Reagan's tax reforms revisited

By Jeffrey Frankel

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The US has plenty of experience with irresponsible tax cuts. Yet its leaders seem not to have learned their lesson. Should Republicans secure the legislative victory they so desire, the entire country – with the exception, perhaps, of the wealthiest few – will lose.

Congressional Republicans must, President Donald Trump has commanded, pass their sweeping US tax bill by Christmas. Otherwise, they will have no major accomplishment to show for an entire year during which they have controlled the legislative and executive branches of government. Having apparently failed in their seven-year campaign to deprive millions of Americans of health insurance, they dare not fail in their Scrooge-like campaign to transfer billions of dollars from the middle class to the ultra-rich.

In an effort to rally support for the tax bill, Trump recently sought to invoke Ronald Reagan's tax initiatives of the 1980s. And he has a point, though not the one he intended. Recalling what transpired under Reagan might shed some light on the Republicans' murky current proposals.

There were actually two huge tax bills during the Reagan years – the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986 – and they differed in almost every respect. The 1981 legislation was not true tax reform, but a rushed and poorly coordinated frenzy of fiscally irresponsible cuts to both corporate and personal income taxes. The 1986 law was the well-thought-out result of an extended, deliberate, and bipartisan process, designed to be revenue-neutral, with low marginal income tax rates balanced by fewer deductions, particularly on the corporate side.

The 1986 reform was a model of how to carry out fiscal reform, whereas the 1981 process was a model to avoid. Yet it is the latter that the Republicans' current tax "reform" most resembles.

As in 1981, the current process has been rushed, with scant deliberation – the usual hearings have not been held – and not even a pretense of bipartisan cooperation. Almost every day brings news of some radical change in the legislation proposed in either the House of Representatives or the Senate. The situation is so volatile that we may not know everything the bill contains – and which special interests won out – until after it is passed.

It goes without saying that thorough deliberation is essential to good legislation, not just to secure the political buy-in of others, but also to avoid drafting errors and limit unintended consequences. Moreover, fiscally responsible reforms involve hard choices, and tend to work only if they are drafted with a spirit of shared sacrifice: "I will give up my cherished benefit, if you give up yours."

Far from pursuing careful deliberation and smart compromise, US Republicans today are pretending that the cuts for which they are striving will carry no costs. If they get their way, these self-professed fiscal conservatives will blow up the budget deficit, just as they did in 1981 under Reagan, and just as they did again in 2001 and 2003, thanks to the massive tax cuts enacted under President George W. Bush.

To be sure, the current proposals do not get everything wrong. Reducing the US corporate income tax rate would be a good move, provided that the lost revenue were recouped through the elimination of business loopholes, such as the corporate interest deduction and the favored treatment of carried interest. But the legislation cuts the corporate tax rate too much

and closes too few loopholes to achieve anything close to revenue neutrality.

But Reagan's 1986 reform prioritized working families over corporations, such as through the expansion of the Earned Income Tax Credit. The current proposed legislation does the opposite. It aims to achieve its supposedly restrained goal of limiting revenue losses to $1.5 trillion over ten years by allowing households' tax cuts to expire before the decade is over, while corporations enjoy their cuts indefinitely. Taxes on families earning less than $75,000 would rise, on average, relative to today.

Of course, today's Republicans do not admit that their plan isn't revenue-neutral. Like their counterparts in 1981, not to mention during the Bush era, they claim that the cuts will stimulate the economy so much that overall tax receipts will stay the same or even rise. Yet such claims have been rejected by virtually all mainstream economists, including the economic advisers of both Reagan and Bush. Those administrations implemented their cuts anyway – and, as economists had warned, budget deficits increased sharply.

The tax cuts that the Trump Republicans are attempting to pass today would be even more damaging. There is good reason to fear much more serious long-term consequences of the rise in the budget deficit, owing to two key issues of timing – one cyclical and the other demographic.

The 1981 tax cuts went into effect at the onset of the 1981-1982 recession, a time when some short-term fiscal stimulus came in handy. The opposite is true today. With a 4.1% unemployment rate, the US economy does not need more stimulus. In fact, the US Federal Reserve is expected to raise interest rates again in December, to prevent the economy from overheating.

Moreover, the baby boom generation is now retiring at a rate of about 10,000 people per day, meaning that Medicare and Social Security outlays – for health insurance and pensions, respectively – will increase rapidly. Despite the slowdown in the growth of *per capita* health-care costs in recent years, the Medicare trust fund is projected to be depleted by 2029, and the Social Security trust fund by 2034.

Meanwhile, the national debt held by the US public stands at 76% of GDP, compared to just 25% when Reagan took office and 46% when George H.W. Bush left office 12 years later. Total national debt, including bonds held by the Fed, stands at 104% of GDP today, compared to only 31% in 1980. In short, this is the wrong time to be increasing the budget deficit and borrowing more – particularly with interest rates set to rise further.

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