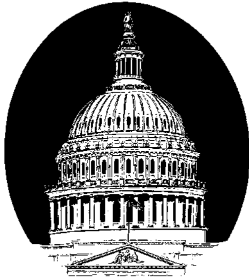

HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

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Why Supply-Side Tax Cuts Do Not Work Today

Dear Democratic Colleague:

You have no doubt heard at least once the following refrain from supply-side advocates of large tax cuts: "If tax cuts increased tax revenue for John F. Kennedy, they will increase tax revenue today." In fact, the economists who implemented President Kennedy's plan, including Walter Heller, Arthur Okun and James Tobin, believed that those tax cuts never did in fact increase revenues. But there is a very fundamental reason why tax cuts today would have much less of an impact on incentives, and on economic activity, than did those of the early 1960s.

Economic incentives are determined by the tax rate that applies to an extra dollar of earnings. The question that each individual faces is: If I exert extra effort and earn an additional dollar, how much of that dollar will I get to keep?

So imagine that you were a top-bracket taxpayer at the time of the Kennedy tax cuts, and that you had the opportunity to earn an additional dollar. Before the tax cuts, the top-bracket tax rate was 91 percent, so that an additional dollar's worth of effort would net you all of 9 cents. The Kennedy-Johnson tax cuts brought the applicable tax rate down to 70 percent, and so the same dollar's worth of effort would put 30 cents in your pocket. Keeping 30 cents instead of 9 cents was like a massive 233.3 percent pay increase (see following chart). That would be enough to get just about anyone's attention.

For perspective, consider some of the major tax-law changes since that time. The 1981 Reagan tax cuts reduced the top-bracket tax rate on capital income from 70 percent to 50 percent. That increased the after-tax take from 30 cents to 50 cents, or the equivalent of a 66.7 percent pay increase. (There was no change for income from labor in many instances, however, because the prior tax law already had a provision limiting the maximum marginal tax rate on labor income to 50 percent.) The Tax Reform Act of 1986 reduced the 50 percent tax rate to a maximum of 33 percent (with the rate as low as 28 percent in most instances), which would yield a further pay-increase equivalent of 34.0 percent.

Now look through the same lens at the Bush 2001 tax cuts, which reduced the top-bracket rate from 39.6 percent to 35 percent. That increases the after-tax reward for a dollar's worth of effort from 60.4 cents to 65 cents — which is the equivalent of a pay raise of only 7.6 percent, or about what many Americans expect to receive from their employers every year anyway. The effect of this tax cut clearly pales relative to any of the notable tax-law changes of the post-War era — especially the Kennedy tax cuts. No wonder the supply-side response to these tax cuts has been muted.

The lesson is clear. Cutting a high tax rate can make a substantial difference in the choices that individuals must face. So even though the Kennedy economists did not believe in supply-side economics, and did not believe either before or after the fact that their tax cuts paid for themselves, they did believe that reducing the highest tax rates of that day was healthy. However, we have come a very long way since then, and our tax rates before 2001 were much lower than before (and were among the lowest in the world as well). With tax rates already that low, there was simply much less "bang" left to be had by reducing tax rates still further.

You will recall that the popularizer of the supply-side notion, Arthur Laffer, described a "Laffer ***curve***" such that beyond some point, the revenue impact of further tax cuts would become negative, and revenues would begin to fall to zero. The Laffer curve was never a rigorously specified intellectual concept, but even Laffer himself recognized that the payoff to additional tax cuts would decline as the tax cuts went further and further. Still, even that very limited kernel of truth in a most ill-defined argument has been lost on the most enthusiastic advocates of today — who seem to think that there is a "Laffer ***line***" that just keeps going and going.

In sum, there is next to nothing in common between the Kennedy tax cuts of the 1960s and the Republican efforts of the last four years. The Kennedy tax cuts were a thoughtful response to a particular circumstance, and were planned within a framework that respected the need for long-term fiscal responsibility. The Republican tax cuts of 2001 through 2004 fell far short of that standard.

Sincerely,
/s
John M. Spratt, Jr.
Ranking Democratic Member

Bush Tax Cut Incentive Effect Is Limited