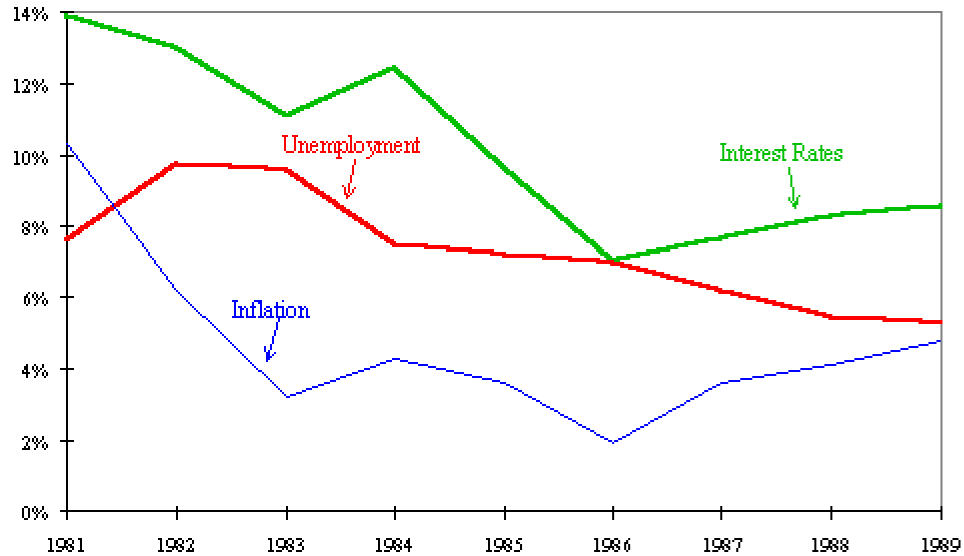
The Reagan Tax Cuts

The experience of the 1970s violated many of the theories of Keynesian economists. Inflation and unemployment were high and increasing throughout the world. When Reagan proposed his tax cuts, many economists predicted dire consequences. Lester Thurow of MIT predicted, "The probability that the president's policies will work as he says they will work is effectively zero.

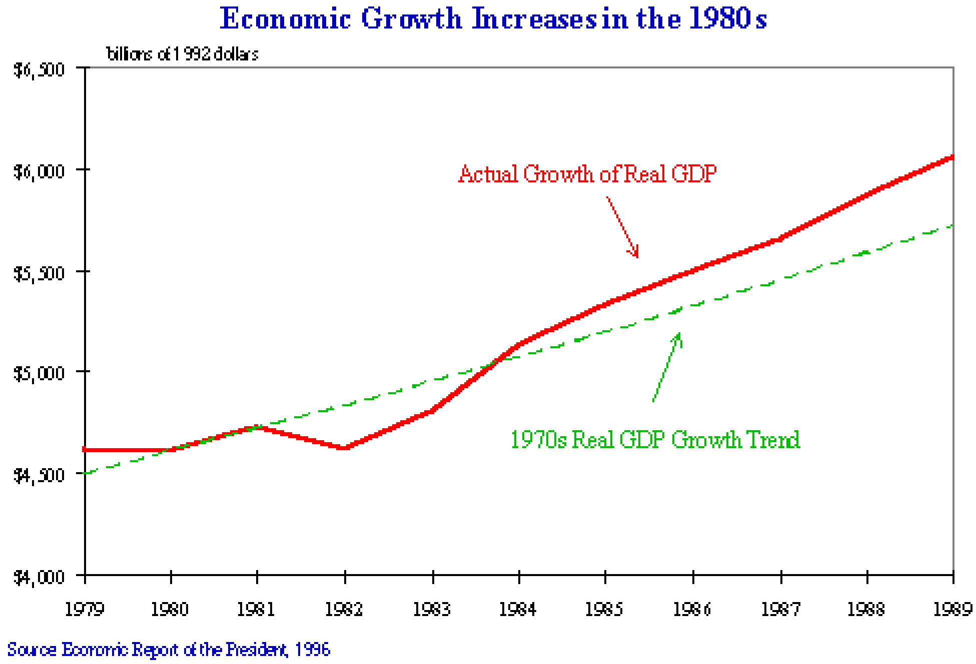
The President promises that favorable expectations will shortly bring down interest rates. It isn't going to happen. There isn't any reason for it to happen."[7]

