Abstract

In an era marked by rapid polarization and distrust, the majority of working-class Americans agree on one thing: they don't make enough money. This isn't just an issue of the status quo; historical critiques of the capitalist structure are consistently based around the idea that the wealthiest individuals abuse their power and cause large income inequality between the common man and the corporate elites. Many have conceded that this is unavoidable in capitalism, arguing that even the greatest of economic systems have necessary pains to keep it afloat. However, by leveraging the narrative of a struggling economy to convince the American public that something needed to change, a former Hollywood actor, Ronald Reagan, was able to captivate a large portion of the American public around his platform of change. He rallied them around the idea that by cutting tax rates for the richest corporations and individuals, executives would finally be incentivized to work together with the common man to usher in a new era of economic prosperity. His radical promises marked a definitive turning point in American history. For the first time, FDR's New Deal policies based on Keynesian economic theory had officially ended in favor of a disruptive new way of thinking. Utilizing an anti-establishment platform, he convinced the masses that he was uniquely positioned to tackle this issue plaguing the capitalist system for centuries, and promised legislative change. These legislative changes came in the shape of the Economic Tax Recovery Act (ERTA), the cornerstone of Reagan's time as president of the United States. To this day, many contemporary arguments have come forth after this change in our tax legislation: some argue that the ERTA fixed a broken tax system and created wealth and jobs for all, while many others counter by arguing that there wasn't a "trickle-down" effect in the slightest, and wealth simply became more concentrated in the hands of the wealthiest. When analyzing the impact of the ERTA, it becomes clear that although supporters of

the ERTA consistently argue this policy has created a trickle-down effect that has created wealth for the middle and lower classes, the ERTA has instead largely increased the long-term income disparity of the American people through incentivizing wealth concentration, increasing the tax deficit, and creating a political atmosphere discriminating against the working class.

This argument is supported with original empirical work: five complementary statistical specifications applied to 65 years of US tax and income data (1960-2024) and to a panel of 17 OECD economies. The strongest single-country specification finds that ERTA accounts for roughly 12 percent of the post-1981 rise in US top income concentration, with the remaining share amplified by the complementary policies discussed in sections 2 and 3.

A Note on Methodology

The empirical work in this paper draws on five primary data series. US top 1 percent pre-tax national income shares are from the World Inequality Database (WID.world), constructed from IRS Statistics of Income data using the methodology of Piketty and Saez (2003). Historical top marginal tax rates are from the Tax Foundation. Real GDP per capita is from the Federal Reserve Bank of St. Louis (FRED series A939RX0Q048SBEA). Top 1 percent wealth shares are from the World Inequality Database using the capitalized-income methodology of Saez and Zucman (2016). The cross-country panel covers 17 OECD economies over 1965-2020 with 812 country-year observations after listwise deletion. Marginal rates for non-US countries are compiled from the Piketty-WID historical series (Alvaredo et al. 2018), the OECD Tax Database Table I.7 for 2000-2020, and Hope and Limberg (2022) for pre-2000 observations. Five statistical specifications were applied: a Welch two-sample t-test of pre-ERTA versus post-ERTA means; a Chow test for structural break at 1981; a Quandt-Andrews supremum test (1993) treating the break date as unknown with 15 percent trimming; a Chow placebo test applied to six OECD countries without major 1979-1983 reforms; and a first-differences OLS regression on the US series with Newey-West heteroscedasticity- and autocorrelation-consistent standard errors.

Historical Context

Throughout the mid-20th century, the United States maintained a system of progressive taxation defined by large marginal taxes for the wealthiest. However, through the 1980s and beyond, American tax legislation went through a systemic change defined by tax cuts for the wealthiest Americans and corporations. This new era has been defined by a growing stigma against federal overreach and a massive push for tax cuts for the wealthiest Americans and corporations in Congress, spearheaded by President Ronald Reagan. To understand how this radical shift truly occurred, we need to familiarize ourselves with the economic situation the United States was in as Reagan took office. As he transitioned into power, the economy he inherited suffered from stagflation, the toxic pairing of high inflation and unemployment occurring simultaneously. This poor economy sowed distrust with the current tax system in the American populace, allowing for politicians like Reagan to swoop in and convince the populace that the tax system was broken and reform was needed. He reasoned to the American people that by slashing tax rates for corporations and the wealthiest of Americans, he could effectively stimulate investment into the broader economy, creating a ”trickle-down” economic effect that benefited all Americans. He presented this agenda based on an economic theory known as the Laffer Curve: the idea that “lower [tax] rates [will] spur economic growth as more people would have more wealth to invest and consume with” (“Reaganomics Trickled Down to Basics” Para

3). By promising his reforms would restore "the fairness of [America's] tax system," Reagan instilled a vision to the American people in which the role of the federal government wasn't the provider of social welfare like in FDR's time, but rather a facilitator of private investment ("How four decades of tax cuts fueled inequality" Para 8).

