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HEALTH CARE BRIEFING PAPER

December 11, 1991

NO. 3

Prepared for Richard K. Armey (R-TX),

Ranking Republican, Joint Economic Committee

GOVERNMENT AND THE U.S. HEALTH CARE MARKET: AN OVERVIEW

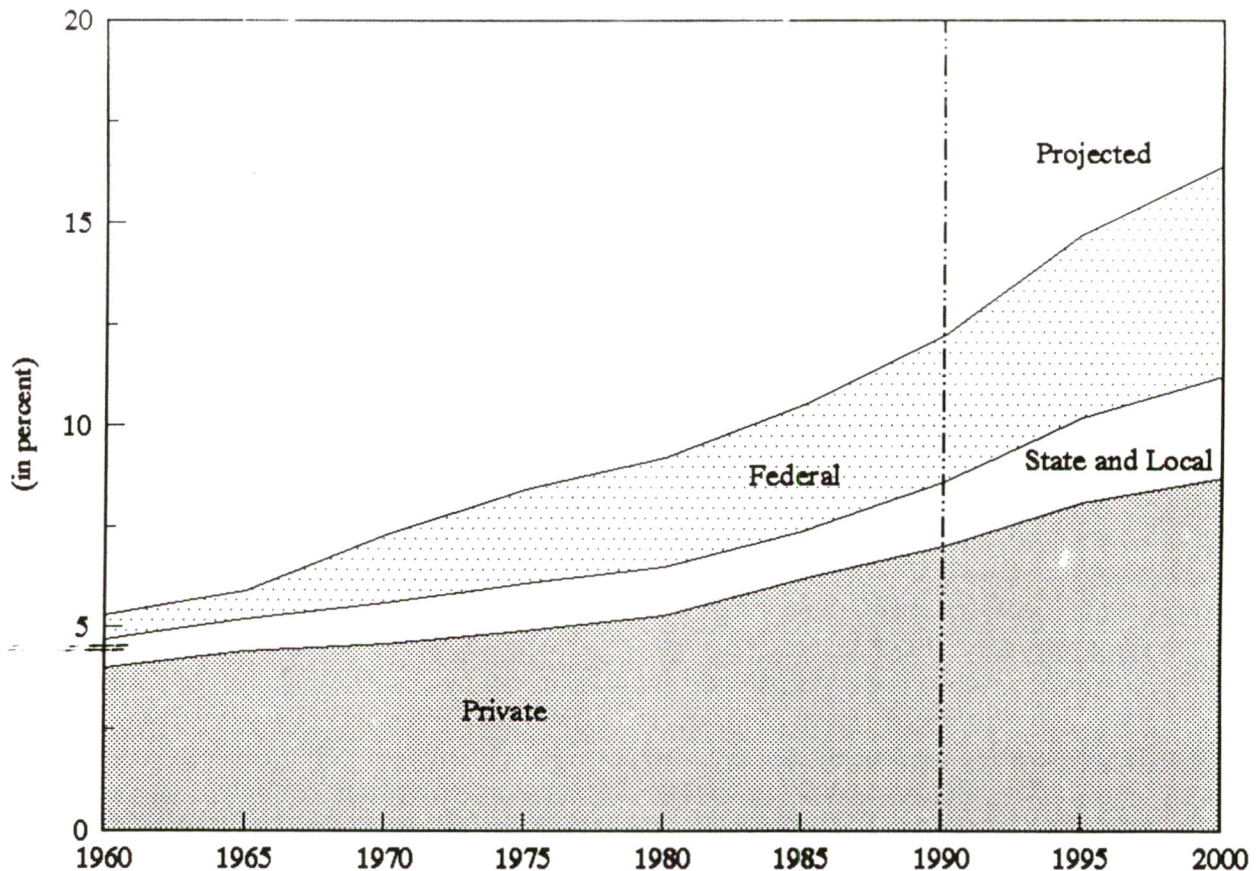
INTRODUCTION

In 1990, total U.S. spending on health care reached \$666.2 billion, an increase of 10.5 percent ~~from~~ the 1989 level. This growth is slightly lower than the 11.1 percent increase from 1988 to 1989, but is still more than twice as fast as the 5.1 percent for the economy as measured by gross national product (GNP), and represents the sixth consecutive year when growth in health spending outpaced growth in the economy. In fact, health care spending has grown faster than the overall economy in 29 of the last 30 years. As a result, as indicated in Graph 1, health care spending absorbed 12.2 percent of the GNP, the highest portion ever achieved and the second largest annual jump since 1960, up from 11.6 percent in 1989. There appears to be no prospect of health care spending levelling off or falling in the future. The Office of Management and Budget (OMB) projects that, in the absence of program and policy change, health care spending will reach 17 percent of the GNP by 2000 and 37 percent by 2030.¹

In fact, Americans spend more for health care than residents of other nations, yet there is a growing consensus that our health care system performs poorly. The argument for reform of the health care system is largely based on the premise that the free market has failed, thus, we need government intervention to correct the private market's shortcomings. While reform of the U.S. health care system may be warranted, it is wrong to characterize this market as governed by *laissez-faire* policies or perfectly competitive forces. In fact, the medical services industry is so heavily regulated and influenced by government bureaucracies that it is probably the most socialized sector of the American economy.

¹ Statement of Richard Darman, Director, Office of Management and Budget, presented to the Senate Finance Committee, April 16, 1991.

Graph 1 -- National Health Expenditures by Source of Funds,
Selected Years, 1960-2000
(as a percent of GNP)



Source: JEC Republican staff calculations based on Health Care Financing Administration data.

Provision of health care in the United States is a strange hybrid of private and public activities dominated by legislative rule-making, government regulatory policies, tax subsidies, direct and indirect grants and loans, and direct price and output controls. Government owns and operates medical facilities and purchases vast amounts of medical sector output at prices it helps to set. Virtually all aspects of the supply and demand sides of the health care market are distorted by government, either directly or indirectly.

The education and training of health professionals is subsidized by government, then regulated by licensure to control entry, professional specialization, and fee structure. The planning, financing, and construction of health facilities as well as their day-to-day operations are under considerable control by Federal, state and local agencies. For example, states set minimum input levels for hospitals, approve investments, and Medicare and Medicaid agencies determine the level and type of reimbursable activities. The introduction of new medical treatments and technologies is subject to strict government control. Further, government may restrict certain businesses (for example, for-profit-firms) from the medical services market. On the demand side of the market, a health care

consumer may only legally seek medical treatment from health care professionals who are licensed by the state, any medications recommended must have prior governmental approval, the price paid for the treatment may well be regulated on his behalf by government and his medical costs are likely to be paid by a third party -- either a regulated insurance company or the government.

This analysis seeks to highlight the extent of government intervention in the U.S. health care market and examine the various forms that intervention has taken, particularly in the last 30 years. This briefing paper does not treat such related health issues as "specific cost drivers" which cause medical care expenses to consistently outpace inflation and the various public policy proposals to reform the U.S. health care system, which will be addressed in future briefing papers.

IS MEDICAL CARE SPECIAL?

The Federal government has become increasingly involved in the health care market, moving from *laissez faire* toward socialized medicine. It is possible to briefly characterize Federal health care policy into three different phases, with proposals for a fourth phase.

Phase 1. *No government role.* It is an individual's responsibility to obtain health care from private income. State governments impose occupation licensure on certain medical suppliers. This policy prevailed from the founding until World War II.

Phase 2. *Government encouragement of private health insurance.* Federal policy promoted the issuance of health insurance as an employee fringe benefit, provided at the discretion of the employer. This started after World War II, when government wage and price controls acted as incentives for employers and employees to provide higher compensation in non-cash terms. Employer-paid health insurance for either group or individual coverage was deemed a fringe benefit and not wages, in the first case by a 1943 IRS ruling and, in the second case by 1954 legislation. A 1953 IRS ruling that employer payments for individual insurance be considered taxable income was overturned by the 1954 law. The exclusion is a strong incentive for workers to overutilize health care, and provides little incentive for employers to limit costs.

Phase 3. *Government provides direct health insurance.* Federal passage of Title XVIII of the Social Security Act of 1965 created the Federal Medicare program and the Federal/State Medicaid program. Both programs fund the direct provision of health insurance for their target populations. Since passage in 1965, these programs have become the two largest government health care programs. Much of the escalation in health care costs can be attributed to the massive increase in demand generated by Medicare and Medicaid. In 1964 the non-poor saw physicians about 20 percent more

frequently than the poor; by 1975 the poor visited physicians 18 percent more often than the non-poor. In 1963 those with incomes under \$2,000 a year had only half as many surgical procedures per 100 persons as those with incomes of \$7,500 or more, but by 1970 the rate for the low-income group was 40 percent higher.²

Phase 4. *Government mandates private coverage or government provision of health care.* As of September 1991, 894 separate pieces of health care legislation had been introduced in the 102nd Congress.³ Many of these are variants of the "pay or play" or mandated health care coverage bills proposed by Senators Mitchell, Kennedy and others. Such mandates serve only to place more persons within a system with no incentives for judicious utilization or overall cost controls. Expenditures are merely shifted from the citizen as worker to the citizen as taxpayer. The logical end result of this trend in Federal health care policy is complete socialized medicine, which can be expected to surface after Phase 4 has been shown to be a failure in limiting health care expenditures.

Why has the Federal government become so deeply involved in the health care market? Far and away the most common description of the organization of economic activity in the United States is a free or competitive market process, where independent decisions of millions of buyers and sellers interact through a network of fluctuating prices to determine the final output and mix of goods or services. Government provision of goods and services is the exception, not the rule. Yet as we have just noted, neither the structure nor the operation of the health care market fits this common organizational scheme. What economic conditions exist in the market for medical services that account for the pervasive role of government? There are different explanations for different categories of government expenditures and activities.

Certain types of medical services have a public good or externality characteristic; that is, their provision confers benefits on third-parties through no action or intent on the provider's part. For example, if a child is vaccinated against German measles, not only does the child benefit from not contracting this disease, but the risk of disease transmission to others is reduced. If left to the private market, inoculations for the treatment of contagious diseases would be less than optimal. This is especially true for medical research, where most discoveries are not patentable, and even if they are, it may not be good public policy to restrict usage. Externalities provide a rationale for the public funding of medical research and the Public Health Service, however, just over 6 percent of Federal medical expenditures in 1990 fell into these two categories.

² Terree P. Wasley, "Origins of the Crisis: A Short History of Twentieth Century Health Care," The National Chamber Foundation, Washington, D.C., November 1991.

³ Louis Harris and Associates, Inc. survey conducted for the Metropolitan Life Insurance Co., October 1991.

A more important explanation for the increasing importance of government in the health care market is the elevation of medical care to a quasi-human right by many in our society.⁴ Expressions such as "everyone has a fundamental right to needed medical care" and "medical care must be available for all" are characteristic of this view and seem to suggest that the consumption of general medical care confers external benefits on society. If this is true, then medical services are different from shoes, books, automobiles, and most other commodities and should not be left to the control of the market. For the non-poor, adequate care is probably purchased without any governmental intervention, however, this type of externality may constitute a rationale for subsidizing the provision of medical care for the poor and elderly via programs like Medicare and Medicaid.

Externality considerations aside, many aspects of the medical market differ from conventional competitive markets, which may provide grounds for government intervention. The two most often cited peculiarities of the medical market are lack of knowledge on the part of the buyer and limited competition on the part of the seller. Consumers of medical care seldom know the consequences of different procedures and treatments or even if any action is needed given their particular state of health. As a result, consumer demand for medical care depends to a large extent on the advice of the supplier, the medical professional. Knowledge is a scarce commodity and while this situation arises in many markets for complex commodities, alternative sources of medical information are less readily available.⁵ For example, contrast the vast independent information market that has arisen to assist consumers in their purchases of computers with the paucity of information on surgical survival rates by doctors and hospitals. The medical consumer is, in essence, purchasing the expertise of the medical practitioner and must rely on his judgment as to whether an operation is required or a specific medication is appropriate. Imperfect knowledge is often cited as the rationale for state government licensing of medical practitioners and the regulation of drugs and medicines via the Federal Food and Drug Administration.

Imperfect information reduces competitive pressures, particularly when coupled with limited numbers of suppliers and lack of price competition. To practice medicine one must graduate from an accredited medical school. State governments have turned accreditation over to the American Medical Association (AMA), which controls entry into most medical markets.⁶ The same process occurs in the other medical fields where licensing is required. While the AMA and similar professional organizations may have limited monopoly power

⁴ For a summary of this viewpoint, see "A Call for Action," A Report of the U.S. Bipartisan Commission on Comprehensive Health Care (The Pepper Commission), September 1990 and the legislative proposal it generated S. 1227, Health America.

⁵ See K.J. Arrow, "Uncertainty and the Welfare Economics of Medical Care," American Economic Review, 53, pp. 941-971, 1963.

⁶ For evidence on the monopoly power of the AMA, see Cotton M. Linsay and Keith Keffler, "The Market for Medical Care," in C. M. Linsay, ed. New Directions in Public Health Care, San Francisco: Institute for Contemporary Studies, 1976.

to restrict entry, their ability to set professional practice standards and codes of behavior certainly affects the cost of medical services. While competition is imperfect, there are a number of indications that competition among providers of health care has increased over the past decade. Advertising by physicians, dentists, hospitals, and other health professionals, once prohibited by state regulations and medical society rulemaking, is accepted practice. The outlets for medical services have expanded from the traditional doctor's office to walk-in clinics and acute care centers.

In addition to lack of direct competition among physicians, there is little competition among hospitals as doctors' services are commonly linked to the specific hospital where privileges exist. Further, since the price of health care is not frequently borne by those who purchase it, there is little or no incentive to carefully shop or negotiate price.

For all these reasons, both the positive analysis and the normative description of the effect of government policies in the medical care field provide a complex challenge.

GOVERNMENT HEALTH CARE PROGRAMS AND EXPENDITURES

Over the last 50 years, the U.S. government has pursued a health care policy aimed at increasing "access" to health care by bolstering the demand for and stimulating the supply of health care services. For example, as early as 1946 the Hospital Survey and Construction Act (Hill-Burton) supplied Federal funds to underwrite the building and renovation of local hospitals. Demand has primarily been stimulated by direct government provision of health insurance for millions of our population and via tax subsidies to underwrite the cost of medical insurance and other medical expenditures. Government has directed resources to the building of hospitals, the expansion of medical schools and numerous other supply enhancing activities while regulating an ever-expanding sphere of price and output decisions.

Direct Intervention

One measure of the impact of government activities in the economy is to examine the types of activities underwritten by taxpayer dollars and the trends in that spending over time. In 1990, Federal health expenditures equaled \$195.4 billion, an increase of 11.7 percent (over \$20 billion) from the 1989 spending level. This represents over \$750 for every person in the United States. State and local governments spent \$87.3 billion in 1990, an increase of 12.5 percent over 1989 funding levels.

While government's share of total health expenditures has remained relatively constant for the last 10 years, the share of the Federal budget allocated to health care has continued to rise, with the 1990 allocation reaching 15.3 percent, the largest share to date. Over 11 percent of state and local government spending goes for health services.