Yet, the 1980s were a remarkable decade for economic growth. From the trough of the recession in 1982 to the peak in 1990, it was the longest **peacetime** expansion in the history of the United States. Interest rates, unemployment and inflation all fell (Figure 6). In the 1980s, real economic growth accelerated from its pace of the 1970s (Figure 7). Like the example set during the 1960s, lower taxes generated a boom in the economy that benefited the nation.

The 1980s:
Unemployment, Interest Rates and Inflation Fall

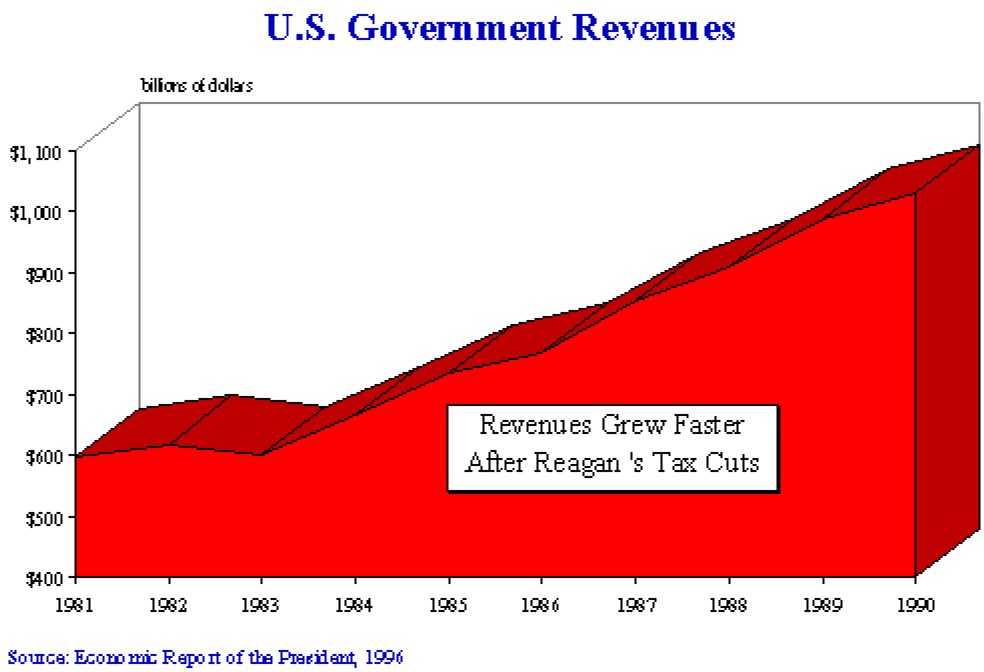


Source Economic Report of the President, 1996



As with the 1960s expansion, the expansion in the 1980s was an investment-led boom. Investment spending increases, on average, 23 percent in the first year immediately following a recession. Investment spending slows down in the second year following a recession; however, investment still grows, on average, at an annual rate of 13 percent in the first two years following a recession. In the first year of the Reagan recovery, investment grew 41 percent. In the first two years of the Reagan recovery, investment grew at an annual rate of 27 percent. The 1980s expansion saw investment spending growth almost double the post-war average for investment spending growth following recessions.[8]

A persistent complaint with the Reagan expansion was that it created high deficits. However, the revenue growth was substantial (Figure 8). The economic boom benefited the Treasury. The deficits were the result of excessive government spending. Congress consistently appropriated more money than the President requested.[9] The 1980s was an era of excessive government. An expanding portion of the nation's GDP went to the government. The lesson of the 1960s and 1980s is that deficits are created by too much spending not too low tax rates.