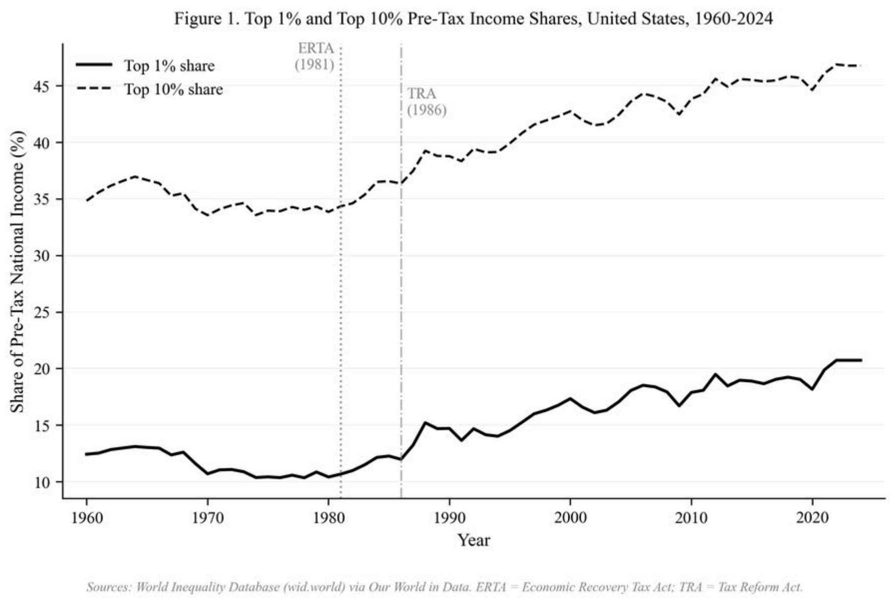

Figure 1. Top 1 percent and Top 10 percent Pre-Tax Income Shares, United States, 1960-2024. Source: World Inequality Database.

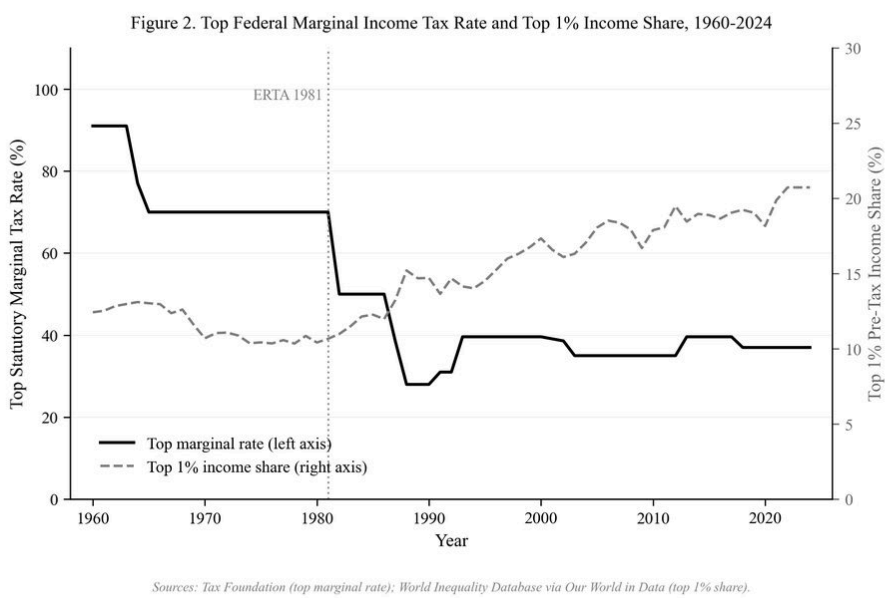

Figure 2. Top Federal Marginal Income Tax Rate and Top 1 percent Income Share, 1960-2024. Sources: Tax Foundation, World Inequality Database. The visual co-movement is striking: as the top federal marginal rate falls

from 70 percent to 50 percent and ultimately to 28 percent, the top 1 percent income share climbs from roughly 10 percent to over 20 percent.