Federal health care spending can be divided into two broad categories: expenditures related to current health care (health services and supplies), and spending for research and

construction of medical facilities. Federal spending on health services and supplies amounted to \$184.3 billion in 1990, 94.3 percent of all Federal health spending.

Although the Federal budget lists literally hundreds of Federal health care programs, just three programs -- Medicare, Medicaid and Veterans Administration (VA) services -- account for in excess of 85 percent of Federal health spending in 1990. The oldest and smallest of these programs is Veterans Administration services, which provides health care to eligible veterans and certain dependents and survivors in 172 VA hospitals, 126 nursing homes, 339 outpatient clinics, and 32 domiciliaries. VA health care spending reached \$11.4 billion in 1990, accounting for 5.8 percent of Federal spending. This category of spending increased 7 percent over 1989 levels, lagging slightly behind the average for all health care spending. As a recently released General Accounting Office report highlights, the Federal government fails miserably when attempting to directly provide health services to our veterans.⁷ A careful study of the VA sheds light on why government-run health care, whether in Warsaw, Poland or Warsaw, Indiana is a poor substitute for a competitive system.

Medicare, a Federal insurance program designed to protect the elderly and disabled from the high cost of health care, accounted for 56.9 percent of Federal health care spending in 1990, making it the largest source of health care funds. Unlike other Federal health programs, Medicare is funded in part by payroll taxes rather than general revenue sources. Medicare spending continued to rise over 1989 levels by 8.6 percent. Over the decade of the 80s, Medicare spending increased by 96 percent. Payment reforms and other cost containment measures for hospital care initially slowed the growth rate in the mid-1980s, however, hospital spending has again reached the double-digit growth rates observed in the past. Physician services spending increased by 9.5 percent -- growing to nearly 24 percent of all Medicare program spending in 1989. Federal bureaucrats are now instituting cost containment measures for physicians similar to the hospital regulations of the 1980s.

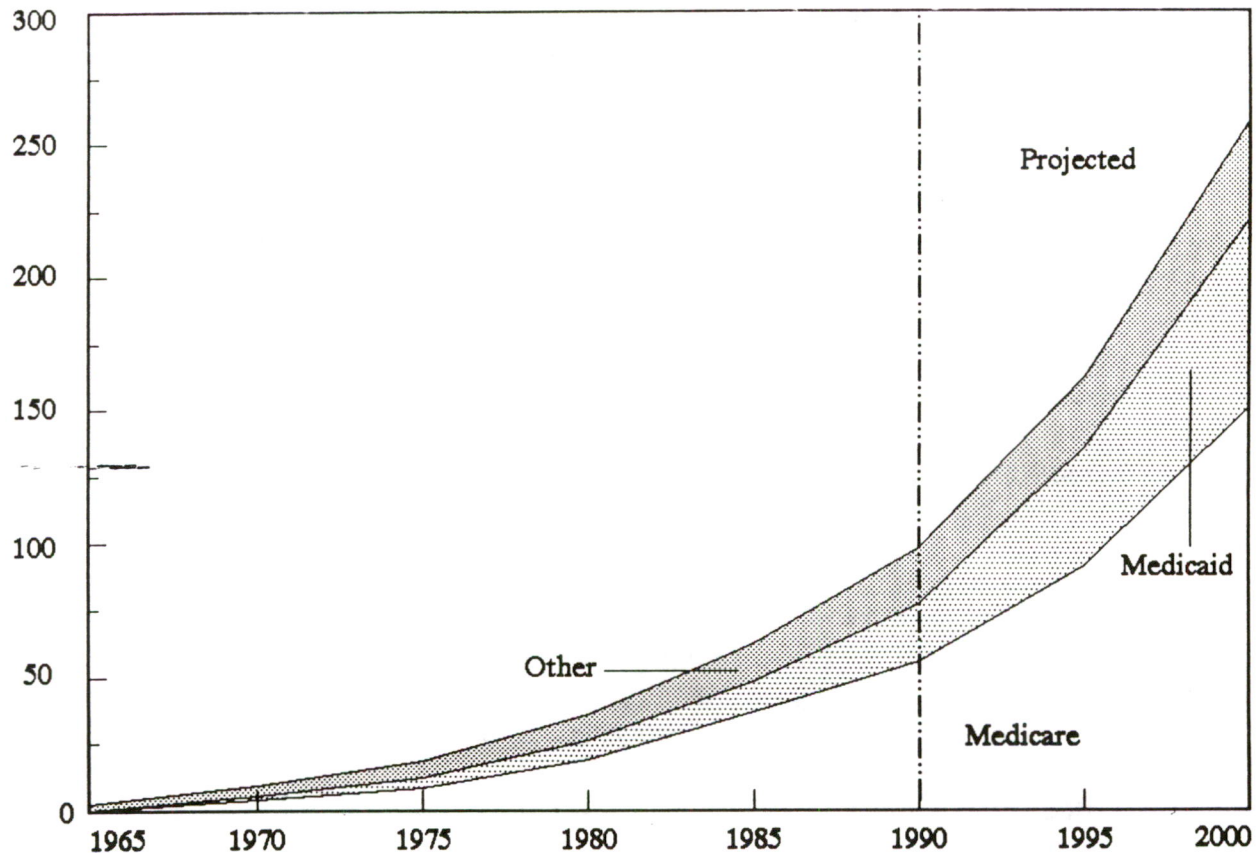
Medicaid, a joint Federal-state-local program providing health care for the poor, had expenditures totaling nearly 22 percent of Federal health care spending. The Federal government sets minimum program parameters for eligibility and services, with states exercising wide latitude as to total program design and coverage. Medicaid expenditures are largely institutional. In 1990, 39.9 percent of Medicaid dollars were spent on hospital care and 33.8 percent on nursing home care, making it the largest third-party payor of long-term care expenditures. Medicaid is the fastest growing Federal program with expenditures up 21 percent from 1989. State and local spending on Medicaid represented 37 percent of their total health care spending in 1990, the largest single program category.

Together, the Medicare and Medicaid programs financed over 30 percent of all personal health care services in 1990. From 1970 to 1980, Medicare's share of total personal health care expenditures increased from 18.9 percent to 27.9 percent and Medicaid's share

⁷ Testimony of Mary Ann Curran, GAO health care specialist, before the House Government Operations Subcommittee on Human Resources and Intergovernmental Relations, November 20, 1991.

increased from 54.8 percent to 70.3 percent of public expenditures. By service, these two programs paid for 37.8 percent of all hospital services, approximately 30 percent of all physicians' services, and over 50 percent of all nursing home care. Graph 2 traces the Federal spending growth of these two programs since their inception in 1965.

Graph 2 -- Total Federal Health Care Spending, Selected Years, 1965-2000
(in \$-billions)

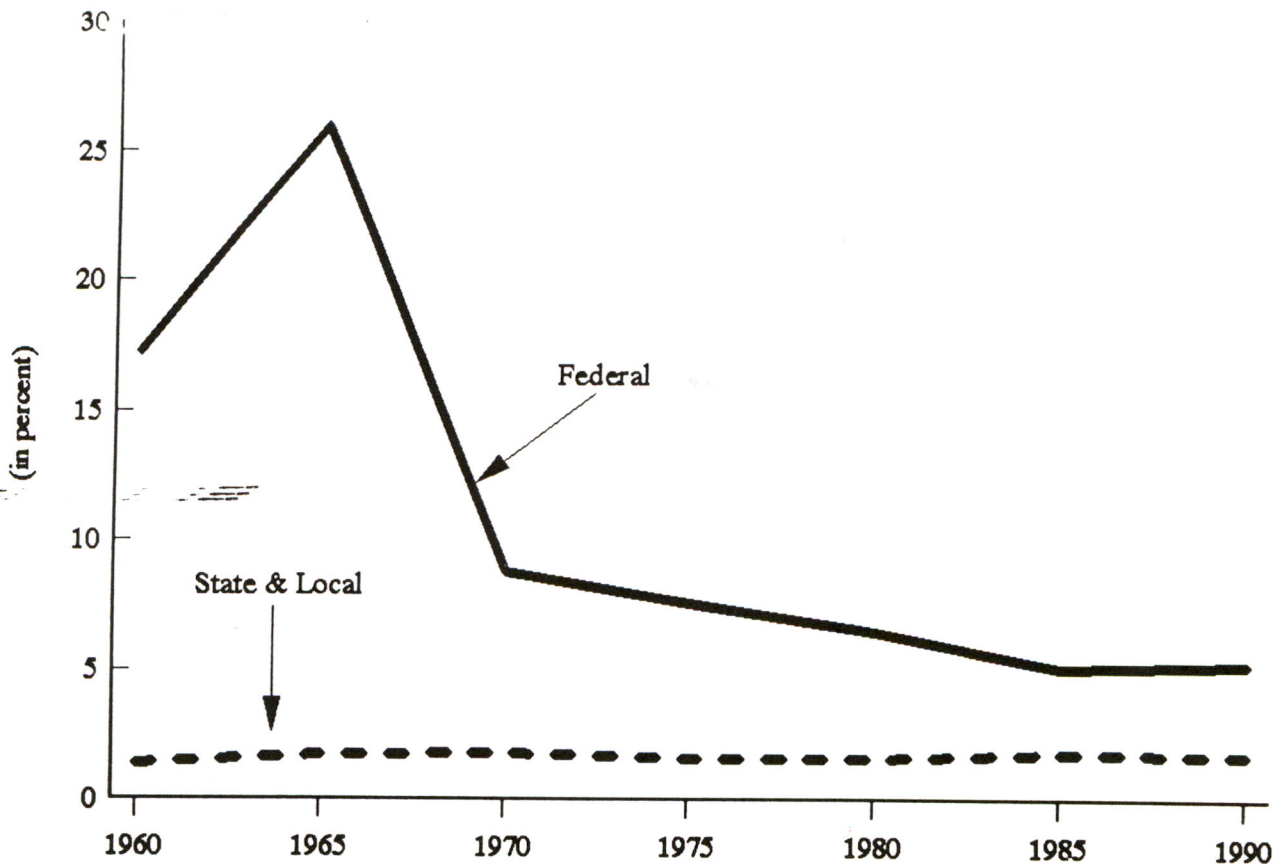


Source: JEC Republican staff calculations based on Health Care Financing Administration data.

Federal spending on medical research in 1990 amounted to \$12.4 billion, an increase of 11.9 percent from 1989 levels. As Graph 3 indicates, however, there has been a dramatic decline in the proportion of Federal dollars going to support medical research over the last 30 years. Throughout the 1950s and up until the enactment of the Medicare and Medicaid legislation, medical research was a rapidly expanding category of Federal government spending, reaching 26 percent of total health care spending in 1965. Since that time, while the absolute level of funding has continued to rise, in terms of total spending, medical research now accounts for just over 5 percent of Federal health care spending. State and local governments' medical research spending has remained fairly stable at between 1.5 and 1.8 percent of their total health care budget over the last 30 years. In addition, philanthropy's role in funding medical research has declined considerably over the last 30

years, falling from 20.1 percent of all research funding in 1960 to under 7 percent in 1990. Research and development expenditures of drug and medical equipment manufacturers are not reported separately so it is not possible to track the trend of this sector's spending.

Graph 3 -- Spending on Health Care Research as a Percent of Total Government Health Care Spending, Selected Years, 1960-90



Source: JEC Republican staff calculations based on Health Care Financing Administration data.

Indirect Intervention

In addition to direct health care expenditures, there are three major categories of indirect Federal intervention to support health care activities -- the exemption from tax of employer-provided medical spending, the tax deductibility of medical expenses and the regulation of health care provider's price and output. The tax treatment of employer-provided insurance means that if an employer pays for health insurance for the employee, the expenditure is not treated as taxable income to the employee nor does it enter the wage base for the payroll tax. This subsidy is open-ended; that is, there is no cap on the amount of insurance that is fully-deductible. It is as if the government simply allowed the

individual to deduct the total health insurance expenditure. The cost of this tax subsidy to the Federal government has been estimated to be in excess of \$50 billion in 1990.⁸

This tax subsidy encourages the purchase of health insurance by employers in lieu of wages and diminishes incentives of consumers to choose the best policy for themselves. In addition, it provides an incentive to increase the consumption of health care beyond the optimal level. Many workers find it in their interest to have insurance coverage for even small, predictable expenses, coverage they would not choose in the absence of the tax subsidy. To illustrate this problem, imagine that the government permitted full tax deductibility for employer-provided automobile insurance. How would the market for auto insurance change? To be sure, most of us would reduce our current out-of-pocket deductible to zero. Then we would seek to expand our insurance coverage to take care of a larger share of our automobile costs, including routine, predictable outlays. We can predict that such an open-ended tax subsidy would lead to rising auto insurance costs and increasing insurance outlays. We observe this exact result in the health care market.

The second major category of indirect intervention is the income tax deduction for medical expenses. Due to the 1985 changes in the tax code, only medical expenses in excess of 7.5 percent of adjusted gross income (AGI) can now be deducted. This deduction lowers the ~~effective~~ price that individuals must pay for medical services and encourages them to consume more of these goods. The magnitude of the effect depends upon the degree of responsiveness of demand for medical services. The estimated 1990 cost of the tax deduction was \$7 billion.

Thirdly, in an attempt to contain health costs, the Federal government has intervened aggressively to regulate health care suppliers' price and output decisions. Faced with skyrocketing hospital costs, the Federal government in 1963 established a "prospective payment system" (PPS) and a peer review system for Medicare hospital reimbursement. While the purpose of the regulations was to make hospitals more competitive and price conscious, the result has been to create shortages, misallocations, and a major shifting of costs to activities not covered by controls. Even though Medicare program costs have not been constrained by regulation, the Federal government will soon institute a massive new regulatory system to control physician fees. The new Resource-Based Relative Value Scale (RVS) system will effectively set fees, by formula, for some 7,000 different medical procedures performed by over 500,000 physicians. The result of these regulations will be a new bureaucratic nightmare for the American medical market. In addition, state governments are increasingly regulating the type of benefits that must be covered by insurance policies with similar national legislation pending in Congress.

⁸ C. Eugene Steurele, "Finance-Based Reform: The Search for Adoptable Health Policy." Paper presented at American Health Policy: Critical Issues for Reform, American Enterprise Institute Conference, Washington, D.C., October 1991.