Economic Incentives for Growth

Some economists have begun to challenge the reasons for the success of the 1980s. Advocates of the Reagan tax cuts argued persuasively that reducing taxes would increase the returns to work, save, and invest. Opponents argued that if the tax cuts had an impact, the impact would be through increased demand stimulating additional production.

The distinction between these two positions marks a dividing line among economists. The advocates of Reagan's tax cut programs have been labeled supply-side or free-market economists. They advocated private, free market solutions to the problem of low economic growth, inflation, and high unemployment. The economists that focused upon demand stimulating production are Keynesian economists. The importance of the debate is that the two philosophies have radically different visions of the proper scope of government policy.

Keynesian Fiscal Policy

Keynesian economics gets its name from John Maynard Keynes, an economist whose major works were written between the World Wars. His major work is *The General Theory of Employment*, *Interest and Money*. The book was the major influence on a whole generation of economists. Writing in the midst of the Great Depression, Keynes saw the major problem of economics as excessive supply. The thesis of his work is that the capitalist system would periodically suffer depressions because businesses and farms would produce more goods than consumers wanted. However, Keynes offered a solution to these periodic crises. When businesses were excessive in their production, the government could provide the extra demand to handle the surpluses by increasing spending through higher budget deficits. After the crisis was solved, the government would run surpluses to pay down the debt acquired during the bad times.

Deficits could be created two ways. Either the government could hike outlays or they could reduce taxes. The important point in this view is that higher government expenditures and lower taxes were equivalent.[10] The appropriate policy for governments was to closely monitor the economy so any weakness could rapidly be solved through government action.

Free Market Policies

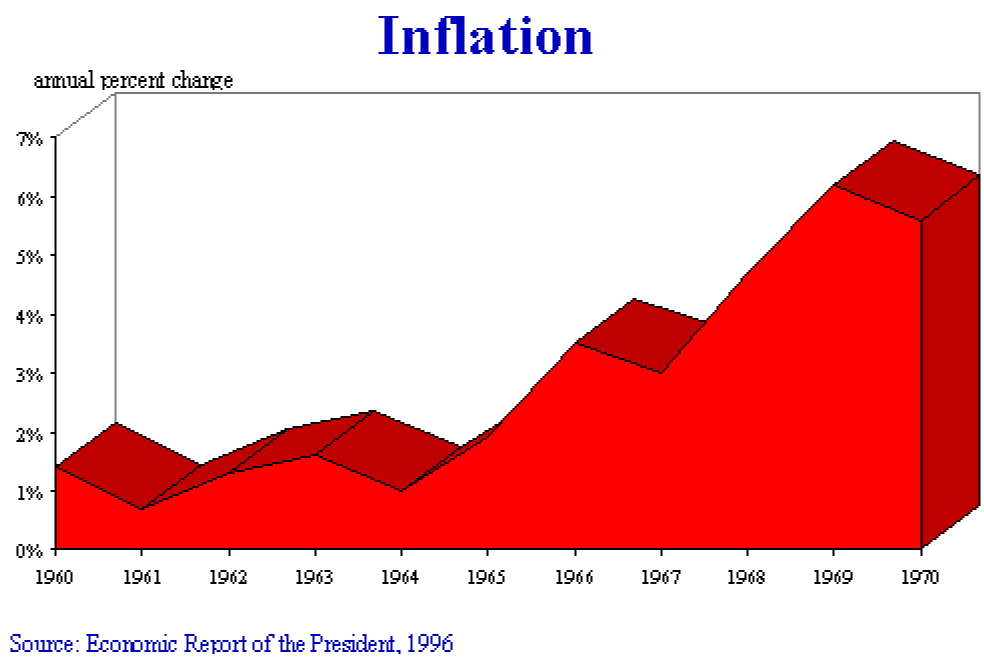
Free market theorists look at government spending differently. They recognized that taxes alter the trade-off between work and leisure. Higher taxes discouraged work and encouraged idleness. Free market economists rejected the notion that the impact on the economy is the same whether taxes were cut or government spending increased. In their view, government spending, no matter how it is financed, diverted resources from the private sector. Taxes destroyed incentives to work. Free market policies removed the primacy of the government in the economic life.

