EPI Issue Brief

Issue Brief #157 Economic Policy Institute May 7, 2001

A TALE OF TWO TAX CUTS

What recent history teaches about recessions and economic policy

by Michael A. Meeropol

As slow growth continues in the U.S. economy, one of the questions policy makers are asking is whether tax cuts can be used to stave off a recession and, if so, how. The Bush Administration claims that its tax cut proposal (conceived over a year ago) is the best bulwark against an economic slowdown. Since supporters of such tax cuts often invoke historical precedent, such as the fiscal policies of past presidents, it is worth looking at previous attempts to mitigate recessions through tax policy. A close comparison of other attempts to fight recessions with tax cuts—one enacted by President Gerald Ford in 1975 and the other by President Ronald Reagan in 1981—shows that approaches that promote increased consumption by middle- and lower-income families have provided the biggest boosts to flagging economies.

Present-day Republicans, however, are promoting a tax cut that disproportionately benefits those with high incomes, the rationale being that this will stimulate the economy by increasing saving and investment. Critics of these cuts prefer smaller overall tax cuts with greater focus on relief for lower-income individuals; it is these lower- and middle-income families, critics argue, that are most likely to spend any extra disposable income and hence stimulate the economy. A look at recent history supports such claims.

Two major recent recessions—1974-75 and 1981-82—were accompanied by Republican-led tax cuts markedly different from one another both in terms of who benefited and in their long- vs. short-run focus. President Ford's tax cut in 1975 was targeted at low- and moderate-income families and helped to stimulate private consumption, putting the economy back on its feet. By comparison, President Reagan's tax cut in 1981 disproportionately benefited those at the top of the income scale and ultimately did nothing for the slumping economy until 1983.[1]

Ford's winning strategy (1974-75)

In 1974, the United States economy fell into a deep recession. Unemployment rose from 4.8% in the fourth quarter of 1973 to 8.9 % in the second quarter of 1975. For over five quarters (from the end of 1973 through March 1975) real GDP per capita fell at an annual rate of 3.8%.[2] In response, President Ford proposed a significant tax cut in early 1975, which Congress passed by March of that year.

President Ford's tax cut was clearly focused on increasing consumption. Marginal rates were not cut, and instead all taxpayers and their dependents received a credit of $30 (almost $100 in current dollars). In addition, the standard deduction was increased, and a refundable earned income tax credit was enacted. As a result, some beneficiaries of the 1975 tax cut carried no liability for federal individual income taxes.[3]

The federal budget was nearly balanced in 1974, with a deficit of less than 1% of GDP. That deficit, however, jumped to 3.4% of GDP in fiscal year 1975 and 4.3% in the following year.[4] It is clear that the 1975 tax cut, plus some increased spending in the form of extended unemployment compensation benefits, helped raise the federal deficit and increase aggregate demand. As a consequence, this deficit increase was temporary; both deficits and debt as a share of GDP fell at the close of the 1970s.

Much of Ford's stimulus was provided by an expansion in government expenditure, both on the refundable portion of the earned income tax credit and on some extensive expansions of unemployment compensation eligibility. Even though unemployment rose dramatically in 1974, the enactment of new legislation ensured that a higher percentage of the unemployed actually received compensation in 1975 than at any other time between 1967 and today. The high point was reached in April of that year, when 81% of all unemployed workers received compensation. Even as the economy recovered in 1976, the percentage of the unemployed receiving compensation averaged 67%, in marked contrast to both previous and subsequent rates. In fact, between 1967 and 1999, the 1975-77 period is the only three-year period when coverage exceeded 52%.[5]

Tax and spending changes in 1975 were designed as the first steps toward countering the 1974-75 recession and were heavily weighted toward increasing the disposable income and consumption of moderate- and low-income persons. Ironically, Alan Greenspan led President Ford's Council of Economic Advisers, which was responsible for developing this tax plan.