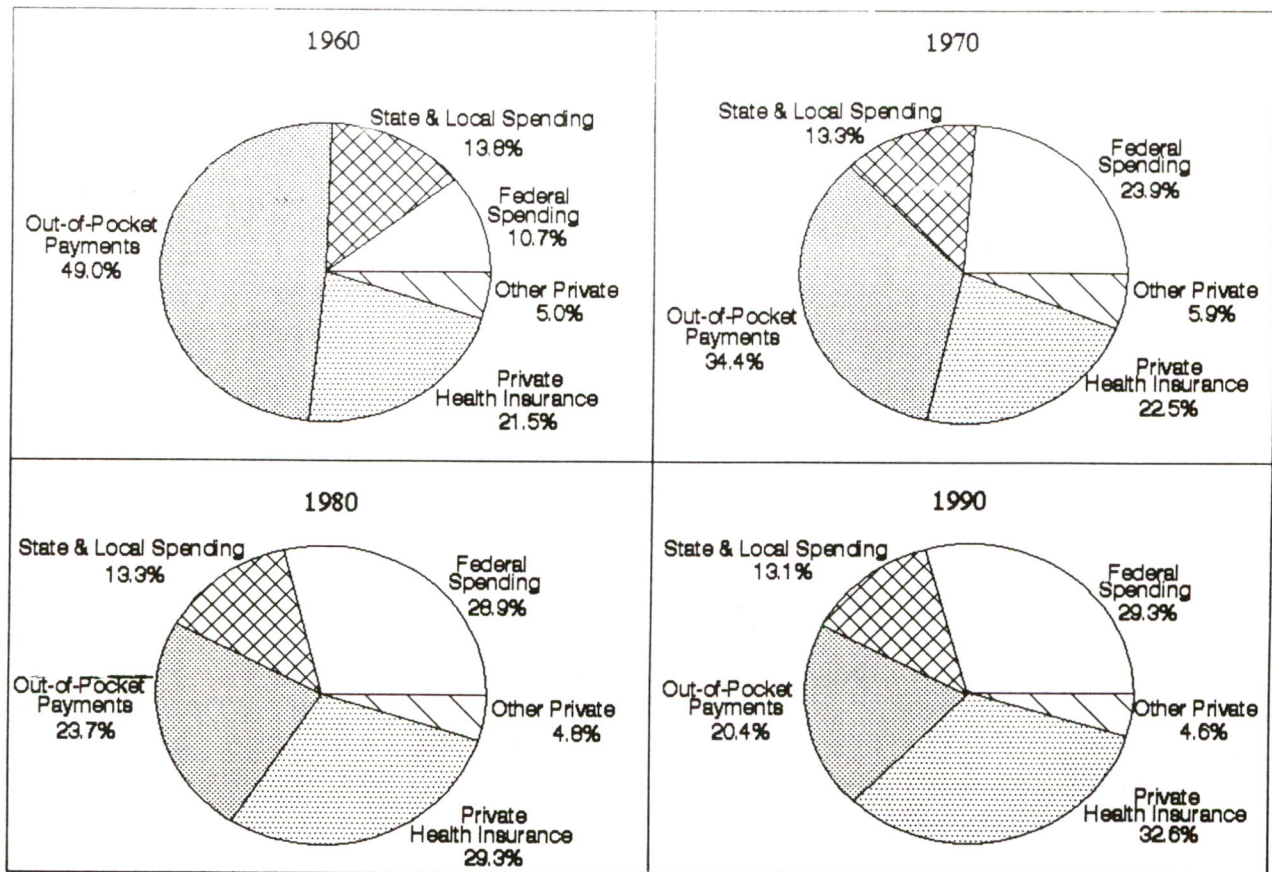
The overwhelming economic evidence suggests that artificially setting prices and controlling inputs and/or outputs via regulation is a policy doomed to failure whether its rent control in New York City or taxi cab regulation in Chicago. It is impossible to devise a scheme to both contain costs and maintain quality. There are always margins that are not controlled which can be exploited to adjust to the legislation. When the RVS system lowers physician reimbursement for procedure X, he will simply spend less time performing it and shift to procedure Y with a high reimbursement relative to the minimum time required to perform the service. Consider similar legislation to control the price of automobile repair fees. A "board of experts" would establish a nationalized auto repair fee schedule covering the 500 most common auto repair jobs complete with enforcement penalties. We can predict that the quality of specific repair services would decline while the cost of total repair increased. Inevitably, the unintended consequences of such a policy would do serious damage to those the policy was intended to help. No crystal ball is needed to predict that when the RVS system is imposed in 1992, it will fail.

SOURCES OF HEALTH CARE FUNDING

During the last 30 years, the principle source of health care funding has shifted from mostly private to government hands. In 1960, nearly half of all health care spending was paid out ~~of~~ pocket, by consumers with another 22 percent covered by private insurance. Federal, state and local government health spending represented less than 25 percent of total outlays. By 1990, Federal, state and local governments spent \$282.6 billion on health expenditures for U.S. citizens, or over 42 cents out of every dollar spent last year for health care. Federal health care spending alone represents over 15 percent of the total Federal budget.

Most dramatic was the fall in out-of-pocket payments to just 20 percent of total spending. Although out-of-pocket spending declined rapidly over the period, when considered as a percent of disposable income, these expenditures have remained surprisingly constant. Out-of-pocket expenditures for health care have accounted for between 3 and 3.5 percent of disposable income for the last 30 years. The share paid by private insurance increased, now covering up to 33 percent of all health expenditures. Graph 4 indicates the changing composition of health expenditures by type of payer over the last 30 years.

Graph 4 -- National Health Spending, by Type of Payer, Selected Years, 1960-90
(in percent)



Source: JEC Republican staff calculations based on Health Care Financing Administration data.

In addition to shifts in funding, the components of health care spending supported by third-party payments have continued to grow over the last 30 years. Further, these third-party payments vary quite dramatically by types of spending. For example, in 1960 consumers paid for 62.7 percent of physician services out of pocket while only 18.7 percent of such payments were out of pocket in 1990. Even more dramatically, the share of hospital care paid out of pocket fell during the last 30 years from 20.7 percent in 1960 to 5.2 percent in 1990. That is, 94.8 percent of all hospital care costs are paid by someone other than the user. Because net out-of-pocket costs are so low, doctors and patients choose more expensive and sophisticated medical care.

To illustrate the behavioral effect of third-party payment, we return to the automobile illustration. Imagine that the government pays 94.8 percent of the cost of your automobile. Would we still find that Honda Accord is the most popular car in America? Hardly! Consumers would not only buy more cars, they would buy more expensive, better quality vehicles -- Jaguars, Mercedes and Porsches -- which cost more to produce. The United States would soon experience spiraling, out-of-control automobile costs. Further, we would

find that the market for low cost, no frill automobiles had dried up as "they are no longer competitive." We can predict that this automobile subsidy would soon consume an ever-expanding portion of GNP, not unlike what is happening in the medical market place.

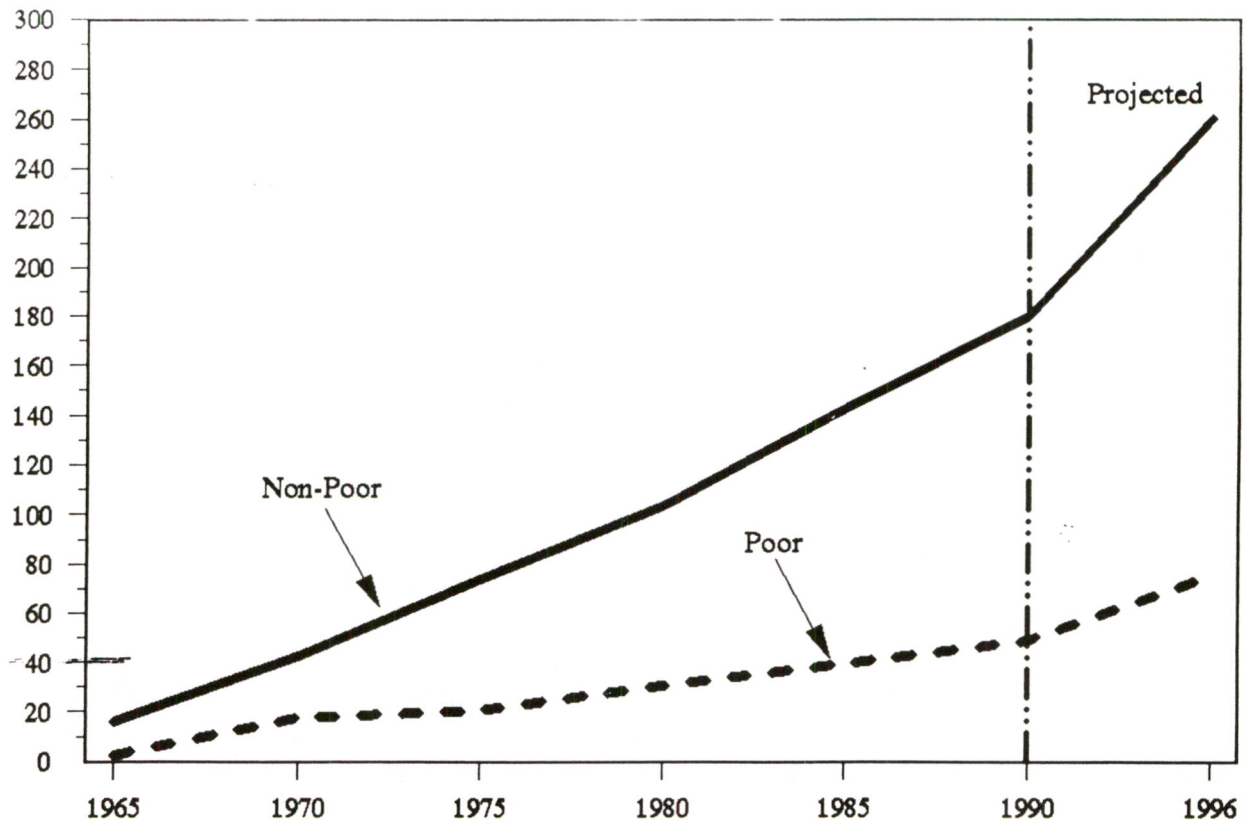
BENEFICIARIES OF FEDERAL HEALTH CARE SPENDING

One measure of the effectiveness of Federal health care policy in achieving its goal of expanding "access" is to examine the distribution of program benefits across various income groups. Although one might suspect that the bulk of Federal expenditures for health care are concentrated on those individuals and families with the lowest incomes, in fact, overwhelmingly the beneficiaries of Federal health spending are the non-poor. As Graph 5 indicates, the vast expansion of Federal spending has primarily benefitted those with incomes above the poverty level. The Office of Management and Budget estimates that only 21 percent of total Federal tax expenditures and direct outlays for 1992 will go to the poor.⁹

Setting aside medical research spending, whose benefits accrue uniformly to all members of society, it is possible to classify the beneficiaries of the three primary Federal health care subsidies -- Medicaid, Medicare, and employer-provided health plans. When enacted in 1965, Medicare expenditures were divided nearly equally between the poor and the non-poor. In the ensuing 25 years, however, there has been a dramatic shift in benefits toward the non-poor so that today they receive almost 90 percent of the benefits of Medicare spending. Given the nature of Medicaid -- a program aimed at providing health care to the poor and disabled -- it is indeed astonishing that only 50 percent Medicaid expenditures go to people at, or below, the poverty level. Nearly 100 percent of the tax subsidy allowed for employer-provided health insurance plans accrues to individuals above the poverty line. Given the projections for expanding Federal health care expenditures throughout the 90s, one means to free up resources to expand access to the least advantaged may be better targeting of Federal health care spending.

⁹ Darman, op.cit. pg. 11.

Graph 5 -- Federal Health Care Spending Benefitting
 Poor vs Non-Poor, Selected Years, 1965-96
 (outlays and tax expenditures in 1992 \$-billions)



Source: JEC Republican staff calculations based on OMB data.

CONCLUSION

The trend toward nationalization of the health care market began slowly in the 1940s, picking up steam with the passage of Medicare and Medicaid in the mid-60s, and now seems poised for further collective control. Government financing, service provision, and bureaucratic regulation of health care services fundamentally flaw the U.S. health care market and contribute to its reduced viability. Government health care policies contribute to rising costs and overutilization by many. At the same time, an increasing number of workers, poor and elderly Americans are being priced out of the market due to misguided government health policies. In summary, there is no private health care market. Health care is disproportionately government controlled and operated to the detriment of the U.S. health care consumer/taxpayer.

This briefing paper was prepared by the Republican staff of the Joint Economic Committee: Senior Economist Dolores Tremewan Martin, Ph.D., Staff Director Edward Gillespie; and JEC Staff Assistant Nancy Speights.

**PUTTING PEOPLE OUT OF WORK:
FIRST-YEAR GROWTH AND EMPLOYMENT
EFFECTS OF THE CLINTON ECONOMIC PLAN**

Prepared for

**Representative Dick Armey (R-TX)
Ranking Republican
Joint Economic Committee**

August 1992

EXECUTIVE SUMMARY

While Democrat presidential nominee Bill Clinton's "Putting People First" (PPF) economic plan has received much favorable media comment since its release, it has been subject to scant economic scrutiny. This analysis evaluates the claims in the Democrat party's major economic policy document and estimates the impact its provisions would have on job creation and employment in only the first year of enactment.

The combination of higher taxes on individuals and corporations and a sweeping array of new mandates on business results in a first-year job loss estimate of nearly two million jobs. These losses overwhelm Clinton's claims of new jobs from government spending programs, and the net employment effect even when these claims are accepted is still a loss of over 1.8 million jobs. A job loss of this magnitude would increase unemployment by 1.5 percentage points above what it would otherwise be. While a disproportionate share of the employment adjustment, particularly that resulting from new mandates, would take place in this first year, total job loss over the four-year life of the Clinton plan could easily exceed three million.

The proposal with the greatest impact on employment is "play-or-pay" health care, which would require employers to provide all workers with a government determined minimum health insurance package -- "play" -- or "pay" a 7 to 9 percent tax to fund a government health insurance program. This one element of the Clinton economic plan results in a net negative employment effect (after taking new jobs in the health care industry into account) of over 712,000 jobs.

New individual and corporate taxes would kill more than 437,000 jobs in the first year, and the new training tax would result in a loss of nearly 265,000 jobs. Environmental regulations, specifically a higher Corporate Average Fuel Economy (CAFE) standard and more stringent CO2 emission standards, would lead to the loss of more than 270,000 jobs, and business mandates other than health care (including an annually increasing minimum wage) more than 100,000 jobs.

The paper also questions the viability of the deficit reduction claims made in Putting People First -- noting that nearly two-thirds of the deficit reduction in the Clinton plan is already built into the Federal budget baseline -- and its projections for economic growth. The most generous economic models assume between \$1 and \$2 in higher gross domestic product from every \$1 in net new fiscal stimulus, whereas PPF asserts \$2.50 for every dollar in gross new spending while ignoring the tax increases.

Clinton's economic plan has all the elements of traditional bridal attire. The tired policy of relying on massive Federal spending for members of Congress to distribute throughout their districts is something old. New taxes totalling about \$240 billion are something new. Republican growth proposals, however watered-down, are something borrowed, and the 1.8 million workers who lose their jobs in the first year of the plan's enactment will be something blue.

DICK ARMEY
Ranking Republican
Joint Economic Committee

PUTTING PEOPLE OUT OF WORK: FIRST-YEAR GROWTH AND EMPLOYMENT EFFECTS OF THE CLINTON ECONOMIC PLAN

EVALUATING CLINTON'S ECONOMIC PLAN

Democrat presidential nominee Bill Clinton's "National Economic Strategy for America," dubbed "Putting People First (PPF),"¹ has received mostly favorable media comment but scarce economic scrutiny. This analysis evaluates the claims in the Democrat party's major economic policy document and estimates the impact its provisions would have on job creation and employment.