In free market theories, the appropriate policies for government actions were those that minimized the burden on the private sector. For free market economists, the first law of government policy is *do no harm*. The government needs to encourage long-term economic growth through low taxes, stable currency, and enforcement of contracts. Keynesian counter-cyclical policy is ineffectual at best and harmful at worst.

Because the two theories have markedly different policy prescriptions, the debate over the 1960s and 1980s has serious implications. If the Keynesians are correct, the size of government has little impact on the economy. If the free market economists are correct, the size of government is a drag on the economy that is harmful to economic growth. Perhaps the debate will never be settled completely, however, a look at the experience of the 1960s and 1980s lends much weight to the contentions of free market economists that high taxes discourage work, savings and investment and reduces long-term economic growth.

Inflation in the 1960s and 1980s

When the demand for an individual good rises, two things can happen: the producers, recognizing their good fortune, could increase the supply of the good, or they may not be able to satisfy the demand and prices for the good would rise. When the demand for all goods rises, two things can happen: the supply of goods increase or price of all goods, inflation, increases. A good example is the 1960s. After the Kennedy tax cuts, inflation remained low; however, when the government expanded to fight the Vietnam War, demand in the economy increased. Because there was no corresponding increase in supply, the inflation rate increased (Figure 9). In historical context, the inflation rates of the late 1960s were extraordinarily high.



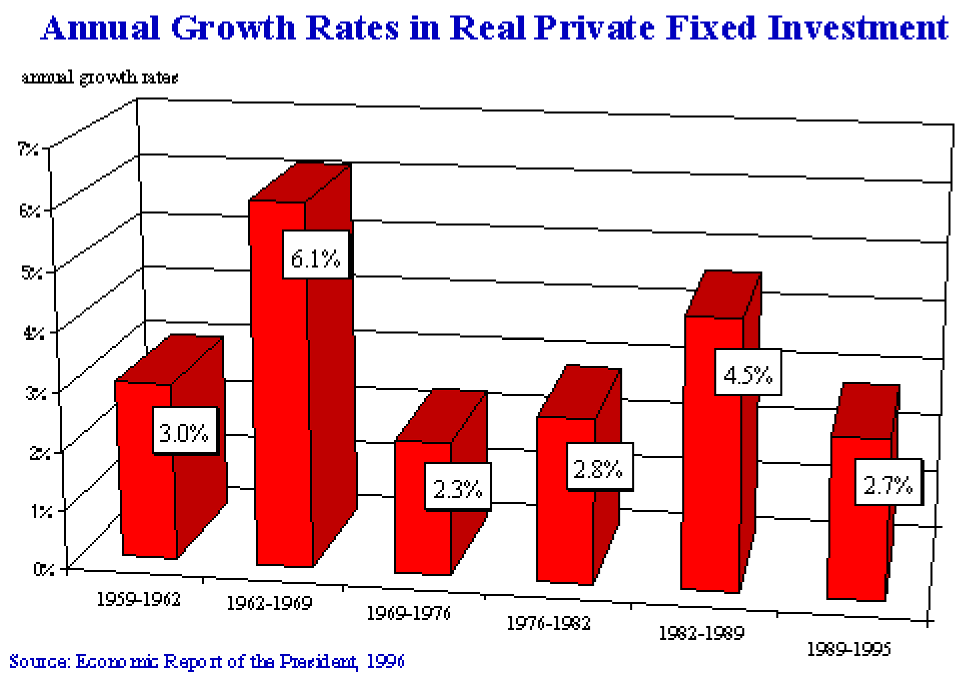
After the tax cuts of the 1980s, the exact opposite happened (Figure 6 above). Inflation fell steadily from the highs of the 1980s. The Keynesian orthodoxy held that cutting taxes would increase inflation without doing much for economic growth. Paul Samuelson, a Keynesian economist, writing in *Newsweek* predicted, "Between 1982 and 1987, the advance in the CPI will average 9.4 percent a year."[11] If the increase economic growth in the 1980s was the result of the growth in demand, one would expect to see an increase in inflation.

