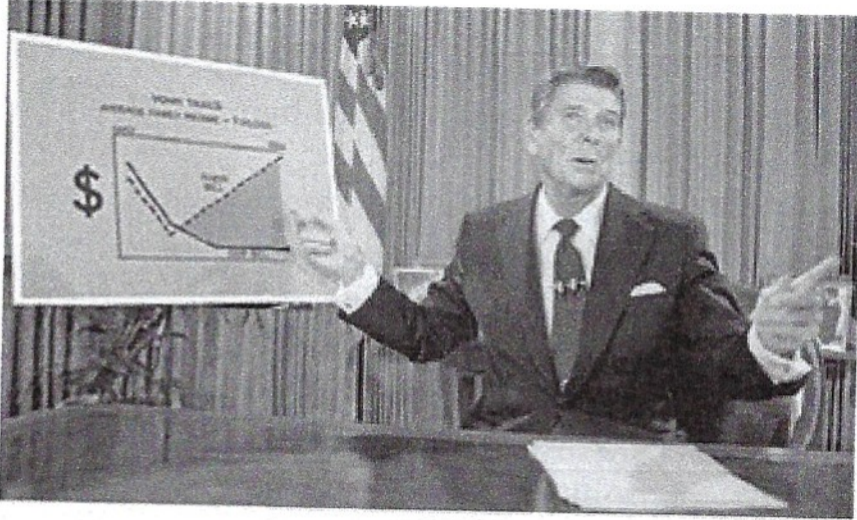


## WSJ Print Edition

*It widened the deficit—not by cutting the top rate, but purely by relieving families from automatic increases through bracket creep.*



President Reagan makes the case for his 1981 tax cut. BETTMANN ARCHIVE

### The Surprising Truth About Reagan's Tax Cut

By Phil Gramm And Michael Solon

No major economic policy in modern American history is as misunderstood or inaccurately portrayed as President Reagan's 1981 tax cuts. According to the Encyclopaedia Britannica, "the tax cuts, in fact, produced the largest budget deficit in the country's history," all to finance "tax cuts for the wealthy." That summarizes the consensus contained in virtually every historical account of the era. Note

The characterization of the tax cuts as "for the wealthy" is easily refuted by comparing relative income tax burdens before and after. Since the top 40% of income earners in America pay some 90% of income taxes, reductions in tax rates would be expected to give a larger dollar-value tax cut to people who pay the most taxes. But data from both the Internal Revenue Service and the Joint Committee on Taxation show that when Reagan took office in 1981, the top fifth of income earners paid 64% of all federal income tax, the next highest fifth paid 21%, and the bottom three-fifths paid 15%. Note

By 1985, the 1981 tax cuts, including inflation indexing of the tax brackets, had been fully implemented. The share of the individual income-tax burden had increased to 67% for the top fifth and dropped to 19% for the next fifth and 14% for the bottom 60%. By 1988, Reagan's last year in office (and after the 1986 tax reforms), the figures were 71%, 17% and 12%. Note

Incredibly, by 2022, the top fifth paid 88% of income taxes, the next fifth 13% and the middle fifth 4%. That adds up to 105%, but the arithmetic works because the bottom 40% received checks from the Treasury thanks to refundable credits like the earned-income tax credit, on net paying them a total of 5% of all income-tax collections. Note

To understand the impact of the 1981 Reagan tax cuts on the deficit, you have to understand what happened in America during the 1970s. With inflation averaging 9.3% a year from 1973 through 1980 and with 24 different tax brackets, the Congressional Budget Office found taxpayers were "paying larger fractions of their income to the federal government in income taxes, even though no legislated rise in income taxes has occurred." Note

Despite tax cuts in 1975, 1976, 1977 and 1978, inflation-driven bracket creep continued to raise the percentage of household and national income taken in federal taxes. CBO found that with the 13.3% inflation rate in 1980, "a taxpayer with two dependents, for example, earning \$15,000 [\$64,206 in 2026 dollars] and filing a joint return, would pay \$294 [\$1,258] more in federal income taxes—a 23.8 percent rise in tax liabilities— if the family's adjusted gross income and Note

itemized deductions both rose by 13.3 percent." In 1980 "single taxpayers with adjusted gross incomes of \$5,000 [\$21,402] and joint return filers with adjusted gross incomes of \$10,000 [\$42,804] experience the largest relative increases in tax liability— increases of 34 to 57 percent."