"Putting People First" is a well-packaged campaign document, which may explain its positive media reviews. It is, however, poor economic policy. In essence, "Putting People First" claims supply-side growth results from reinstating discredited Keynesian policies. The plan is a counterproductive package of traditional taxes, spending and mandates that will depress the economy and make more than 1.8 million people jobless in 1993. Its claims of reducing the deficit, stimulating economic growth and creating jobs are spurious.

The PPF plan is based upon the proposition that government knows how to spend the taxpayers' money better than do taxpayers. Taxes are to be raised to shift resources from unenlightened private citizens to virtuous and omniscient government bureaucrats and Congress. The proffered 1992 Democrat solution to the widespread dissatisfaction of the American people with the operation of their government is simply more government, just as it has always been.

The view that "Putting People First" is economically unsound is widespread among independent economists. Martin Feldstein argued that Clinton's "numbers don't make any sense," that it is "politically dishonest and fiscally irresponsible," and that the plan would "increase the budget deficit and slow the rate of economic growth."² Rudolph Penner noted that Clinton's "policy changes don't make much difference."³ It has come under criticism

¹ Bill Clinton, "Putting People First: A National Economic Strategy for America," June 1992, Little Rock, Arkansas.

² Martin Feldstein, "Clinton Flunks the Budget Test," Wall Street Journal, July 3, 1992, pg. A6.

³ Jeffrey H. Birnbaum, "Clinton's Plan to Reduce Deficit Relies More on Economic Growth Than Policy," Wall Street Journal, June 25, 1992, pg. A22.

from supply-siders like Paul Craig Roberts and traditional liberals like Isabel Sawhill.⁴ Former Council of Economic Advisors Chairman Beryl Sprinkel noted that the plan will "reduce incentives and deter growth."⁵ Even Clinton economic advisor Derek Shearer noted that the economic impact of the plan had not been evaluated by economic models.⁶

DEFICIT REDUCTION CLAIMS

The first sign of a problem in PPF is its deficit reduction claim. Given present trends, the deficit is scheduled to decline from \$333 billion in 1993 to \$200 billion in 1996, a reduction of \$133 billion or about 40 percent. PPF claims to reduce the 1996 deficit to \$141 billion, "cutting the deficit in half." Impressive at first blush, approximately two-thirds of PPF's deficit reduction is built into the baseline.⁷ Indeed, past evidence suggests the tax increases in the PPF plan will actually stimulate higher levels of deficit spending.⁸

ECONOMIC GROWTH CLAIMS

More misleading is PPF's asserted impact on the nation's economic growth. The fundamental premise of the plan is that its implementation will spur higher economic growth, providing a "growth dividend" in more tax revenue and lower government spending to achieve the claimed deficit reduction figures.

In the first year, under moderate economic growth, PPF claims its \$10.7 billion net new spending (\$36.8 billion in new spending programs minus \$26.1 billion in cuts), and self proclaimed \$15.9 billion in total direct deficit reduction will create between \$64 billion and \$148 billion additional gross domestic product (GDP) above baseline. Over four years, \$50 billion net new spending (\$190.2 billion in new programs minus \$140.3 billion in cuts) and a claimed \$74.9 billion net direct deficit reduction will generate from \$302 billion to \$695 billion more GDP. This GDP bonus will raise receipts and reduce entitlement spending, "painlessly" cutting the deficit between \$11.4 billion and \$24.5 billion in the first year and between \$67.7 billion and \$230 billion over four years. Figured by percent of GDP, the

⁴ Bill Nichols, "Clinton Takes Gamble With Recovery Plan," USA Today, June 23, 1992, pg. A2.

⁵ Beryl W. Sprinkel, "Clintonomics: A Loser," Christian Science Monitor, July 15, 1992, pg. 18.

⁶ John R. Cranford, "Clinton Makes Priorities Clear in Revised Economic Plan," Congressional Quarterly Weekly Report, June 27, 1992, 1899-1901.

⁷ For further details on this claim, see Rep. Dick Armey, "Assessing Clinton's 'National Economic Strategy for America,'" July 1992.

⁸ JEC GOP staff study, "Taxes and Deficits: New Evidence ('The \$1.59 Study')" prepared for Senator William V. Roth, Jr. (R-DE) and Representative Richard K. Armey (R-TX), October 30, 1991.

"moderate" growth path assumes PPF will boost 1993 real GDP growth about 1 percentage point from the current baseline.⁹ The "strong" growth path in the plan assumes 2.3 percentage points real GDP growth above the baseline.

No credible economist will defend these assertions about the GDP impact of new Federal spending. The most generous economic models use a multiplier of between 1.0 and 2.0 for fiscal stimulus. That is, for every \$1 in net new fiscal stimulus, these models would argue there is between \$1 and \$2 in higher GDP. As such, the small negative stimulus in PPF would cause from \$16 billion to \$32 billion lower GDP for 1993, and between \$75 and \$150 billion lower GDP over four years. Only if gross new spending is considered by itself (ignoring spending cuts and tax increases) would economic models predict GDP changes approaching even Clinton's "moderate" growth path scenario.

There are two additional fundamental flaws with asserting that new government spending generates growth -- one, the failure of government spending itself to have lasting impact and, two, the removal of taxed and government-leveraged funds away from the private sector that new government spending implies.

There is little basis for the premise that new spending generates large or lasting economic stimulus. The most direct demand inducement the Federal government employs, speeding up previously authorized public works spending, will generate jobs in the short term and a small bump in consumption. But after less than one year these effects disappear.

No causal relationship has been established between this or any other type of Federal spending and lasting higher economic growth. A few economists using Keynesian economic models did publish articles in the late 1970s and early 1980s, showing a correlation between public works spending, private investment and economic growth in the 1950s and 1960s. These results were interpreted by some as implying higher economic growth from more public works spending. But later studies using more recent data showed no causal relationship between public works spending and economic growth, with changed energy costs explaining most of the correlation previously attributed to public works spending.¹⁰

The possibilities of economically effective fiscal stimulus, even in the short term, are limited in the present climate. President Bush earlier this year authorized Federal agencies to speed up public works funding. These "pipelines" are now full; for example, only about 60 percent of the funds available under the new highway bill has been committed by the states. New obligations for highways and other public works would be unspent, or wasted on "make-work" projects of lower priority.

⁹ Letter from CBO Director Robert Reischauer to Sen. Pete Domenici, August 3, 1992, pg. 2.

¹⁰ For a review of the literature and a critique of the public capital hypothesis see, for example, John A. Tatom, "Public Capital and Private Sector Performance," Federal Reserve Bank of St. Louis Review May/June 1991, pp. 3-15.

Second, Clinton/Gore economic advisors fail to note the negative economic consequences of a transfer of resources from private to public spending. Government spending on "infrastructure" increases aggregate welfare only as long as extra dollars spent on public works projects yield benefits greater than those derived from private use of the same funds. To be of net benefit, government spending has to outperform private investment. This expected return is highly dubious. For example, Clinton's plan to "leverage" public pension money for public works projects fails to consider the current private activities in which many pension funds are invested. PPF claims that pension fund investors will anticipate greater economic return from, say, building a bridge than investing in a new business in a high-growth private industry.

The fiscal and economic growth effects of Clinton's economic plan do not stand up to scrutiny. His combination of tax and spend will not stimulate growth or have a positive impact on any economic indicator. Moreover, it would put at risk the pension benefits and retirement security of the middle class.

EMPLOYMENT EFFECTS OF KEY ELEMENTS

In addition to the suspect claims about growth, Governor Clinton's claims about the job creation aspects of PPF are problematic. As employment is a key concern of national policy makers at this time, the remainder of this study examines the employment effects of the major elements of the "Putting People First" plan. The analysis evaluates the first-year effects of the Democrat candidate's policies as outlined in PPF, assuming one full year of implementation. The appendix describes the methodology used to estimate employment consequences, where applicable. The major elements of the PPF plan, and their budget impact as asserted by Governor Clinton (when they are provided), are listed in Table 1. More detailed explanation of the methodology used to estimate employment effects is attached as an appendix to this paper.

Policies Causing Job Losses

Defense Cuts

The PPF plan proposes to reduce defense outlays below President Bush's proposed levels by \$11.0 billion in the first year and \$58.5 billion over four years. Already, the President's proposal will generate significant employment dislocation in the defense industry. Dr. Avraham Shama of the University of New Mexico simulated the employment effects of a \$50 billion (the Administration plan) and a \$100 billion (slightly less than the PPF proposal) defense cut. This analysis relied on the New Mexico study, adjusting for the additional \$8.5 billion four-year cut Governor Clinton proposes. The result is an estimated 240,685 jobs lost, beyond the Administration proposal, in 1993 for Clinton's defense cuts.

Table 1 - Asserted Policy Effects of Clinton Economic Plan
(key elements and budgetary consequences in \$-billions)

Policy	1993	1994	1995	1996	4-Year Total
<u>Spending Cuts</u>					
Defense cuts beyond Bush request	-11.0	-12.5	-14.5	-20.5	-58.5
Overhead, personnel & administrative cuts	-11.1	-17.7	-20.1	-22.3	-71.2
Specified cuts (item veto, HUD Grants, nuclear waste disposal fee, honey subsidy)	-4.0	-2.2	-2.2	-2.2	-10.6
Subtotal - Spending Cuts	-26.1	-32.4	-36.8	-45.0	-140.3
<u>Spending Increases</u>					
Putting America to work (non-tax portion)	23.2	29.3	27.2	26.1	105.8
Rewarding work & families (non-tax portion)	3.5	5.0	6.0	6.5	21.0
Lifetime learning (non-tax portion)	10.1	14.3	17.3	21.7	63.4
Subtotal - Spending Increases	36.8	48.6	50.5	54.3	190.2
<u>Tax Reductions*</u>					
Expand EITC	0.0	0.5	0.5	0.5	1.5
Urban Enterprise Zones	0.0	0.1	0.2	0.3	0.6
R&D Tax Credit	0.8	1.4	1.6	1.8	5.6
Targeted ITC	4.5	5.0	6.0	6.3	21.8
Limited Capital Gains	-0.2	-1.2	0.4	0.9	-0.1
Apprenticeship Program	0.0	0.0	0.1	0.1	0.2
Subtotal - Tax Reductions	5.1	5.8	8.8	9.9	29.6
<u>Tax Increases/Entitlement Cuts</u>					
Cut Medicare	-0.6	-1.0	-1.0	-1.8	-4.4
Individual Income Taxes	-19.8	-20.5	-21.6	-23.0	-84.9
Individual Taxpayer Fraud	-2.0	-2.2	-2.3	-2.3	-8.8
U.S. Corporation Taxes	-2.3	-3.4	-3.8	-3.8	-13.3
Foreign Corporation Taxes	-9.0	-11.0	-11.5	-13.5	-45.0
Training "Tax" (Lifetime Learning)**	-21.0	-21.0	-21.0	-21.0	-84.0
Subtotal - Tax Increases	-52.7	-59.1	-61.2	-65.4	-238.4
<u>Regulatory Changes/Unscored Items</u>					
Play or Pay Health Care					
Indexing Minimum Wage					
Environmental regulation					
Middle Class Tax Relief					
Family and Medical Leave					

Source: Putting People First and JEC/GOP calculations.

*The EITC is the tax portion of "Rewarding Work & Families," and the remaining tax reductions are the tax portion of "Putting America to Work."

**The Training Tax is a new tax equivalent to 1.5 percent of payroll. The table portrays net new cost, minus current spending (see appendix for methodology).

Health Care

Earlier this year, the Joint Economic Committee Republican staff estimated the employment effects of a "play or pay" health care plan, modeled on the Democrat Senate leadership bill, which incorporated a 7 percent payroll tax. The direct costs to employers was calculated at \$42.09 billion, a figure which compares favorably with estimates of similar plans made by others.¹¹ Governor Clinton has embraced "play or pay" as his model for health care reform. In our earlier analysis, we projected 712,742 jobs would be lost in the first year of implementing a 7 percent payroll tax "play or pay" health insurance scheme.¹²

Environmental Regulations

Clinton's platform includes ambitious environmental goals that translate into increased regulatory and tax costs to American industries. The Democrat ticket has endorsed the goals of limiting carbon dioxide emissions to 1990 levels by the year 2000 and increasing the Corporate Average Fuel Economy (CAFE) standard from the present 27.5 miles per gallon (MPG) to 45 MPG, in addition to other steps that would create additional burdens on industry, especially high wage manufacturing. In this analysis we estimate only the Corporate Average Fuel Economy (CAFE) and CO₂ costs.

A commitment to major carbon dioxide emissions regulation would create large economic losses and job loss. The base case, assuming no new emission controls, predicts an annual growth in CO₂ emissions of between 1.4 and 2.7 percent. Freezing those levels will be very costly in lost economic output and jobs. Even done in the most economically efficient way, by imposing a carbon tax, the Democrat promise would reduce real GDP by between 0.5 and 2.0 percentage points by 2000, or between \$34.9 billion and \$139.5 billion in constant 1990 dollars. The Urban Institute found that a carbon tax of \$15 per ton, rising by 5 percent annually for 20 consecutive years, would be necessary in order to stabilize CO₂ emissions at 1990 levels. Such a tax would lead to a loss of 616,300 jobs in the first three years following imposition. About 31.7 percent of the three-year burden of this tax would be borne in the first year, and if job losses are distributed in the same pattern as costs, the first-year employment effects would be 195,500 lost jobs in 1993.

A Senate bill endorsed by Senator Gore would raise the CAFE standard to 40 MPG by 1996. Such a jump in CAFE standards would, by the time it was fully effective, lose approximately 166,000 jobs in auto manufacturing and at least 150,000 jobs in general

¹¹ For example, the Urban Institute estimated employer costs of a slightly different play or pay plan, with a 7 percent payroll tax, at \$29.7 billion, however, premium costs were underestimated by approximately \$8 billion, in Zedlewski, Acs, Wheaton and Winterbottom, "Pay or Play Employer Mandates: Effects on Insurance Coverage and Costs." (Washington: Urban Institute, January 1992). A higher tax rate would increase employer costs.

¹² JEC\GOP Health Care Briefing Paper No. 5, "Run From Coverage: Job Destruction From a Play or Pay Health Care Mandate," prepared for Representative Richard K. Armey (R-TX), April 9, 1992.

manufacturing for a total job loss of 316,000, and a 45 MPG CAFE standard would lead to a loss of at least 232,400 jobs in automobile manufacturing and another 210,000 jobs in general manufacturing, for a total job loss of 442,400. If there is a 3-4-5-5 MPG improvement over the four years with a similar gradually rising cost burden to industry, the first-year share of the employment losses is 75,840 jobs. Total jobs lost in 1993 from the carbon dioxide and automobile mileage goals of the national Democrat ticket is 271,340, with far greater job losses in later years.

Indexing Minimum Wage

The platform passed at the Democratic Convention in New York advocates "an indexed minimum wage"¹³ although there were no details of how this would be achieved. In preparation of this report, a member of the Clinton staff indicated that the Governor "was committed to the notion of indexing the minimum wage, however, he has not as yet focused on any details of that process."¹⁴

Given this lack of detail, we conservatively assumed a simple indexation of the present wage to the Consumer Price Index (CPI). There is no dispute that an increase in the minimum wage loses jobs. GAO has summarized the evidence regarding the minimum wage, finding "virtually total agreement that employment is lower than it would have been if no minimum wage existed... As the minimum wage reduces employment, some workers lose jobs or are unable to find jobs, and thus lose income."¹⁵ To adjust for price changes from 1990 to 1991, the Federal minimum wage would have had to increase by 4.2 percent. Such an increase in the minimum wage will directly raise absolute and relative costs to hire and retain low-wage workers. Employers will find that many of these workers are not economically advantageous to employ. We estimate that the first-year employment adjustment will be a loss of 42,021 jobs in the economy.