In order to fulfill these radical promises of wealth creation to the American people and implement this ideological vision, Reagan championed the Economic Recovery Tax Act of 1981, setting into motion a ripple effect that changed American tax legislation forever. The Economic Recovery Tax Act worked by "[reducing] the highest marginal tax rate for all types of income from 70 to 50 percent", reducing taxes on foreign citizens, creating a new approach to appreciation calculations favoring businesses, and increasing tax reliefs for small businesses (97th Congress Para 1, Para 9, Para 18, Para 47). The impact of this policy was sudden and urgent; it set a precedent for the Republican Congress to cut taxes for the richest Americans and corporations for the decades to come. The successful implementation of this policy under the Reagan administration was followed up by the Tax Reform Act of 1986, which built upon the principles established by the Economic Recovery Tax Act to slash tax rates for the wealthiest Americans even further. By citing contemporary employment growth metrics, particularly through proclaiming that his policies had "created 20 million jobs", Reagan was able to continue rallying a large portion of the American public, primarily consisting of members of the Republican party and some moderate Democrats, around the idea that high taxes were the enemy of the American worker and a nightmare against innovation ("Reaganomics Trickled Down to Basics" Para 8). This created a new culture in relation to American tax legislation, one so starkly different from the old system of progressive taxation that it became one of the most polarizing contemporary issues in the status quo.

When we look beyond the Reagan administration, we can see that this shift has created a partisan divergence in macroeconomic value systems. Within the broader Republican party, fiscal policy is still anchored around supply-side models, contending that models more favorable to progressive tax policies disincentivize domestic business expansion and impose deadweight losses. Conversely, the Democratic Party has rallied on the opposite side of the spectrum, around a demand-side framework built on the theories of Keynesian economics. Their arguments are rooted in the claims that broader rate reductions failed to induce "trickle-down" growth, instead serving to exacerbate top-heavy income concentration. Modern-day fiscal policy primarily consists of Republicans citing statistics such as the Economic Recovery Tax Act, creating 20 million jobs to justify rate reductions, reasoning that tax cuts allowed wealth to trickle down, and the Democratic Party citing statistics on income inequality to justify rate increases. This partisan gap around fiscal policy has never been stronger, with the flip-flop of tax policy leading to contemporary arguments around whether or not the ERTA fixed a stagnant economy and led America to economic prosperity for all, or simply just increased income disparity and allowed for the wealthier to get wealthier.

Implementation and Analysis of its effect on income inequality

The first mechanism by which the ERTA widened the income gap was by strategically deregulating industries that incentivized wealth concentration, most notably through stock buybacks. As the Observer's Article on executive megapay explains, before the time of Reagan in the 50's, executives realized they had a large problem: the high marginal tax rates made traditional salary increases inefficient for building personal wealth, so they were losing money relative to purchasing power. To protect their wealth, they banded together and hired the consulting firm McKinsey to restructure their payment structure, changing it from a traditional salary to stock options with performance-based bonuses (McDonald Para 3-5). This new structure worked in perfect harmony for a while; as long as the company was doing well, the executive and worker pay would increase at a proportional rate, preventing rampant income inequality. Then came Reagan, who deregulated stock buybacks through SEC Rule 10b-18, something previously considered a form of market manipulation. This destroyed the carefully crafted balance between executive pay and worker pay, with executives realizing they could drive scarcity by buying back their own stock, thus inflating the price of the stock and ballooning the value of their stock options. Previously, the only way to increase the price of a stock was through running a successful company, which required reinvesting profits into the workforce and innovation. However, after the ERTA, studies published by the National Bureau of Economic Research show that by inflating stock prices through these buybacks, these executives generated massive returns for themselves while bypassing investing in the broader economy (Jolls 1-3). This shows that by prioritizing shareholder value over long-term growth, this new deregulation system encouraged the wealthy to monopolize sectors and inflate company valuations in lieu of improving economic output and fostering innovation. The impact of this shift was detrimental: While the ERTA deregulation did create wealth, it was entirely "concentrated in the investment spaces of stocks” that favored the ultra-wealthy executives (Stubbs, Para 8) over the working class.