The results of the plan were striking. First of all, consumption as a percentage of GDP rose from an average of 61.7% in 1974 to 63.1% in 1975. It stayed at that higher level through 1979. Consumption as a percentage of disposable personal income rose from an average of 88.3% in 1974 to over 90% in 1976 through the end of the decade.[6] Meanwhile, investment as a percentage of GDP was *lower* in 1975 than it had been in 1974. It did not recover to the 1973 level until 1977.[7] In other words, as with most recession recoveries, consumption increases led and investment increases lagged. The lesson to be learned is that successful counter-cyclical fiscal policy requires tax and spending changes that specifically target increased consumption. President Ford's stimulus package did just that by targeting the low- and moderate-income families most likely to spend any extra income. After establishing this strategy, monetary policy was then designed to support the president's efforts to stimulate the economy. Nominal interest rates fell throughout 1974, and when they began to rise in early 1975, the recovery was already well under way.[8]

President Ford's exercise of counter-cyclical fiscal policy worked. A recovery began in the second quarter of 1975. Real GDP per capita had been negative for all of 1974 and was falling at an annual rate of 6.7% in the first quarter of 1975. For the final three quarters of 1975, beginning with the quarter when the temporary tax cuts

went into effect, the rate of growth of real GDP averaged over 4%. The rate of growth for 1976 was 3.8%. The unemployment rate fell to 7.7% in 1976 and continued to fall for the rest of the decade.[9]

The Reagan experiment (1981-83)

In 1981, before the recession had begun, President Reagan convinced Congress to accept a three-year tax cut. He did not justify his proposal as a way of combating recession but claimed instead that it would stimulate the "supply side" of the economy by enhancing incentives to work, save, and invest. The tax cut was heavily weighted toward reducing the tax burden of higher-income taxpayers and corporations. Its impact was also delayed—very little of the cuts actually took effect in 1981.[10]

A recession began in the fourth quarter of 1981, as unemployment rose from 7.4% to 8.2%. By the fourth quarter of 1982, the unemployment rate peaked at 10.7%. Between October 1981 and December 1982, the shrinkage in per capita GDP averaged 3.4% in annual terms.[11] In 1981 the economy needed a stimulus, just as in 1974-75, but this time none was provided. In fact, the federal deficit as a percentage of GDP actually declined in 1981, due to increased revenues resulting from "bracket creep" in the individual income tax and from scheduled increases in the payroll tax for Social Security. Nor was any extension of unemployment benefits passed.

The tax cuts of 1981 brought significant reductions in income tax collections at the high end of the income spectrum and a dramatic reduction in corporate taxes. However, the impact on consumption was virtually nonexistent. In 1982—the first year of 10% rate cuts—the federal budget deficit rose dramatically. Consumption as a percentage of GDP rose in 1982, but investment fell so much that the overall increase in aggregate demand was insufficient to lift the economy out of its recession. The recession lingered through the fourth quarter of 1982 and the unemployment rate continued to rise, reaching its 10.7% peak in the fourth quarter, just when the business cycle was in its trough.

Relative to 1975, the recession did not last much longer. It did, however, do much more damage to the economy because it was so much deeper. Unemployment was above 8% for only four quarters during the 1974-75 recession, with the peak coming in the second quarter of 1975 at 8.9%. In 1981-83, unemployment was above 8% for a full seven quarters, stretching all the way into the first four quarters of the recovery. (It is also worth noting that monetary policy may have been less expansive in 1982 than in 1975 and 1976.)[12]

Even though Reagan's tax cut was passed before the recession of 1981 began, its impact wasn't even felt until 1983 when the recovery had already begun. That same year, the federal deficit as a percentage of GDP reached 6.1%, as the second of the 10% tax cuts went into effect. So, although 1983 saw growth in real GDP, unemployment was almost as high in 1983 as in 1982, despite a continued increase in the level of consumption relative to GDP. A policy change that might have stimulated even more consumption, such as the passage of extended unemployment benefits, did not occur in 1981. The percentage of unemployed actually receiving benefits averaged only 45% in 1982 and 44% in 1983, far less than the rates in the 1975-77 period.[13]

Lessons learned

The experience of the 1981-83 recession contrasts sharply with the policy changes made in response to the 1975 recession. The main differences were that:

- the Reagan tax cut was backloaded. It had its greatest impact in fiscal year 1983 (federal tax revenue actually declined in that year).