The inflation rate fell for two reasons. First, the Federal Reserve relearned the basic lessons of economics. Inflation is the result of excessive money supply. When Paul Volcker committed to reduce inflation by slowing the growth of the money supply, the inflation rate plummeted. Second, Reagan's tax cuts increased the incentives to work, save, and invest that increased the productive output of the economy to more than adequately meet the increase in demand in the economy.[12]

Investment

Free market theorists argue that lowering taxes on capital and work would increase work, savings, and investment. At brief look at the historical record confirms their theories. Investment performed very well after the tax cuts in the 1960s and 1980s.

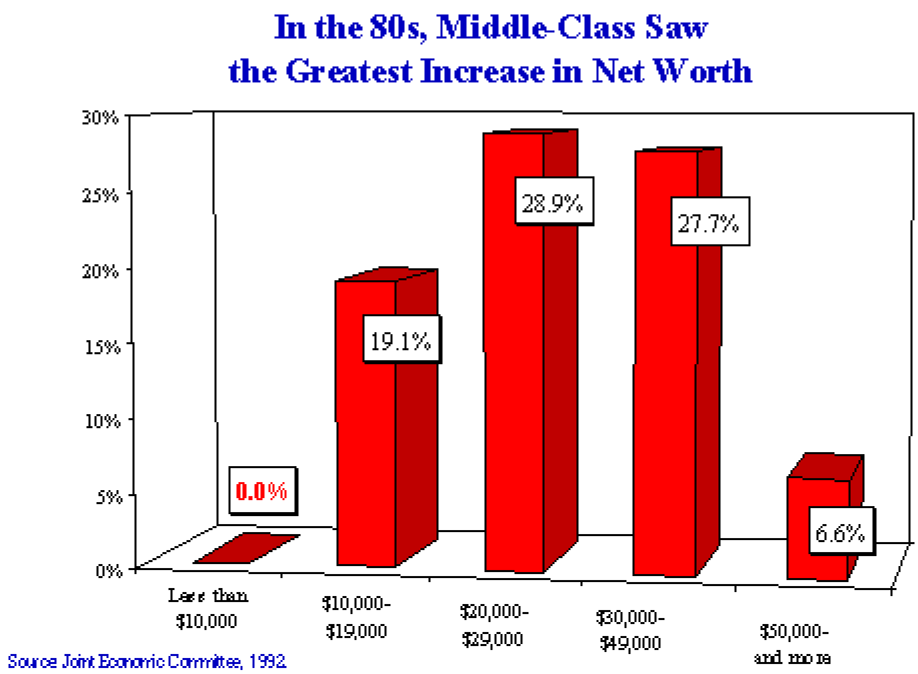
Investment not only stimulates economic growth, it also responds to individual views of the future. Investment is a forward looking endeavor. Businesses will invest only if they perceive that they will be rewarded with higher profits in the future. A healthy desire to invest will increase economic output. Figure 10 demonstrates how investments increase following the tax cuts of the 1960s and 1980s. Also, expanding investment, since it is oriented to the future, is the way we can improve the economic well-being of ordinary Americans. Increasing per capita output can only occur when labor productivity increases. Productivity increases when businesses use existing methods and machines better or businesses provide employees with additional plants or machines. Either way requires investing in fixed or human capital. Productivity increases, hence per capita output, depends crucially on investment.