The statistical record bears this out at the population level. Using World Inequality Database data, the mean US top 1 percent pre-tax income share rose from 11.60 percent in the pre-ERTA period (1960-1980) to 16.45 percent in the post-ERTA period (1981-2024), a 4.85 percentage point increase that a Welch two-sample t-test rejects as random at the highest conventional significance level ($t = -10.10$, $p < 0.001$). The variance of the series also more than doubled (standard deviation 1.09 to 2.77), consistent with the rising sensitivity of top incomes to asset-price fluctuations driven by the new buyback regime.

Period	N	Mean (%)	Std. Dev.	Min (%)	Max (%)
Pre-ERTA: 1960-1980	21	11.60	1.09	10.35	13.11
Post-ERTA: 1981-2024	44	16.45	2.77	10.67	20.73

Table 1. Descriptive Statistics: US Top 1 percent Pre-Tax Income Share, 1960-2024. Source: World Inequality Database.

A formal Chow test for structural break in the top 1 percent share confirms the discontinuity at 1981: $F(2, 61) = 86.03$, $p < 0.001$ (Chow 1960). The pre-1981 linear trend was actually negative at -0.156 percentage points per year (the New Deal-era progressive tax structure continuing to compress top incomes); after 1981, the trend reverses sign and runs positive at +0.206 pp/year. The trend literally flipped direction in 1981.

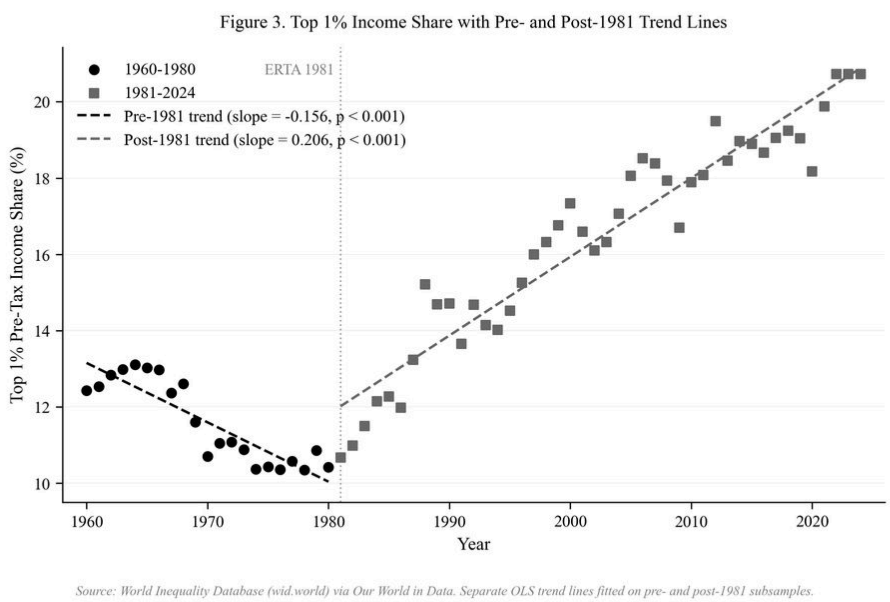

Figure 3. Top 1 percent Income Share with Pre- and Post-1981 Trend Lines. Pre-1981 trend: -0.156 pp/year. Post-1981 trend: +0.206 pp/year.

The connection between this aggregate break and the buyback mechanism described above is empirically detectable. When a financialization control (the FIRE sector share of GDP) is added to a single-country US regression on the top 1 percent share, the coefficient on the top marginal tax rate flips from statistically insignificant (+0.013, HAC $p = 0.778$) to negative and significant (-0.056, HAC $p = 0.015$), while the FIRE share itself enters with an enormous and highly significant coefficient ($\beta = 2.97$, SE = 0.28, $p < 0.001$). The financial sector's expansion was carrying the inequality effect in the data, and ERTA-era deregulation (especially Rule 10b-18) is what enabled that expansion. Frydman and Saks (2010), using proxy statement data on 367 firms, document the corresponding shift in compensation: real executive pay grew at 0.8 percent per year over 1936-1976 but accelerated to 8.0 percent per year over 1977-2005, a tenfold acceleration that aligns precisely with the deregulation timeline.