· the Reagan tax cut was not focused on the lower- and middle-income workers whose consumption must rise in order to begin the process of recovery. It also was not combined with significant expansion of transfer payments in the form of unemployment compensation, as Ford's tax cut was.

Consumption is the main driving force that can get the economy out of a slump. Investors are notoriously conservative. Once they get spooked by a recession, they usually wait for consumption to rise again before committing to new investment projects. Investment as a percentage of GDP usually doesn't rise until long after a recovery is underway. The past tax cuts show that Ford's cut induced an investment recovery within one year, while the Reagan tax cut failed to induce any recovery for almost two.

The parallels between President Bush's proposal and Reagan's earlier failure are indisputable. Like Reagan, Bush's plan was designed well before the current signs of economic slowdown. And as in 1981, Bush's plan tries to sell the merits of supply-side doctrine that incentives can be improved by reducing marginal tax rates for those subject to income tax. But the Bush proposal goes even further than Reagan's—Bush's cuts are even more concentrated on higher-income families and are even more extremely backloaded.

As recent history makes clear, backloaded tax cuts delay the impact on aggregate demand and mute efforts to fight recessions. And tax cuts that neglect the individuals most likely to spend extra income do not work well when the goal is to combat a recession. A large share of any stimulus should be focused on low- and moderate-income families. To this end, a plan along the lines of the recently proposed "prosperity dividend"—a proposal to issue each taxpayer a one-time rebate of around $500 drawn from the federal budget surpluses—would raise aggregate demand and have the best chance of heading off any imminent recession.[14]

Endnotes

1. For details of the Ford plan, see *Economic Report of the President* (1976, 50-57). For details of the Reagan plan and its impact, see Michael Meeropol's *Surrender: How the Clinton Administration Completed the Reagan Revolution* (1998, 79-81, 91-92).

2. See the web page for *Surrender* (Meeropol 1998) at <http://mars.wnec.edu/~econ/surrender/>. The unemployment rate and rate of growth of per capita real GDP data are in Table W.4 found on that web page.

3. See *Economic Report of the President*, 1976, p. 51.

4. See *Economic Report of the President*, 1998, p. 373.

5. For data on the percentage of the unemployed receiving compensation from 1967 to 1999, see *Committee on Ways and Means, U.S. House of Representatives 2000, Green Book,* pp. 284-5.

6. See http://mars.wnec.edu/~econ/surrender/ Table W.5.

7. For investment as a percentage of GDP, see Table W. 4 at < http://mars.wnec.edu/~econ/surrender/>.

8. For the nominal federal funds rate, see Table W. 2. For the nominal prime rate, see Table W.3.

9. For the nominal federal funds rate, see Table W. 2. For the nominal prime rate see Table W.3.

10. See Table W.4.

11. See *Surrender,* pp. 79-81.

12. For data on consumption as a percentage of GDP, see Table W.5 at <http://mars.wnec.edu/~econ/surrender/>. For data on investment, unemployment, and the rate of growth of real GDP, see Table W.4. For data on the federal budget deficit, see *Economic Report of the President* (1998, p. 373). For the rate of growth of the money supply and the nominal and real federal funds rate, see Table W. 1.

13. For data on coverage of unemployment compensation, see *Green Book*, op cit. For data on consumption, see Table W.5. For data on investment and the rate of growth, see Table W.4.

14. For more details on the prosperity dividend proposal, see EPI's reports *Declare a Prosperity Dividend: A Stimulating Idea for the U.S. Economy* (2001) and *The Case for a Prosperity Dividend* (2001) by Eileen Appelbaum and Richard B. Freeman.