An alternative indexing approach has been contained in legislation offered previously by the Democrat leadership.¹⁶ This scheme would set the minimum wage equal to 50 percent of the average private, nonsupervisory, nonagricultural hourly wage. Using the Bureau of Labor Statistics (BLS)-indexed minimum wage, the current Federal minimum hourly wage rate would equal \$5.17 or a 92 cent increase. First-year disemployment effects from the BLS-indexed minimum are estimated to exceed 360,000 jobs. For the sake of this analysis, we employed the CPI-indexed minimum wage with its lower disemployment effects.

¹³ "Party Statement of Policies Mirrors Clinton's Goals," Congressional Quarterly, July 18, 1992, pg. 2111.

¹⁴ Personal conversation with Mr. Paul Weinstein, Clinton-Gore for President Committee, July 22, 1992.

¹⁵ U.S. General Accounting Office, Minimum Wage Policy Questions Persist, Report to the U.S. Senate Committee on Labor and Human Resources, 1983.

¹⁶ See for example, The Minimum Wage Restoration Act of 1987, S. 837 offered by Senators Kennedy and Mitchell.

Family and Medical Leave

Advocates of government-mandated family and medical leave present it as pro-family legislation; however, they neglect to mention that only upper income families benefit. Without question, legislation such as the Family and Medical Leave Act of 1991, which Mr. Clinton says he "will immediately sign into law,"¹⁷ differentially benefits baby boomers. This benefit, however, comes at the expense of poor working families, low-skilled workers and working women who are least able to afford it.¹⁸

Mandated family and medical leave is a costly and not widely attractive addition to employee benefit packages. This is because there are relatively few two-worker families with young children or aging parents who have the economic resources to take advantage of up to three months of unpaid leave from work. This mandate would impose significant new costs on business, balanced by small apparent demand. Even though employers may not pay the salaries of leave-taking employees, the SBA notes that during unpaid leave times firms incur costs in excess of the salary "savings."¹⁹ Additional costs arise from the mandate that firms continue to provide health benefits during the three-month leave period. The cumulative new mandate burden translates into 59,027 lost jobs, disproportionately affecting America's least skilled, lowest paid workers.

Higher Taxes On Individual Investment Income and On Corporations

Although the magnitude varies, virtually all economic literature and all economic models agree that higher taxes on individuals and on corporations reduce growth and employment. This study analyzed the disemployment effects of the higher taxes on "wealthy" persons (a group not clearly defined in PPF, but apparently reaching down to individuals with income near \$90,000 and families with income near \$130,000) and on corporations with two separate methodologies, taking the average of the two estimates.²⁰

¹⁷ Governor Bill Clinton, Putting People First: A National Economic Strategy for America, June 1992, 9.

¹⁸ JEC/GOP staff study, "An Analysis of S.5/H.R.2: The Family and Medical Leave Act of 1991 and Its Impact on Poor Working Families," prepared for Representative Richard K. Armey (R-TX) and Senator Bob Smith (R-NH), June 1991.

¹⁹ E. Trzcinski and W. Alpert, Leave Policies in Small Business: Findings from the U.S. Small Business Administration Employee Leave Survey, Washington, D.C., U.S. Small Business Administration, Office of Advocacy, October 1990.

²⁰ Clinton advisors have avoided stating a precise rate for the new bracket for the top 2 percent, but independent estimates range from 36 percent to close to 50 percent. A rate near the upper estimate will probably be needed to achieve the \$82.9 billion in additional revenue claimed by PPF through a higher AMT, a millionaire surtax and a higher top rate. The level of revenue generated is a function of the tax rate and of the amount of taxable income. CBO and JCT usually overestimate revenues from higher taxes on upper income persons, mostly by failing to account adequately for greater tax avoidance and lower economic growth.

Two methods are used because of the special emphasis of the Clinton tax increases on business and on investment income. Taxes so targeted will have a disproportionate impact on employment as they more directly tax productive enterprises and sound investors. Taking the mid-point of these two estimates, yields 437,078 lost jobs as a result of Governor Clinton's higher taxes.

Training "Tax"

This new mandate on all private employers is part of Clinton's "Lifetime Learning" initiative. The new programs have a net cost of \$21 billion in the first year and \$84 billion over four years. PPF packaged the proposal to hide additional mandated spending on training, billions a year above an estimated \$14.8 billion spent under current tax preferences. Given that many businesses will have to increase spending on training to meet the minimum 1.5 percent of payroll, we conservatively assume a \$21 billion first-year additional tax increase, and a total \$84 billion four-year tax hike. Using estimated civilian work force and average earnings of covered employees, we estimate that this new regressive payroll "tax" will increase labor costs enough to result in job losses of 264,950 jobs in the first year.

Reduction in Federal Workforce

Clinton has pledged to reduce the Federal workforce by 100,000; that figure is incorporated here. PPF includes \$15.1 billion first-year cuts in current domestic program administration and spending. Of this \$15.1 billion, an ambiguous \$11.1 billion occurs in overhead, personnel, administrative and accounting changes. The remaining \$4 billion 1993 domestic spending cut consists of the line-item veto, reduced HUD grants, increased nuclear waste disposal fees and a terminated honey program. Presumably, the 100,000 person workforce reduction is the combined employment effect of the real and asserted changes.

Policies Creating Jobs

Expanding EITC and the "Middle Class Tax Cut"

These tax cut elements of "Rewarding Work and Families" are aimed at spurring consumption rather than encouraging investment; as such, the economic growth potential is lessened. According to the Clinton plan, the EITC would have zero revenue effect in 1993, and a net \$1.5 billion revenue loss over four years. The "middle class" tax cut was not scored in the PPF document, but Clinton economic policy advisor Gene Sperling indicated later that the revenue loss would be at least \$60 billion over four years.²¹

By themselves, these tax cuts would increase consumer demand, thus production of consumer goods, and eventually jobs in goods producing industries. However, \$56 billion of the four-year \$60 billion middle class tax cut is offset by the proposed new taxes on non-

²¹ Birnbaum, Wall Street Journal, op. cit.

investment income of upper income individuals. Consequently, there is virtually no net positive economic or employment effect to this portion of the Clinton tax plan.

Highway Portion of "Putting America to Work" -- "Rebuild America"

Both PPF and an earlier version of Clinton's economic plan (A Plan For America's Future) would "spend the first two years of (highway bill) money in the first year."²² This amount is about \$17 billion. The claim is made that expedited highway construction spending would create 200,000 additional jobs. Despite the full "pipeline" for highway spending noted above, this analysis accepts this jobs claim at face value.

Non-Highway Portion of "Putting America To Work"

The non-highway portion of "Rebuild America" is \$6.2 billion in 1993, to initiate a high-speed rail network, develop the V-22 Osprey for commercial use, create a fiber-optic network, spend more on "environmental technology" to reduce pollution and energy consumption, and other initiatives. Although most projects would entail more than one year in planning time before implementation, we generously assume that the job creation rate of the remaining \$6 billion will equal Clinton's claims for highway spending. Thus, this portion of "Putting America to Work" will create 72,941 jobs in 1993.

Summary of Economy-Wide Employment Effects

At a minimum, Clinton's economic plan will cause widespread economic dislocations, with 1.855 million jobs lost in the first year. The civilian unemployment rate will increase by 1.5 percentage points above what it would otherwise be. The projected first-year employment effects of the Clinton economic plan are summarized in Table 2.

²² Clinton for President Committee, "A Plan for America's Future," January 1992, pp. 4-5.

Table 2 -- First-Year Job Effects of Clinton Economic Plan

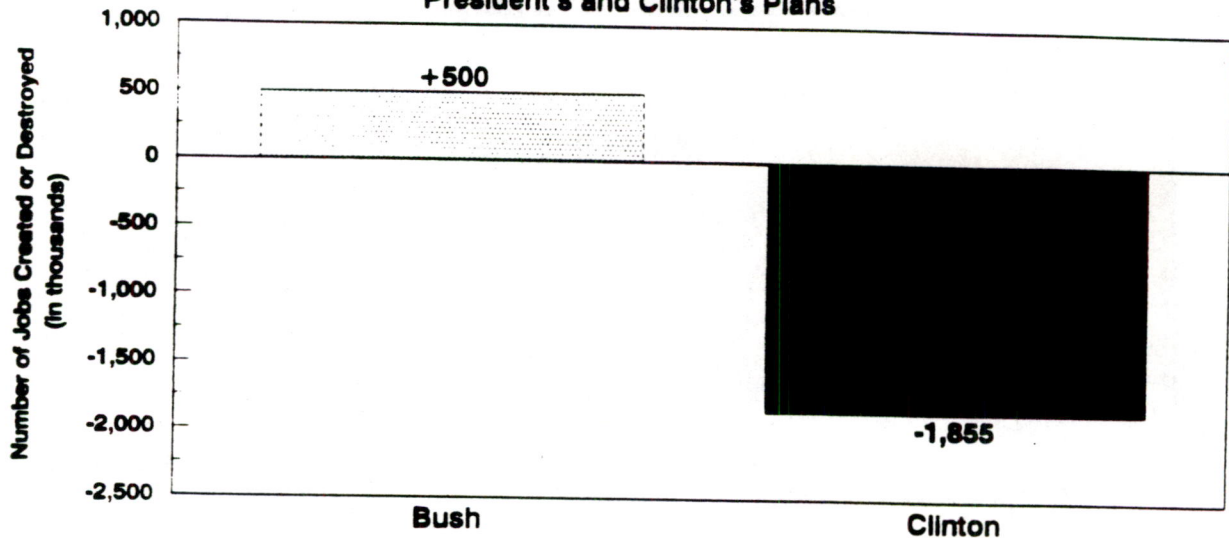
Policy	First-Year Employment Effects
<u>Policies Destroying Jobs</u>	
Defense Budget Cuts	240,685
Health Care Mandate	712,742
New Environmental Regulation	271,340
Increases In Minimum Wage	42,021
Family and Medical Leave Mandate	59,027
New Training Tax	264,950
New Individual and Corporate Taxes	437,078
Federal Work Force Cuts	100,000
Gross Employment Losses	2,127,843
<u>Policies Creating Jobs</u>	
Highway Spending Increases	200,000
Non-highway Spending Increases	72,941
Gross Employment Gains	272,941
<u>Net Employment Effect of Clinton Economic Plan</u>	
Net Employment Losses	1,854,902

Source: "Putting People First" and JEC\GOP staff calculations.

Comparison With the President's Economic Growth Package

The employment effects of the Clinton economic proposals stand in stark contrast to the estimated impact of President Bush's economic growth package, which was rejected by Congress earlier this year. According to the Council of Economic Advisers, the President's initiatives would have had the effect of creating an additional 500,000 jobs in their first year of enactment. This would lower the 1993 unemployment rate by 0.4 percentage points. A comparison of the first-year impact of the Clinton proposals with those of the President is provided in Graph 1, where the employment gains net of anticipated growth in the labor force and employment under the two alternatives are shown. The difference between the programs creates a "swing" in the number of jobs created/destroyed of 2,355,000.

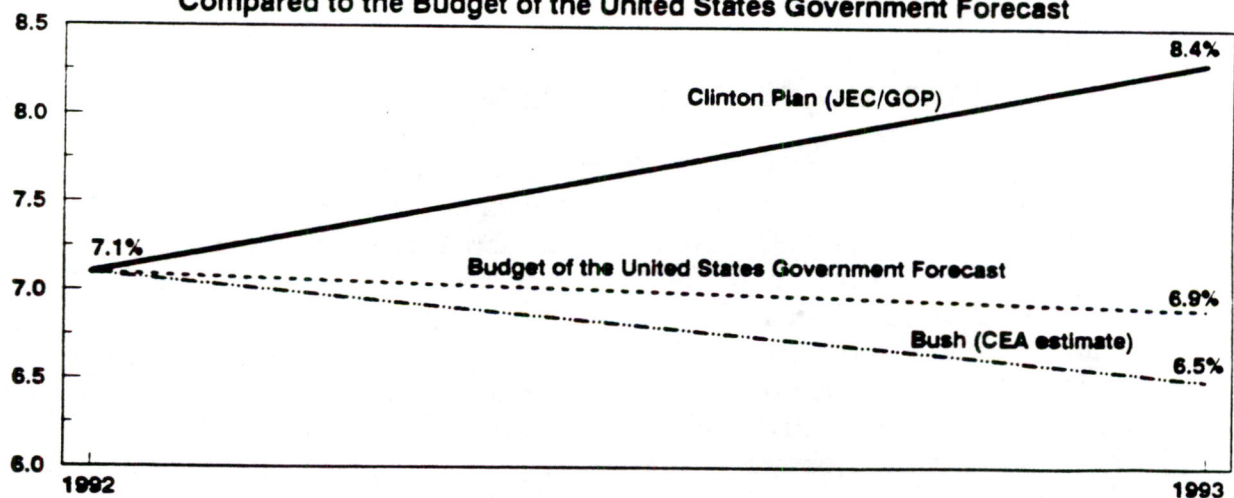
Graph 1 -- First-Year Employment Impact Under President's and Clinton's Plans



Source: JEC/GOP staff calculations and President's Council of Economic Advisers

The differential job creating impacts of the two plans translate into a 1.9 percentage point difference in the unemployment rate. In Graph 2 the estimated effects on the unemployment rate are compared with the forecast of the unemployment rate for 1992 and 1993 provided in the Budget of the United States.²³ The Budget forecast for 1992 is assumed to hold under either plan, with the effects of the two plans being felt in 1993.

Graph 2 -- Estimated Unemployment Rates 1992-93 Under Bush and Clinton Plans, Compared to the Budget of the United States Government Forecast



Source: JEC/GOP staff calculations and President's Council of Economic Advisers.