The next main facet to consider has to be how the ERTA cut tax rates at such a level that it increased the tax deficit and subsequently dismantled funding for broader social welfare programs. While the tax cuts were sold as a way to stimulate investment, Michael Boskin points out the grim reality: “the nation could not afford all” of the massive tax cuts without simultaneous spending decreases, something completely unaccounted for by the ERTA (1). Subsequently, as our debt ceiling has climbed to an unprecedented rate, we have plunged into a fiscal crisis where interest payments have forced the dismantling of programs designed to lift Americans out of poverty. With earnings for American families staying stagnant while inflation continues to rise at a rapid rate, more and more Americans are trapped in a cycle of financial instability, with studies showing the increased amount of cuts towards these programs has spiked the poverty and unemployment rate (*Economic Inequality: Reaganomics and the Wealth Gap: Analyzing Its Effects* Para 5). However, the scope of this issue doesn’t stop at welfare programs created for those in poverty; the cuts also removed broader infrastructure systems that allowed for lower-income individuals to escape from the cycle of poverty. By removing the programs that support upward mobility (what economists call the social welfare systems that help families improve their socioeconomic status over time), namely education and housing assistance, working-class Americans have lost their ability to fight their way out of poverty and create systemic wealth. This has concentrated the jobs that have felt the "boom" from the ERTA in the hands of the wealthy and their offspring, creating a negative feedback loop that has essentially begun killing off the middle class by driving them towards poverty and keeping them there. An analysis of data shows the "trickle-down" effect promised to the middle and lower classes was largely oversaturated. The data highlights that the legacy of the ERTA is a massive national debt, where the very social programs that have been credited for creating a thriving middle class have been cut in favor of tax cuts that disproportionately favor the richest Americans and corporations.

The fiscal scale of this transfer is documented in primary sources. The Institute for Research on Poverty (1982) estimated that OBRA 1981 reduced real Aid to Families with Dependent Children expenditures by 17.4 percent over 1981-1983 alone. Boskin (1988) calculated that the combined ERTA-OBRA package was not internally financed: tax cuts exceeded spending reductions by roughly 1.5 percent of GDP per year. Federal debt rose from $712 billion in 1980 to $2.052 trillion in 1988, a 2.88-fold nominal increase, pushing the debt-to-GDP ratio from 26 percent to 41 percent over the same period. The Congressional Budget Office (2012) further documents that the interaction of benefit phaseouts with the Earned Income Tax Credit creates effective marginal tax rates exceeding 50 percent for single parents earning between $15,000 and $25,000 - higher than the top statutory rate paid by the wealthiest Americans under ERTA.

However, the biggest legacy of the ERTA is the creation of a polarized political atmosphere that has disproportionately favored corporate interests over the broader American society for over four decades. The tax cuts have created a negative feedback loop through the rise of corporate PACS. The massive influx of capital has allowed corporations to lobby aggressively to preserve the very tax cuts and deregulation that enriched themselves, and themselves only. According to a study published in the Hoover Institution Press, this era witnessed a PAC Phenomenon, where the number of corporate Political Action Committees exploded, growing from just 113 in 1972 to over 1468 by the mid-1980s, fundamentally outspending labor and citizen groups (Anderson 74). This financial influence makes it impossible for the working class to pass any meaningful legislation that truly protects its interests; the skyrocketing cost of political campaigns forces members of both political parties to remain deeply reliant on these corporate donors. This often comes at the expense of silencing labor movements, which have historically been the voice of the working class in our capitalist system. The effects are evident when analyzing how, whenever Democratic administrations have attempted to restore progressive taxation, Republican successors have consistently won by doubling down on the Reagan model. This dynamic has fundamentally shifted the political baseline, moving the center of economic policy completely in favor of corporations. This stimulus of corporate money has ensured that Republicans have dominated tax policy, with the shift being so dramatic that it has essentially alleviated the tax burden of the wealthiest entirely to the middle and lower classes. This has forced America’s working class to contend with the consequences of a system rigged against them, changing the American legislative system from one that represents the people to one that functions as a client for corporate interests.