Savings

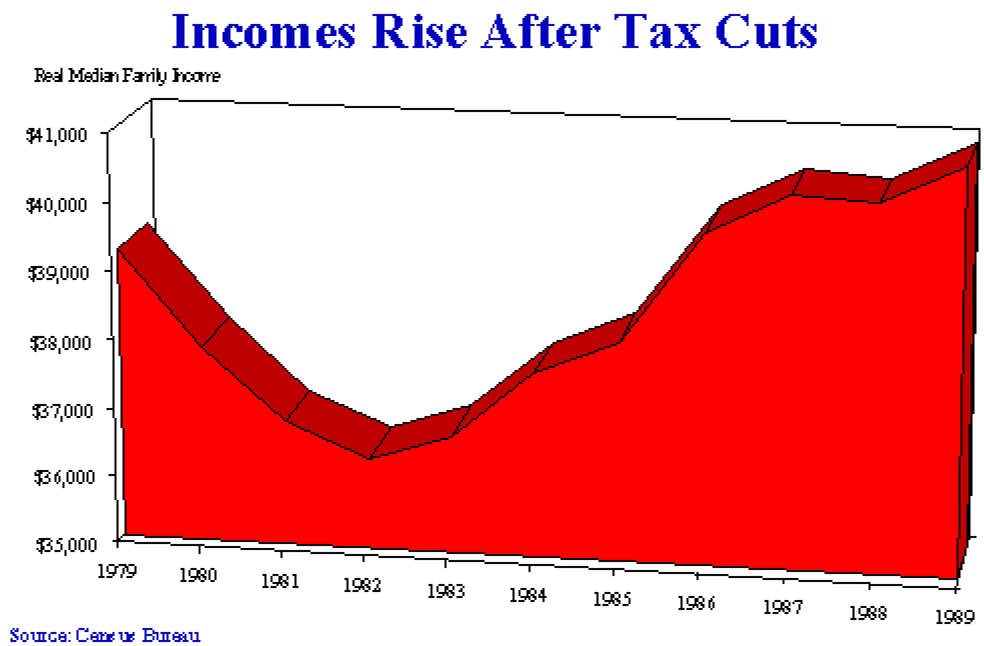
The 1980s were also a period of healthy increases in net worth. Families save in a variety of ways. They buy assets, put money in the bank, or invest in stocks. In the 1980s, there was a paradox in saving. Although the savings rate (as defined by the Commerce Department) fell, net worth rose. It seems apparent, that with the rapid increase in the stock market and home values, families changed the manner in which they provided for the future. The 1980s was one of the best decades in history for the stock market. The improved business climate translated to increased wealth for the millions of Americans who hold stock, either as individual investors or through their pension or 401(k) plans.

It is important to note that the increase in net worth was balanced throughout the income distribution (Figure 11). The 1980s are often slandered as the decade when the rich prospered at the expense of the poor. The reality is that during the 1980s, there were improvements throughout the income distribution. In fact, the improvements were better for the middle class than for the rich. As President Kennedy explained, "A rising tide lifts all boats."