Federal revenue as a share of gross domestic product grew twice as fast from 1973 through 1980 as it had grown to that point in the postwar period—reaching 19.1% in 1980, a peacetime record. Bracket creep had become bracket gallop.

With no legislated changes in the tax code in 1979 and 1980 and a stagnant economy in 1980, which experienced a slightly negative growth rate of minus 0.2%, tax collections still spiked by 0.5% of GDP due to bracket creep from a 13.3% inflation rate. Without that bracket creep, the 1980 recorded deficit of 2.6% of GDP would have been 3.1%.

In the 1970s inflation-adjusted social welfare spending—entitlements and means-tested welfare programs—nearly tripled, but much of the cost never showed up in the federal deficit. As prices exploded, bracket-creep tax increases transferred much of the cost to the taxpayer with stealth tax increases. The budget deficits of the 1970s were, therefore, partially hidden as the surging cost of social welfare spending shifted from the federal budget to the family budget.

In the decade before Reagan took office, defense spending fell from 7.3% of GDP to 4.8%, and bracket creep pushed revenue to a peacetime high—yet surging welfare spending helped turn a budget surplus in 1969 into a 4.1% deficit as a percent of GDP by 1976. Congress, which had modestly reduced tax rates every year since 1974, responded by ending its annual tax cuts in 1978, dramatically increasing the bracket-creep taxes imposed on families in 1979 and 1980.

The most consequential omission in historical accounts of the Reagan tax cut is a failure to note that both political parties supported major tax cuts in 1981. In 1979 and 1980 CBO warned that recessionary "fiscal drag" from bracket creep would require tax cuts "to be enacted in the 1980-1984 period to provide sufficient stimulus to achieve the economic growth targets." When CBO's forewarned recession began in January 1980 and double-dipped in July 1981, Democrats conceded that a major tax cut had to be passed. House Ways and Means Chairman Dan Rostenkowski's proposed alternative to the Reagan tax cut was slightly larger through 1983, the year the deficit peaked, but its 1984 tax cuts were conditioned on levels of inflation, interest rates and deficits nobody believed would be met, and the Democratic alternative didn't index the tax brackets for inflation.

When inflation plunged to 3.2% in 1983, a year for which CBO had projected a 9% inflation rate, bracket-creep revenues collapsed and the deficit soared to 5.9% of GDP. By 1985 income- tax rates had been cut by a quarter, and the tax brackets had been indexed to eliminate bracket creep. The economy was in its third year of rapid growth. Compared with 1980, defense spending was 1.1% of GDP higher, nondefense spending was 1.2% of GDP lower, and the deficit was 2.4% of GDP higher—all without the 1980 inflation revenue gain of 0.5% of GDP produced by bracket creep.

The day Reagan left office, the American economy was one-third bigger than when he arrived. Tax rates had been cut and tax brackets indexed to eliminate bracket creep. Nondefense spending was 2.5% of GDP less than it had been the day Reagan took office, and defense spending was 0.9% bigger.

The deficit was 3% of GDP—up from 2.6% in 1980. But revenue from bracket creep narrowed the 1980 deficit by half a percentage point. That means the entire increase in the deficit during the Reagan presidency resulted from the abolition of bracket creep—which by definition doesn't help anyone rich enough to be already paying the top rate. The untold story of the Reagan era is that the cost of financing the welfare spending explosion of the 1970s was always there but much of it did not show up in the federal budget deficit. Inflation-created bracket creep took the money from taxpayers to cover much of the cost without Congress ever voting to raise taxes. The full cost of making America a welfare state wasn't fully recorded in the federal budget deficits of the 1970s because inflation and bracket creep tax increases transferred much of the cost to the family budget.

When the Reagan program helped bring 40 years of relative price stability and indexed incometax brackets, the cost of the explosion in social welfare spending became the driving force in increasing the federal budget deficit and has been ever since. Even though the level of general prosperity has improved dramatically since 1988, sending real per capita income up by 80%, real means-tested welfare spending has more than quadrupled, rising from \$283 billion in 1988 to \$1.435 trillion in 2024 (the last year data are available).

The legacy of the Reagan program is that by reversing the growth of the welfare state and cutting tax rates, Reagan gave the nation 25 years of prosperity. The Reagan defense buildup brought down the Berlin Wall, won the Cold War and yielded the peace dividend that enabled President Clinton to balance the budget. And the budget deficit grew only because families were protected from automatic tax increases triggered by inflation.

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