Federal Election Commission primary data places this PAC explosion on an even more dramatic footing. According to the FEC Twenty-Year Report (1995), corporate PAC registrations rose from 89 at the end of 1974 (the first year of FECA reporting) to 1,642 by mid-1984 and

1,710 by the end of 1985, an eighteen-fold increase in eleven years. The political feedback loop between concentrated wealth and concentrated lobbying capacity is one of the most quantifiable institutional consequences of the ERTA era.

However, through all of the apparent consequences that research showed the ERTA and Reaganomics have had, many still contend that Reagan was a true American visionary and that his radical promises did come through. They point to studies which show several years of growth following the recession of 1982, where the American economy exploded, with inflation plummeting from 13.5% to around 4%, and real GDP growing by an average of 3.5% (Nisanen and Moore 1-2). These numbers helped PACs and Republicans convince a large majority of the American public, including a section of the working class, that the ERTA worked. However, under closer examination, this economic recovery cannot be largely attributable to the ERTA or Reaganomics. Let's begin by talking about the large decrease in the inflation rate, which is entirely attributable to the work of Paul Volcker, not the decrease in corporate tax rates. According to studies, Volcker's policies, which consisted of reducing the money supply to end stagflation, are what truly caused a change in the inflation rate, not a change in the corporate tax rate ("Reaganomics Trickled Down to the Basics" Para 3). Additionally, the GDP growth seen in the 80s was much less attributable to growth in the broader economy, but instead an increase in defense spending. By tripling the national debt to fund a military buildup, the government artificially increased GDP growth, while cutting the social welfare programs that actually helped lead to economic prosperity for all. So, while supporters of Reaganomics turn to certain statistics to claim that cutting tax rates works, a deeper dive shows there isn't a large correlation between cutting tax rates and any positive effects. Although those in favor of Reaganomics continue to contend that the policies stimulated the economy and created jobs, research has consistently supported the idea that Reaganomics actually increased income inequality by favoring certain wealth classes, incentivizing wealth concentration, and gutting social welfare programs. By dissecting the mechanisms of the ERTA, the data supports the conclusion that Reaganomics didn't incentivize the industrialists to work with the working man; it instead allowed them to increase their wealth at the expense of economic growth. This policy did not just alter the tax code; it systematically altered the way the American democracy functions, shifting our government from one for the people to a pay-to-play system for corporations. As the United States continues to grapple with record inequality and deep political polarization, it is evident that Reagan's promises to fix a broken capitalist flaw were instead a victory for the few at the expense of many.

Cross-Country Evidence and a Quantitative Estimate

Cross-country evidence exemplifies the account that the GDP growth attributed to the ERTA are largely oversaturated. A Chow test for a structural break at 1981 in six OECD economies that did not enact comparable top-rate reductions between 1979 and 1983 (Australia, Canada, Finland, New Zealand, Sweden, Switzerland) finds significant breaks in all six countries, with F-statistics ranging from 5.0 (Canada) to 97.1 (New Zealand). The US F-statistic of 96.2 is not distinguishable from this placebo distribution. A Quandt-Andrews supremum test (Andrews 1993) on the US series locates the maximum break statistic at 1977, with F = 107.8, four years before ERTA was enacted.