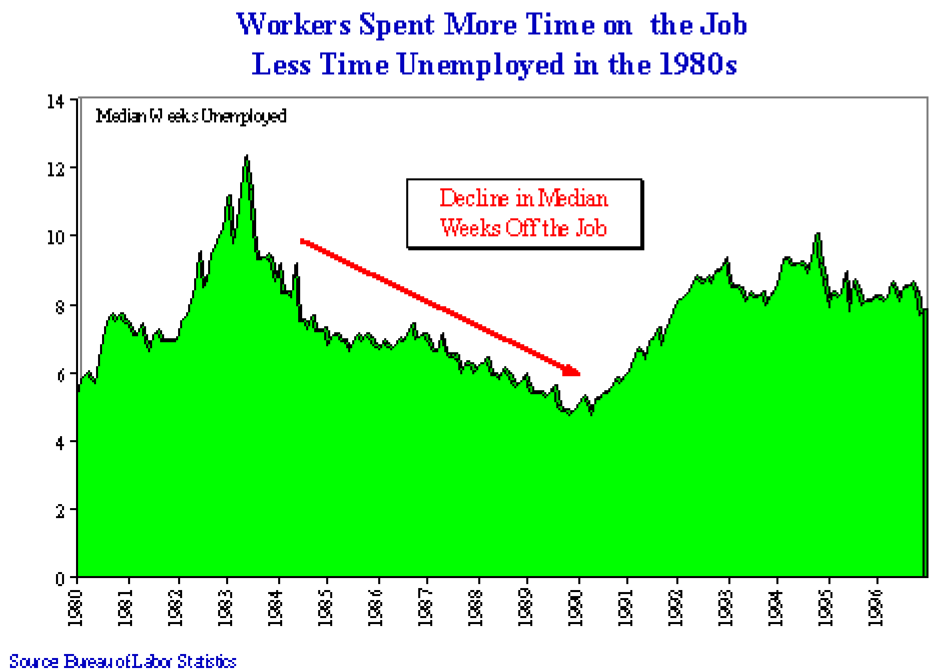


Work

The economic performance after the tax cuts of the 1980s was a welcome change for America's families. Incomes, which stagnated in the 1970s, experienced a sustained increase (Figure 12). An important reason for the increase in incomes was the ability of Americans to find employment. Employment grew 2.4 percent per year, as opposed to an increase of 1.2 percent in the 1990s. Also important, the 1980s saw a reduction in the time the unemployed stayed off work.



A key finding of free market economists is that workers respond to higher taxes by reducing their supply of labor. One way labor supply is diminished is by varying the weeks workers remain unemployed. As tax rates rise, some workers will increase the amount of leisure by staying unemployed longer. The trend in the 1980s supports the conclusion that lower tax rates will encourage workers to work instead of staying idle. The rapid job growth and the desire for people to work was partially the result of lower taxes. Figure 13 shows that the amount of time the median worker stayed unemployed fell drastically in the 1980s. The economic improvement in the 1980s touched every sector.



Conclusion

The 1960s and 1980s demonstrate the effectiveness of cutting taxes in improving economic incentives. The current economic debate has been focused on the importance of balancing the budget. Some argue that balanced budgets and tax relief are contradictory objectives. This argument creates a false dichotomy. The Kennedy cuts demonstrate that balanced budgets and tax relief are not necessarily incompatible. The example from state budgets demonstrate also show how tax cuts and balanced budgets are compatible.

Balanced budgets require a president and Congress that is committed to holding the line on spending. A balanced-budget amendment will help enormously is helping politicians find the will to say no to demands for government largesse.

The way to improve the economy is by returning more control of the economy to private citizens. The simplest way to accomplish this objective is a tax cut. The history of the American economy demonstrates to all observers the importance of low taxes. Low taxes coupled with reduced government spending and lower regulatory burden is the surest path to improve our long-term economic growth outlook.

Reed Garfield
Senior Economist

Endnotes:

1. Productivity growth was a paltry one-tenth of one percent in 1995. The lowest level since for eight years.

2. This view of fiscal policy was popular for many years as Keynesian economics.

3. Institute for Policy Innovations, 1996, *Another Look At the Kennedy Tax Cuts*, Sept. 20.

4. Kennedy, John F., 1964, *The Burden and the Glory*, p. 223.

5. Joint Economic Committee, 1982, *The Mellon and Kennedy Tax Cuts: A Review and Analysis*, p. 24.

6. This example is from Henderson, David R., 1994, "The Truth about the 1980s," *Essays in Public Policy*.

7. Moore, Stephen, 1996, "Clinton's False Prophets," *Investors Business Daily*, October 17, p. A2.

8. Lindsey, Lawrence B., 1990, *The Growth Experiment*, p. 115.

9. Institute for Policy Innovations, 1996, *Whose Free Lunch? The Truth about the "Reagan Deficit."*

10. In reality, according to Keynesian economists, government spending would be more powerful since all the additional resources the government raised would be spent and increase demand. A portion of any tax reduction would be saved so the impact on demand would be smaller.

11. Samuelson, Paul A., 1980, "Outlook for the '80s," *Newsweek*, Dec. 15.

12. See also, Niskanen, William A., 1996, "Myths About the 1980s," *Wall Street Journal*,. Nov. 5, p. A22.