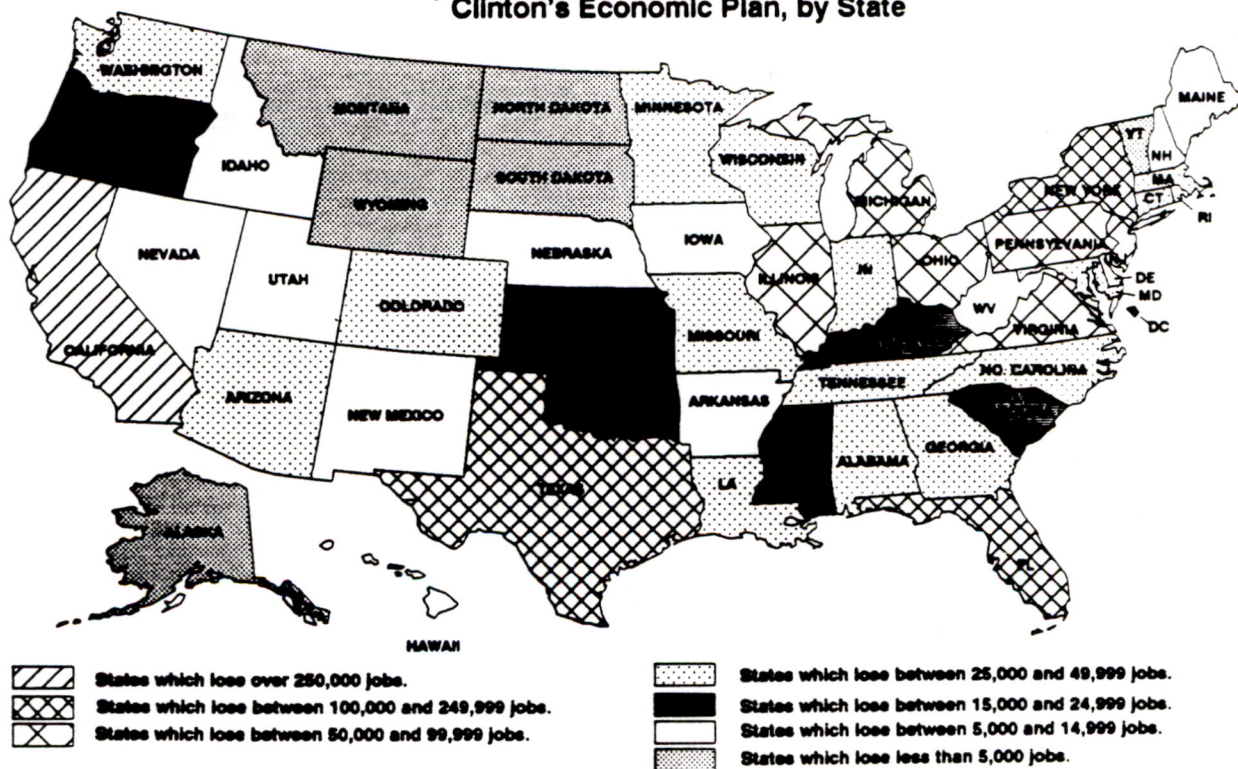
²³ For details of the analysis, see Budget of the United States Government, Fiscal Year 1993, (Washington, D.C.: U.S. Government Printing Office, 1992), Part One, Chapter 1. The budget forecast for the 1992 unemployment rate is 7.1 percent, only 0.1 percentage points less than the 1992 forecast contained in the most recent issue of Blue Chip Economic Indicators, vol. 17, No. 7, July 10, 1992. The Budget forecast for 1993, 6.9 percent, is more conservative than the Blue Chip forecast of 6.7 percent.

STATE-BY-STATE FIRST-YEAR JOB LOSSES FROM THE CLINTON ECONOMIC PLAN

"Putting People First: A National Economic Strategy for America" is an anti-growth package of increased taxes, wasteful government spending and oppressive new regulations that would result in a loss of over 1.8 million jobs in 1993 alone. Overall employment measures, however, mask the markedly different job prospects within the U.S. economy. Industrial production and service-sector employment vary widely across the 50 states, thus the impact of Clinton-induced employment losses can be predicted to be non-uniform throughout the United States. As Map 1 indicates, the magnitude of job loss varies across state boundaries.

- One state -- California -- leads the United States in every category of employment effects with the net job loss accounting for 15 percent of all job losses.
- Three additional states -- New York, Texas and Florida -- account for over 20 percent of the disemployment effects.
- Even the states with the fewest job losses -- South Dakota, Vermont, Wyoming, and North Dakota -- lose well over 2,000 jobs each.

**Map 1 -- Estimated First-Year Job Loss From
Clinton's Economic Plan, by State**



Source: JEC/GOP staff calculations.

The combination of regulations, taxes and new government spending initiatives contained in the PPF plan places differential burdens on state economies based upon their unique employment base. For example,

- Increased environmental regulations would hit the industrial heartland of America the hardest. Over 67,500 lost jobs or 25 percent of environmental disemployment effects would be concentrated in just four states -- Illinois, Michigan, Ohio and Pennsylvania.
- Clinton's play or pay health care plan would differentially harm small employers with job losses concentrated in the very small business sector, with firms with fewer than 20 employees losing 308,500 jobs. Of the 1,795 jobs Montana can expect to lose if play or pay becomes the law of the land, over 61 percent will occur in firms with fewer than 20 workers. Ten states -- Wyoming, South Dakota, North Dakota, Iowa, Alaska, Idaho, Vermont, New Mexico, Oklahoma, and Oregon -- will experience 50 percent of their job losses in firms with fewer than 20 employees.

New Federal mandates on business will have particularly deleterious effects, with over 60 percent of the estimated 1.85 million job losses coming from the increased encroachment of government on business practices. The five areas of increased Federal mandates -- health care, family and medical leave, minimum wage indexing, training tax and environmental regulations -- add thousands of dollars to the cost of employing every worker.

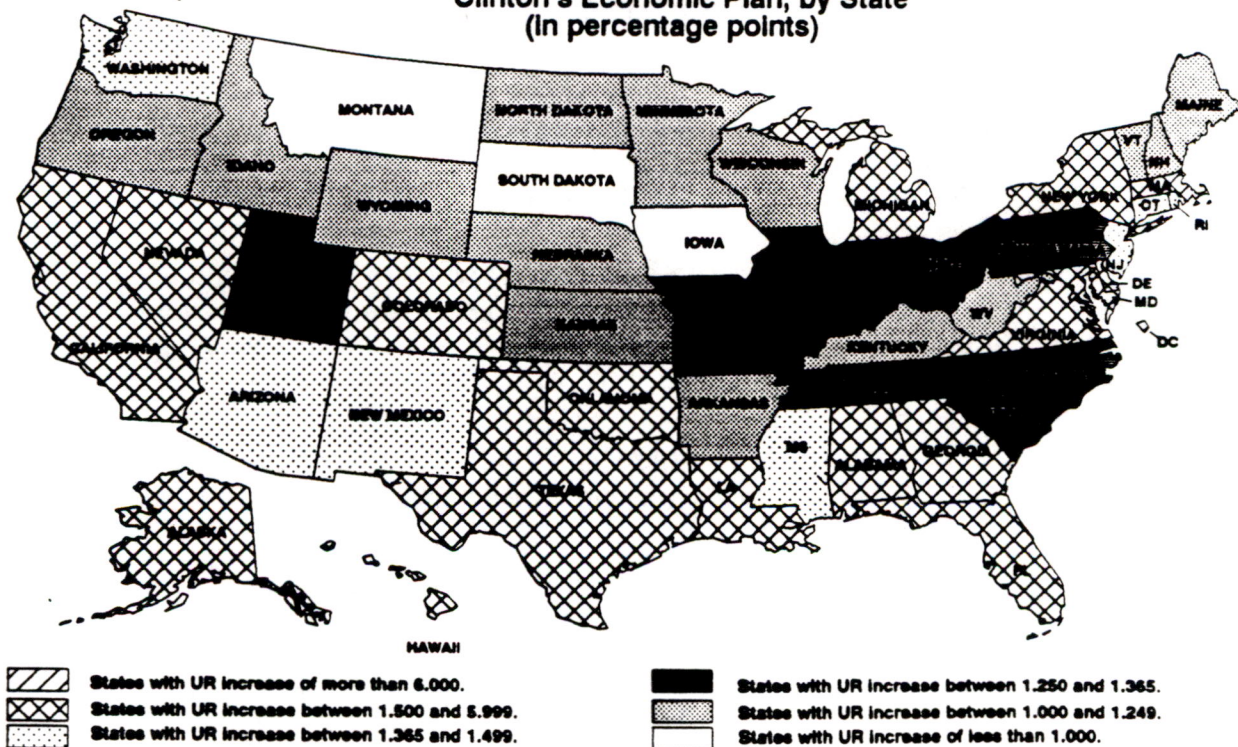
- Six states -- California, Texas, New York, Florida, Michigan and Ohio -- would bear the brunt of the mandates losing a total of 600,000 jobs.
- Even non-industrial North Dakota would face the prospect of losing over 2,000 jobs.
- New mandates would not tax wealthy business owners and stockholders; they would tax the use of labor, particularly low-skilled, marginal workers. As employers cut payrolls in response to the new costs imposed by PPF, workers paid at or near the minimum wage rate are particularly vulnerable. Other workers will see their cash wage decline as employers adjust the total compensation bundle.

The loss of over 1.8 million jobs would add approximately 1.5 percentage points to the U.S. employment rate (UR) while having differential effects across the states as illustrated by Map 2.

- Due to the disproportionate number of Federal employees in the District of Columbia, the unemployment rate would increase by over 6 percentage points if PPF were enacted.
- Sixteen states would experience UR increases of over 1.5 percentage points.
- Only 3 states -- Iowa, South Dakota, and Montana -- would have UR increases below 1.0 percentage points.

American voters, as well as Members of Congress, would be greatly concerned if a private company employing thousands of workers in their city or town announced plans to close its doors forever. They would rally around their community to see what could be done to prevent the business closure. The consequences of imposing the flawed Clinton economic plan on the U.S. economy would achieve the same undesirable result for millions of American workers and their families.

Map 2 -- Increase in Unemployment Rate (UR) from Clinton's Economic Plan, by State (In percentage points)



Source: JEC/GOP staff calculations.

WHICH WORKERS WILL FACE JOB LOSSES

At the heart of the Clinton National Economic Strategy is the belief that it is possible to shift the cost of "desirable" social programs to employers without any negative economic consequences. Proponents of this approach argue that Federally mandated health care, family and parental leave, training and an indexed minimum wage rate are all necessary to assure that all workers have equal access to such benefits. Ironically, those individuals and families proponents assert they are most interested in helping would be subject to the most harm from such a flawed approach.

To understand the consequences of these new taxes and mandates on employment, it is essential to carefully examine the characteristics of the workers these policies are intended to help. In almost every case, these are workers with low earnings, few skills and low attachment to the labor force. They are precisely the workers that can least afford to lose their employment.

Imposing a training tax in combination with an indexed-minimum wage, family and parental leave and health benefit mandates has the effect of dramatically raising the cost of using human labor in the production process and increasing the relative attractiveness of capital, i.e., replacing workers with machines. As a result, the Clinton approach would lead to a reduction in the demand for labor and an increase in the demand for capital equipment that can supplant workers in the production process. As not all labor is of equal value to the employer, we can predict with certainty that the imposition of these policies will have differential effects across the labor pool as well as within any given firm.

Professional and administrative employees are highly trained, earning far in excess of the minimum wage. In addition, they are far more likely to have medical benefits and parental leave coverage than are blue-collar workers.²⁴ Thus, increases in labor costs from these mandates will be disproportionately concentrated among lower income employees. As employers seek to minimize production costs, more options to substitute capital for labor exist among the least skilled workers in the production process.

Further, employers will seek to hire workers who are unlikely to take advantage of this new benefits. For example, everything else equal, we should expect that employers will be less likely to hire women of child-bearing age and low skilled workers given a parental leave and medical benefit mandate.

New mandates, as well as the training tax, will change the benefit package that small employers can offer their employees, placing an even greater wedge between the kinds of

²⁴ Meisenheimer II, Joseph R. "Employer Provisions for Parental Leave," Monthly Labor Review, 112, No. 10, pgs. 20-24, 1989 and Jill Foley, Sources of Health Insurance and Characteristics of the Uninsured, Analysis of the March 1991 Current Population Survey, EBRI, Issue Brief No. 123, February 1992.

benefits offered by small and large firms. This impact would be particularly onerous for lower paid workers employed in smaller firms who already receive a relatively smaller proportion of paid benefits. The result will be fewer of these workers with jobs. Even those lucky enough to remain employed will now find their total compensation bundle of less value.

CONCLUSION

The Clinton economic plan entitled "Putting People First: A National Economic Strategy for America" would be more accurately entitled "Putting People Out of Work." While shrouded in economic growth rhetoric, implementation of the plan would mean the elimination of hundreds of thousands of jobs during the first term of a Clinton presidency.

A conservative estimate of the plan's components reveals that:

- the claims of deficit reduction are overinflated by a factor of two-thirds;
- economic growth claims based on new government spending exceed even the rates of the most optimistic Keynesian economic models;
- new taxes and regulations on business and industry will place a stranglehold on the American "job machine" and generate massive employment losses and economic hardship;
- widely variant disemployment effects will occur across the 50 states with the job losses differentially distributed in the work force resulting in relatively low-wage labor bearing a higher proportion of the job losses; and
- the small business sector will be hardest hit by the taxes and mandates as they are the major employer of minimum wage workers without benefits like health insurance and medical and family leave. The detrimental impact on small business is magnified further as smaller establishments are more sensitive to incremental cost increases than large businesses.

This study was prepared by JEC\GOP staff: Senior Policy Analyst Doug Koopman, Ph.D., Senior Economist Dolores Tremewan Martin, Ph.D., Visiting Scholars Gary Anderson, Ph.D., and Lowell Gallaway, Ph.D.

APPENDIX

Methodology Underlying Job Loss Estimate

Carbon Taxes

A commitment to major carbon dioxide emissions regulation would create large economic losses and job loss. The baseline case, assuming no new emission controls, predicts an annual growth in CO₂ emissions of between 1.4 and 2.7 percent. Freezing those levels will be very costly.

Most experts agree that the most efficient means available to achieve a stabilization of CO₂ emission levels is a carbon tax. Jorgenson and Wilcoxon²⁵ estimate that carbon taxes needed to stabilize CO₂ emissions at 1990 levels would reduce real gross national product (GNP) by 0.5 percent by 2000, or \$34.9 billion (in constant 1990 dollars). Others have projected a tax of this size would reduce GNP in 2000 by 2.0 percent, or \$139.5 billion (in constant 1990 dollars).²⁶

A disproportionate share of job loss will fall on those industries where carbon use is the greatest, and in those industries most dependent on carbon-based fuels. A carbon tax implies large cost increases for most major forms of energy (including coal, natural gas, gasoline, and electricity from public utilities which operate generating stations requiring non-nuclear, fossil fuels) and will consequently result in higher cost increases and greater job losses on industrial sectors most dependent on energy as an input.

Hardest hit by a carbon tax will be metal mining, oil and gas production, petroleum and coal products manufacturing, and primary metals manufacturing. All of these industries either produce, sell, or in their operations utilize large quantities of fossil fuels. Employees in the transport services sectors serving these industries will also be severely affected. The imposition of a carbon tax will also produce indirect job losses in industries that furnish goods and services to the above-mentioned industries.

About 68 percent of the jobs lost due to a carbon tax will occur, however, in other than these most severely affected industries. General manufacturing establishments will confront higher prices for needed energy; restaurants will face higher energy costs and decreased demand for their meals; the construction industry will pay more for materials and see a drop in home sales. Energy producing industries will be the most severely affected,

²⁵ Dale W. Jorgenson and Peter J. Wilcoxon, "Reducing U.S. Carbon Dioxide Emissions: An Assessment of Different Instruments," Harvard Institute of Economic Research, Discussion Paper 1590, April 1992.

²⁶ Congressional Budget Office, Carbon Charges as a Response to Global Warming: the Effects of Taxing Fossil Fuels (Washington, D.C.: August 1990).

but the biggest impact in terms of jobs lost will be in other sectors.