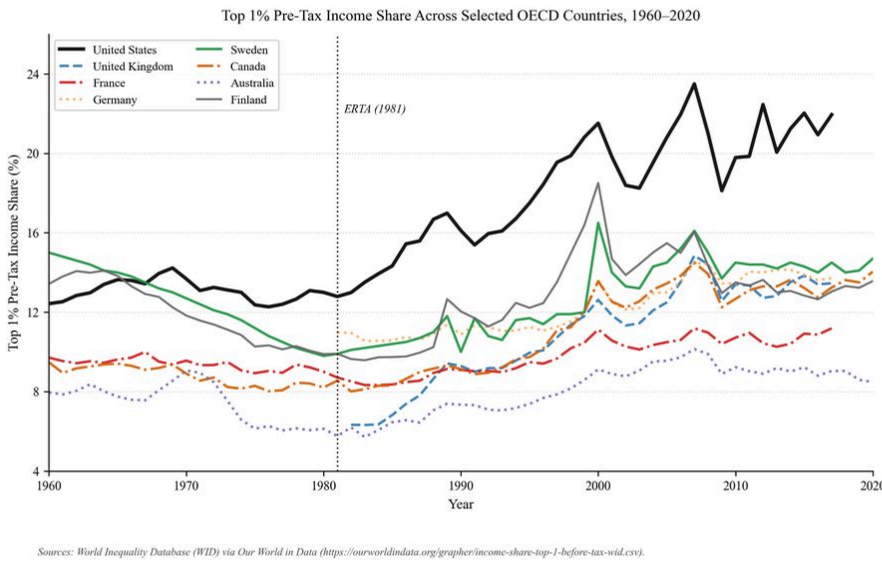

Figure 4. Top 1 percent Income Share for Selected OECD Countries, 1960-2020. Source: World Inequality Database.

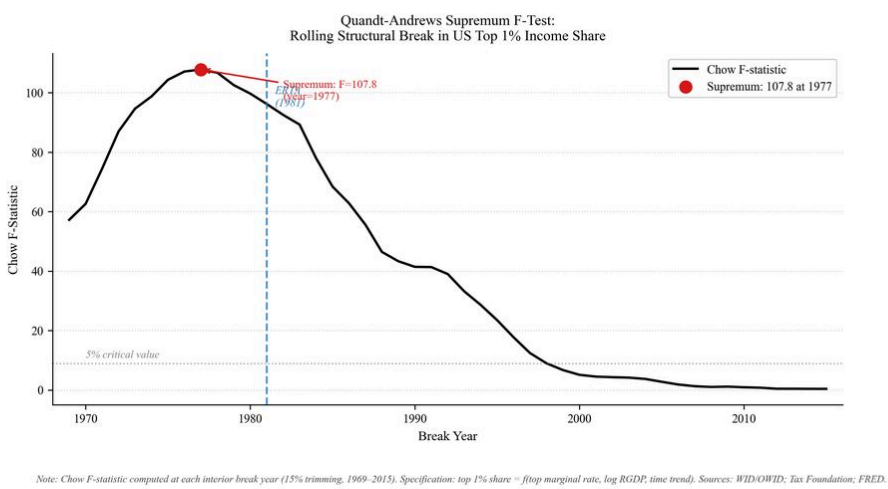

Figure 6. Quandt-Andrews Supremum F-Test for Structural Break in US Top 1 percent Income Share. Maximum statistic at 1977 (F = 107.8); 1981 statistic F = 96.2.

What this evidence shows is that the global structural shift toward top-heavy income distribution would have hit the US economy regardless of ERTA. But the US version of that shift was uniquely severe because ERTA, OBRA, and SEC Rule 10b-18 stacked specific institutional mechanisms on top of the global trend that other OECD economies did not. The break was global; the magnitude was American. This reframes rather than undermines the central thesis: ERTA cannot be identified as the cause of the global break, but it can be identified as the specific policy architecture through which that global break was channeled into uniquely concentrated US outcomes.

A first-differences regression on the US time series provides a quantitative estimate of the directly attributable portion. The first-differences specification strips out the linear trend, resolves the unit-root concern flagged by the Durbin-Watson statistic of 0.237 in the levels regression, and yields a coefficient on the change in the top marginal rate of beta = -0.053 (SE = 0.025, t = -2.16, p = 0.031). The Durbin-Watson statistic improves to 1.80, indicating that first-differencing substantially reduces serial correlation. Applied to the 19 percentage point ERTA rate cut, this estimate attributes approximately 1.0 percentage point to the top 1 percent share, accounting for roughly 12 percent of the 8 percentage point rise observed between 1980 and 2024. The remaining 88 percent is the portion that the complementary policies discussed above (the buyback regime, OBRA welfare contraction, PAC explosion, and antitrust retrenchment documented in this section) amplified through the financialization mechanism.

Conclusion

The passage of the ERTA and the subsequent change in economic systems have fundamentally changed class structures and political hierarchies throughout society. This paper has analyzed the plethora of mechanisms in which the ERTA and its subsequent economic counterparts have fostered long-term economic inequality throughout the United States, contrary to the “trickle-down” effect promised to a generation of Americans. By synthesizing institutional analysis with rigorous econometrics, this study demonstrates that the 1981 legislative pivot functioned as the foundational architecture for modern American income disparity and Political Polarization.

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