This lost economic output will generate very large job losses. The Urban Institute²⁷ calculates that a carbon tax of \$15 per ton, rising by 5 percent annually for 20 consecutive years, would be necessary in order to stabilize CO₂ emissions at 1990 levels. Such a tax would lead to a loss of 616,300 jobs in the first three years following imposition.²⁸ About 31.7 percent of the three-year cost of this tax would be borne in the first year. If job losses are distributed in the same pattern, the first-year employment effects would be 195,500 lost jobs in 1993.

CAFE Standards

A Senate bill endorsed by Senator Gore, S. 279, would raise the CAFE standard to 40 MPG by 1996. Such a CAFE standard would kill approximately 166,000 jobs in auto manufacturing, and at least 150,000 jobs in general manufacturing, for a total job loss of 316,000.²⁹ If the cost in jobs lost for every additional MPG increase in the CAFE standard is constant, a 45 MPG CAFE standard would lead to a loss of at least 232,400 jobs in automobile manufacturing and another 210,000 jobs in general manufacturing, for a total job loss of 442,400. If there is a 3-4-5-5 MPG improvement over the four years with a similar cost burden to industry, the first-year share of the employment losses is 75,840 jobs.

More stringent CAFE standards would tend to increase the cost of manufacturing new cars, and adversely impact on consumer demand for new autos. Choice among technically available car designs would be restricted, reducing aggregate demand for new cars. These two effects taken together will reduce the demand for labor in the auto industry, and result in net job loss. The many industries which support auto manufacturing (for example, parts manufacturers) will similarly experience a decline in demand for their products, and reduced employment. Finally, automobiles mandated to achieve higher miles-per-gallon will be more expensive, adversely affecting the many industries which rely on car fleets in their business. Robert Crandall of the Brookings Institution calculates that the increased cost of each additional mile-per-gallon for a given model year's cars is \$1 billion. Firms confronting these higher costs will reduce employment still further.

The Motor Vehicle Manufacturing Association calculated the anticipated job loss due to a 40 mpg CAFE standard for the national economy. This estimate is divided into two parts -- job loss in the passenger car manufacturing sector and job loss in the general

²⁷ Urban Institute, Preliminary Analysis of Distributional Effects of Energy Taxes (Washington, D.C.: February 1992).

²⁸ See Wilbur A. Steger and Frederick H. Rueter, Jobs-at-Risk: Short-term and Transitional Employment Impacts of Global Climate Policy Options (Pittsburgh, PA: Consad Research Corporation, May 1992).

²⁹ Job loss estimates calculated by the Motor Vehicles Manufacturers' Association.

manufacturing sector. The cost of a more stringent CAFE standard will be partly passed on to consumers of automobiles. Based on Crandall and Graham (1989),³⁰ increasing the CAFE standard to 45 MPG will result in added costs to car consumers of \$17.5 billion.

More stringent CAFE standards also generate large human costs. The chief means to increase vehicle MPG is reduce vehicle weight. Unfortunately, lighter vehicles are less safe than heavier cars. Crandall estimates that a 40 MPG CAFE standard would result in between 4,800 and 8,600 additional highway fatalities over the life of a model year.

Minimum Wage

The minimum wage was \$4.25 per hour in 1990 and the percent change in the Consumer Price Index (CPI) between 1990 and 1991 (the latest available period) was 4.2; therefore, a CPI-indexed minimum wage would be \$4.43 per hour, up 18 cents. We estimate that a 4.2 percent increase in the minimum wage will adversely affect employment by directly raising the absolute and relative cost of hiring and retaining low-wage workers. Given the higher Federal minimum and the limited productivity of low-wage workers, employers will find that many of these workers are not economically advantageous to employ. We estimate that the first-year employment loss will be 42,021 jobs.³¹

An alternative approach to indexing the Federal minimum wage rate has been contained in legislation offered previously by the Democrat leadership.³² This methodology would set the minimum wage rate equal to 50 percent of the average private, nonsupervisory, nonagricultural hourly wage, as determined by the Bureau of Labor Statistics (BLS). Using BLS-indexed minimum wage, the current Federal minimum hourly wage rate would equal \$5.17 or a 92 cent increase. First-year disemployment effects from the BLS-indexed minimum are estimated to exceed 360,000 jobs.

Family and Medical Leave Act

Legislation such as the Family and Medical Leave Act of 1991, which Mr. Clinton says he "will immediately sign into law,"³³ differentially benefits baby boomers. This benefit, however, comes at the expense of poor working families, low-skilled workers and working women who are least able to afford it:

³⁰ Robert W. Crandall and John D. Graham, "The Effect of Fuel Economy Standards on Automobile Safety," Journal of Law and Economics, XXXII (April 1989); pp. 97-118.

³¹ R. McKenzie and C. Simon, The Proposed Minimum Wage Increase: Associated Job Loss by State, Region and Industry, The National Chamber Foundation, Washington, D.C., 1988.

³² See for example, The Minimum Wage Restoration Act of 1987, S. 837 offered by Senators Kennedy and Mitchell.

³³ Putting People First, pg. 9.

- Low-income workers will be forced to work longer to compensate for lost production due to higher paid co-workers taking leave;
- The set of benefits available to low-income workers will be restricted and of less value. Low-income workers are more likely to work for small firms that offer increased flexibility in working conditions. Mandates have a chilling effect on tailoring working conditions to individual needs.
- Low-skilled workers are more likely to be phased out of the production process as employers shift to more capital-intensive processes.
- Mandated family leave reduces employment opportunities for females. Women are less likely to be hired and are more likely to face employment discrimination on the job.

Mandated family and medical leave is a costly addition to employee benefit packages, yet employees indicate it has little value when compared with other more desirable benefits such as health care or increased sick or vacation leave. This is because there are relatively few two-worker families with young children or aging parents who have the economic resources to take up to three months of unpaid vacation. A 1988 Small Business Administration (SBA) study, updated to 1991, indicates that slightly more than two million workers would take up to 12 weeks unpaid leave upon passage of a federally mandated, employer provided parental/family leave policy.³⁴

This mandate would impose significant new costs on business even if the leave was unpaid. The 1991 average net cost per new leave-taking worker is estimated at \$1,995 to cover continued health benefits and handle the leave takers' workload. This figure represents an increase in payroll costs of 8.9 percent for the average full-time worker in 1991. The new labor cost burden on America's business would exceed \$3.3 billion a year. Even though employers may not pay the salaries of leave-taking employees, according to the SBA, firms incur costs in excess of the salary "savings." In addition, costs arise from the mandate that firms continue to provide health benefits during the three-month leave period. The new mandate burden translates into 59,027 lost jobs, disproportionately affecting America's least skilled, lowest paid workers.

Taxing High Income Individuals, Investment and Business

Taxes on upper income individuals will have a disproportionate and negative impact on economic growth and employment. Because a larger share of the income of upper income individuals (compared to taxpayers at other income levels) is investment income,

³⁴ E. Trzcinski and W. Alpert, Leave Policies in Small Business: Findings from the U.S. Small Business Administration Employee Leave Survey, Washington, D.C. U.S. Small Business Administration, Office of Advocacy, October 1990.

"taxes on the rich" more directly punish productive enterprises and sound investors. In this study, we used two methods to capture the disemployment effects of these new taxes.

The first method does not distinguish between types of taxation, and is based on a DRI/McGraw-Hill model used by, among others, the Congressional Research Service of the Library of Congress. That model calculates that every \$10 billion in individual or corporate tax increases raises joblessness 0.1 percentage point. Under this rule, PPF's net \$26 billion first-year tax increase would raise unemployment 0.26 percentage point, or by about 325,000 persons.³⁵ The second method utilized more fully considers the employment impact of taxes on investment. Robbins and Robbins have found that a \$1 billion tax change on investment income correlates with a \$25 billion drop in nominal GDP over five years.³⁶ First-year GDP effects are about 20 percent of the total effect; consequently, every \$1 billion in higher investment taxes correlates with \$5 billion lower GDP in the first year. For the top 2 percent of individual tax returns, about 40 percent of taxable income is generated by investment (rents, interest, dividends or capital gains). Therefore, PPF's \$19.8 billion individual tax increase on this group is a \$7.92 billion tax on their investment income. On the corporate side, PPF's net tax increase is \$6 billion in the first year (a \$11.3 billion increase minus \$5.3 billion in research and development and investment tax credit (ITC)) tax breaks, meaning a total new investment tax of \$13.92 billion in the first year.

This \$13.92 billion tax increase will result in \$69.6 billion lower GDP for 1993, about 1.1 percent below the projected \$6.337 trillion. The standard rule of thumb relating employment changes to changes in GDP is Okun's law, which notes that a 2.5 percentage point decrease in GDP is associated with a 1.0 percentage point increase in the civilian unemployment rate. With a work force of approximately 125 million, the projected decrease in GDP by this second method would mean 549,156 lost jobs in 1993.

Training Tax

The training tax job losses were calculated under the DRI/McGraw-Hill model. Based upon the estimated \$4.74 billion tax expenditure for employee education and training for 1992, currently employers spend \$14.8 billion total in this area. The training tax would mandate an additional \$21 billion of spending in employer-provided training each year. The new burden translates into 264,950 lost jobs in the tax's first year.

Redistributing Taxes From Upper To Middle Income

Some have argued that redistributing income through the tax system from upper income levels to lower income levels would be stimulative, because persons at lower income

³⁵ Conversation with Congressional Research Service staff, Economics Division, July 29, 1992, with estimate based on DRI/McGraw-Hill quarterly model of the U.S. economy.

³⁶ National Center for Policy Analysis, "Study: Recession Lingers Because of U.S. Tax Policy," January 22, 1992, pg. 1.

levels are more likely to consume. But a review of the theoretical and empirical evidence suggests that there are no significant differences in the marginal propensity to consume or save across the income spectrum, thus there would be no stimulative effect of such a government-induced shift.³⁷ Consequently, the stimulative effects of the \$60 billion four-year middle income tax cut in PPF is canceled out by the stifling effects of the \$56 billion tax increase on the non-investment income of the wealthy.

³⁷ Library of Congress, Congressional Research Service. "Current Tax Cut Proposals: An Economic Analysis," Issue Brief 92-004, December 9, 1991.



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FOR IMMEDIATE RELEASE

STUDY: CONGRESS SPENDS \$1.59
FOR EVERY DOLLAR IN NEW TAXES

Since World War II, the Federal government has spent \$1.59 for every dollar raised in new taxes, which means that tax increases tend to increase rather than reduce the Federal budget deficit, according to a recent study released by the two top Republicans on Congress's Joint Economic Committee (JEC).

"Increases in Federal tax revenues continue to be associated with greater increases in Federal expenditures, leading us to conclude that tax increases do not reduce budget deficits," write economists Richard Vedder, Lowell Gallaway and Christopher Frenze in the conclusion of "Taxes and Deficits: New Evidence ('The \$1.59 Study')," which was released by U.S. Sen. William Roth (R-DE) and Rep. Dick Armey (R-TX) of the JEC.

According to this latest JEC Republican study, the political gains from government spending are greater than the political costs of deficit spending, so lawmakers are willing to borrow to finance programs. This "marginal political benefit" of deficit spending is higher today than at any time in American history.

Between 1791 and 1825, every dollar increase in taxes was associated in a three cent decrease in spending. Between 1867 and 1913, every dollar in new taxes was associated with 72 cents in new spending. Between 1947 and 1990, every dollar in new taxes has resulted in \$1.59 in new spending.

"Congressional support for higher taxes and pork-barrel spending has turned the economy into a chamber of horrors for the American taxpayer," said Sen. Roth in releasing the study. "Just last year during the budget summit, arguments were made that a tax increase was needed to cut the deficit. And what happened? The deficit has soared to record levels and is expected to reach \$362 billion by the end of this fiscal year."

Rep. Armey added, "The \$1.59 study demonstrates statistically what American taxpayers know intuitively. We don't have budget deficits because taxpayers don't pay enough, we have deficits because

TAXES AND DEFICITS: NEW EVIDENCE

("The \$1.59 Study")

by Richard Vedder, Lowell Gallaway and Christopher Frenze

Prepared for

Senator William V. Roth, Jr. (R-DE)
Senior Republican Senator

and

Representative Richard K. Armey (R-TX)
Ranking Republican

Joint Economic Committee

October 30, 1991

EXECUTIVE SUMMARY

In recent years higher taxes have been repeatedly justified to reduce the Federal budget deficit. This strategy has been based on a self-styled "pragmatic" approach, pragmatism being defined as what works. Concern about the effect of new taxes on the economy, or on the spending habits of public officials, was given short shrift by pragmatism. The crowning triumph of this strategy was the 1990 budget agreement, which raised taxes \$160 billion, supposedly to reduce the deficit. However, the facts contained in this study and elsewhere show that Federal spending actually accelerated after the 1990 tax increases were enacted, and budget deficits have hit record levels. The only problem with this fiscal pragmatism is that it doesn't work.

This stimulation of higher deficits by tax increases is not surprising. An earlier study by the same authors on the postwar years 1947-86 found that every \$1.00 in new taxes generated \$1.58 in new spending. Other research as well as practical knowledge about how Congress operates suggests the same general conclusion: new revenues will be spent on more or bigger programs rather than deficit reduction. The hemorrhaging of spending under the 1990 budget summit was predictable and in fact predicted by its Congressional opponents. The only mystery is how anyone could believe that Congress would not spend all of the new taxes, and then some.

This new study reaches several conclusions about the relationship between taxes and spending, based on an analysis of 1947-90 data, and more recent budget information:

- The tax-deficit relationship has remained fairly constant in recent years with no evidence that the tendency of new taxes to stimulate new spending has decreased. If anything, the new data suggests a slight increase so that \$1.00 of new taxes would be expected to generate \$1.59 of new spending.
- Over the history of the United States, the tendency of Congress to spend additional taxes rather than devote them to deficit reduction has climbed to an all time high. In the first decades of our fiscal history, tax increases were associated with declines in Federal deficits. Currently, increases in taxes have resulted in sharply higher deficits.
- The budget "deficit reduction" agreement is a dismal failure which has pushed taxes and budget deficits higher than ever before.
- The tax-deficit data at the state level do not show that tax increases spur higher deficits. This suggests that institutional constraints such as constitutional restrictions on deficit spending, and line item veto power of governors, may be useful tools in controlling the spending habits of legislators.

WILLIAM V. ROTH, JR.
Senior Republican Senator
Joint Economic Committee

TAXES AND DEFICITS: NEW EVIDENCE

("The \$1.59 Study")

by Richard Vedder, Lowell Gallaway and Christopher Frenze¹

In a study prepared in 1987 for the Ranking Republican Senator of the Joint Economic Committee, we argued that the econometric evidence for the 1947-86 period suggested that every \$1.00 of new Federal tax and nontax revenues was associated with \$1.58 in new Federal spending, implying that budget deficits rose with increases in the aggregate Federal tax rate.² This new follow-up study reaches six conclusions:

First, the tax-deficit relationship observed in 1987 has been maintained with little change with the passage of four more years of American Federal fiscal history. In other words, the 1987 to 1990 experience suggests that there has been no evidence of any diminution in the high Federal marginal propensity to spend new tax revenues; if anything, that propensity to spend has risen.

Second, the evidence suggests that tax increases have been associated with dramatic increases in expenditures for income transfers of various kinds, but with actual decreases in purchases of defense-related goods and services. Non-defense service spending is not affected by changing tax revenues. Thus new tax initiatives seem to be closely tied to efforts to redistribute income rather than offer new governmental services; clearly those initiatives have tended to increase, not reduce, budget deficits.

Third, the historical evidence from the first administration of President George Washington to the present shows that the Federal propensity to spend new tax revenues has grown consistently over time, as the political advantages of new spending have increased. At one time, new taxes were associated with very significant deficit reduction, but not in recent decades. Furthermore, the 1990 budget deal, which resulted in the largest tax increase in U.S. history, also generated the largest deficits on record.

Fourth, the findings are better understood by use of a simple cost-benefit theoretical framework of fiscal behavior developed by Dwight Lee of the University of Georgia and Richard Vedder of Ohio University, that draws on the laws of demand and supply. In the context of the findings reported here, the framework reveals that in the postwar era there

¹ Richard Vedder and Lowell Gallaway are both Distinguished Professors of Economics and Faculty Associates of the Contemporary History Institute of Ohio University. Christopher Frenze is a Republican staff economist with the Joint Economic Committee of Congress. The support of the Earhart Foundation for Professor Vedder was instrumental in developing some of the findings.

² "Federal Tax Increases and the Budget Deficit, 1947-1986: Some Empirical Evidence," Congressional Record, April 30, 1987, pp. S 5754-5755.

has been a pronounced increase in the marginal political benefits to spend; put differently, "the political demand for spending has increased."

Fifth, the positive relationship between taxation and deficits observed at the Federal level is not obtained at the state and local level, suggesting that different institutional arrangements constraining state governments, including balanced budget constitutional amendments, have a real impact on political and thus fiscal behavior. This suggests that those interested in constraining the amount of spending growth to or below the growth in revenues might learn from the experience of the states.

Sixth, a variety of other studies tend to confirm the findings reported here. Thus our confidence in the basic finding has been strengthened, not diminished, since the initial 1987 study.

I. THE TAX, SPENDING AND DEFICIT RELATIONSHIP, 1947-90

Taking data on Federal expenditures and Federal revenues from the national income accounts for the calendar years 1947 through 1990, we regressed Federal tax (revenue) levels against Federal spending levels.³ The statistical results indicate that each \$1.00 in tax revenues was associated with \$1.59 in expenditures, with the result highly significant statistically.⁴

In 1987, we argued that additional variables might affect receipts and expenditures and thus should be incorporated into the analysis for control purposes. For example, receipts and expenditures of the Federal government vary with the business cycle. We accordingly introduced a variable measuring real economic growth, **Growth**, and the rate of joblessness, **Unemployment**.⁵ Similarly, military spending presumably grows with major threats to national security as reflected in wars. Accordingly, we introduced a "war dummy"

³ The basic data were mostly taken from the 1991 Economic Report of the President, especially p. 381, and from U.S. Bureau of the Census, The National Income and Product Accounts of the United States, 1929-76 (Washington, D.C.: Government Printing Office, 1981), pp. 122-123.

⁴ In the actual statistical estimation, both variables were divided by GNP. Estimating absolute dollar amounts would not change the estimated coefficients, although it would impact on the constant term in the regression equation, an irrelevant consideration here. The obtained result is (ignoring an autoregressive adjustment term introduced to deal with serial correlation):

$$\begin{array}{rcll} \text{Spending} & = & -9.914 & + & 1.586 \text{ taxes,} & \bar{R}^2 = .601, \\ & & (2.115) & & (6.424) & D-W = 1.971, \end{array}$$

where the numbers in parentheses are t-values.

⁵ We used the growth in real GNP as our measure of growth, and the unemployment rate for civilian workers; both indicators are found in the 1991 Economic Report of the President.

variable, **War**.⁶ Finally, we introduced a variable for unanticipated inflation, **Inflate**, defined as inflation in the year in question minus the average of the previous three year's inflation rate.⁷ Introducing all of these additional variables makes a negligible difference in the reported tax-spend relationship:

$$\begin{aligned} \text{Spending} = & 14.453 + 1.587 \text{ Taxes} + 0.0806 \text{ Unemployment} \\ & (3.442) \quad (6.383) \quad (4.087) \\ & -0.044 \text{ Growth} + 0.480 \text{ War} - 0.128 \text{ Inflate,} \\ & (0.525) \quad (0.833) \quad (1.496) \\ \bar{R}^2 = & .782, D-W = 2.033, F\text{-Statistic} = 22.972, \end{aligned}$$

where the numbers in parentheses are t-statistics. Excepting the unemployment variable, all the control variables are statistically not significant.

The model explains well over three-fourths of the variation in spending over time, compared with about two-thirds in the similar model reported four years ago. The tax-spend relationship has actually strengthened slightly, suggesting the propensity to spend out of tax revenues has, if anything, increased with time.⁸

In this regard, in 1987 we stated "perhaps the changing institutional framework (e.g., the Gramm-Rudman budget law) has changed sufficiently so that the historical experience is not valid, although we are highly skeptical of that perspective given the growing indications the Gramm-Rudman limits are not going to be met in 1987."⁹ It appears our skepticism was justified, that the changes in effect in the late 1980s made no discernible impact on improving the budget deficit by constraining spending.

II. DISAGGREGATING THE TAX-SPEND RELATIONSHIP

Using alternative versions of the model (including, even, somewhat different time periods), the evidence is extremely consistent with the view that increases in tax revenues are associated with even bigger changes in Federal spending. Nonetheless, it is possible that

⁶ The variable took the value of one for the years 1950-53 and 1965-72, and the value of zero for all other years.

⁷ The annual CPI value for all urban consumers was used in calculating price changes; in the 1987 study, calculations were based on December-to-December price changes.

⁸ In 1987, we reported a \$1.58 coefficient on the tax variable. Incorporating some data revisions to some variables, we now obtain a coefficient of \$1.50 using the 1947-86 period, but the reported \$1.59 using the 1947-90 period, suggesting the additional years strengthened the positive tax-spend deficit relationship.

⁹ *op. cit.*, *Congressional Record*, p. S 5755.

the infusion of Federal revenues has a differential impact on spending. Have all forms of spending been equally enhanced by increases in tax revenue?

Following standard Federal classifications, we divided spending into six categories: purchase of defense goods and services; purchases of non-defense goods and services; transfer payments; grants-in-aid to state and local governments; net interest payments; and "other," a category that primarily includes subsidies to government-owned business enterprises. Using regression analysis, we then looked at the relationship between Federal tax (and nontax) receipts and expenditures in each of these categories over the 1947-90 period. In doing so, we used fiscal year data (because the detailed expenditures were more readily available on that basis) rather than calendar year data as in the 1987 study.¹⁰ We also dispensed with inclusion of control variables in the regressions, mainly because they seem to make no difference in the results relating to the tax-spend relationship, but also because of data difficulties on a fiscal year basis.

Using the fiscal year data, we observe that each \$1.00 in new revenues is associated with \$1.57 in new spending, as opposed to \$1.59 obtained using the calendar year data. Table 1 indicates the tax-spending relationship for each of the six categories of spending outlined above.

Table 1 -- Estimated Impact of \$1.00 Increase in Taxes on, 1947-90

Spending Category	Impact of \$1.00 Increases in Federal Tax Revenues	Statistical Significance
Transfer Payments	+ \$1.15	1 Percent*
State and Local Grants-in-Aid	+ \$0.48	1 Percent*
Net Interest Payments	+ \$0.31	1 Percent*
"Other" Payments (mostly subsidies to government enterprises)	+ \$0.03	5 Percent*
Defense Goods and Services	- \$0.39	1 Percent*
Non-Defense Goods and Services	\$0.00	Insignificant
All Spending	+ \$1.57	1 Percent*

* Probability that the observed positive or negative relationship could have occurred by chance -- that is, the observed relationship is spurious.

Source: See text.

There is a very strong positive relationship between tax revenues and transfer payments. Indeed, spending on transfers alone changed more than \$1.00 for each dollar of

¹⁰ *Ibid.*, pg. S 5755.

tax revenues. Similarly, there are important increases in grants-in-aid and interest payments associated with new taxes, and a minor one between taxes and "other" expenditures. The interest-tax relationship is interesting. It implies that: one, increased taxes increased deficits and thus interest payments on the national debt; two, increased taxes served to increase interest rates on government securities (perhaps because higher nominal interest rates are necessary after taxes rise to obtain any given after-tax return), or, three, both of the above factors.

Transfer payments, grants in aid, interest payments and "other" all involve the redistribution of income. Money received from taxpayers and, through borrowing, from new bondholders, is distributed to individuals, governments, old bondholders, and government enterprises. Together, each \$1.00 in new taxes is estimated to be associated with nearly \$1.97 in income transfers in one form or the other.

By contrast, new tax revenues are associated with reductions in government purchases of goods and services. There is no relationship between non-defense purchases and taxation. Regarding defense spending, a dollar in new tax revenues is estimated to be associated with a 39-cent reduction in defense spending.

These results suggest that new tax monies are associated not only with greater deficits but with reductions in traditionally provided government services. The results lend support to those who argue that tax increases promote income redistribution, or what some economists call "rent-seeking," the use of political power by special interest groups to obtain added income without a corresponding provision of added labor or capital services.

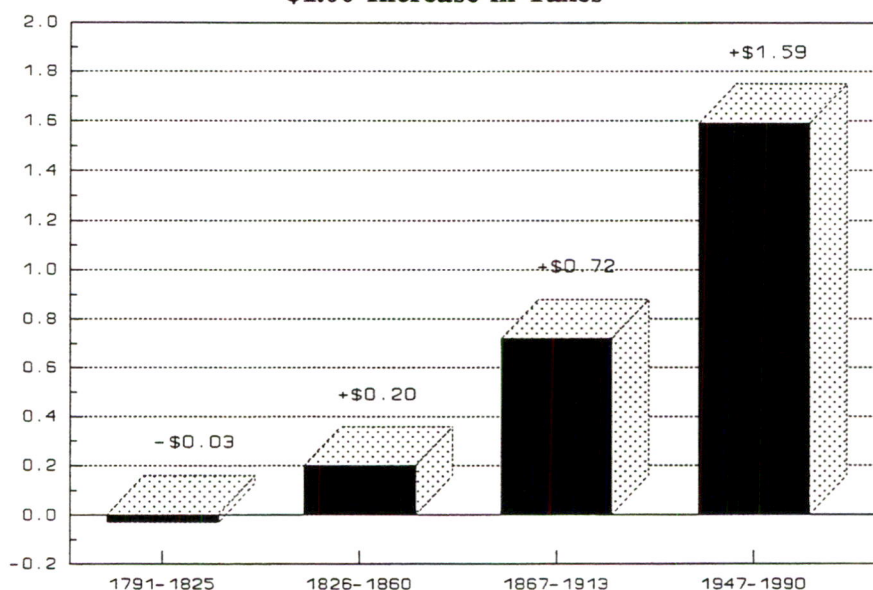
III. SOME HISTORICAL EVIDENCE

The tax-spend-deficit relationship has changed drastically over time. We used regression techniques similar to those used initially to estimate the relationship between spending and taxation for four fairly lengthy (at least 35 years), predominantly peacetime periods in American history: 1791-1825, 1826-1860, 1867-1913, and 1947-1990. Other control variables, shown unimportant above, are excluded mainly because of data limitations.

The results are summarized in Graph 1. In the earliest years of the Republic, revenue increases were not associated with spending increases; indeed, spending fell slightly (the type of change envisioned in the 1990 budget agreement). Even as late as 1867 to 1913, tax increases seem to induce some spending increases, but also some deficit reduction (if spending rises 72 cents per dollar of new taxes, then the other 28 cents of that dollar goes for deficit reduction).

Over time, the Federal government's "marginal propensity to consume" has risen consistently. The political benefits of spending are on the rise. Whereas, in an earlier era, shifts in the deficit or tax supply curve raised the possibility that a tax increase could lead to some deficit reduction, that has not been the case since World War II (and was becoming less the case even before then).

**Graph 1 -- Estimated Spending Associated with
\$1.00 Increase in Taxes**



Fiscal Outlook Under the 1990 Budget Agreement

All of the data needed to empirically measure the fiscal results of the 1990 budget agreement are not yet available. However, currently available information does indicate the general direction of tax and spending trends under this agreement, and their conformity to the model presented earlier. A review of the facts shows that the analytical framework presented in 1987 and in this paper is more than adequate to explain the increases in Federal spending and deficits after adoption of the 1990 tax increases.

On the basis of the public choice assumptions presented in our 1987 paper, several results of the 1990 budget agreement were predictable. These results follow from the notion of "fiscal illusion," a distortion of the cost-benefit calculus by the way publicly provided goods and services are financed. Fiscal illusion explains how the actual results of policymakers' decisions can contradict the expressed aims of the policymakers.

One form of fiscal illusion, "entails justifying additional taxation for a relatively popular purpose, though revenues will actually be diverted by government to other uses deemed less popular. For example, tax increases may be justified to the public as a means of deficit reduction, whereas the actual result will be to stimulate additional spending on programs favored by influential special interest groups. This 'bait and switch' tactic would be all the more effective under complex or incoherent budget processes which make taxpayer oversight almost impossible."¹¹

¹¹ *Ibid.*, pg. S 5755.

Screened from the public by an increasingly complicated and arcane budget process, policymakers in 1990 could have been expected to justify the largest tax increase in U.S. history by claiming it was needed to produce the largest deficit reduction ever. However, the tax model used here predicts that the actual result of the large tax increase would be to spur higher, not lower, Federal spending. As a result, Federal deficits would be expected to rise to record levels. Unfortunately, this is precisely what has transpired under the 1990 budget agreement.

The budget agreement initially was presented as a cumulative reduction of nearly \$500 billion in the deficit over a five-year period. About \$160 billion in projected new revenues were raised, \$18 billion in the first year and over \$30 billion annually in each of the next four years. Around \$120 billion was supposedly cut from hypothetical increases in domestic program spending over the same period, while debt service savings amounted to \$59 billion. Projected defense spending was trimmed \$91 billion.

It was claimed that \$2 in spending "cuts" were provided for every \$1 in tax increases.¹² Of course, virtually all of the spending "cuts," aside from those in defense, were from projected "baseline levels" which assume ever higher spending levels. Unfortunately, an examination of actual Federal outlays shows no evidence of actual spending control.

It will be recalled that the 1990 budget agreement was justified as a draconian measure to address the urgent "crisis" caused by deficit spending. Nonetheless, a review of budget data after the agreement reveals the unsurprising fact that Congressional spending is rising briskly. Under current circumstances, one of the best tests of the restraint imposed by the agreement is the trend in domestic discretionary spending, annually appropriated expenditures directly under Congressional control. A serious spending control measure to reduce the deficit would at least be expected to restrain this category of spending.

However, as Table 2 shows, domestic discretionary spending under Congressional control has actually accelerated under the budget agreement. Between fiscal 1990 and 1991, domestic discretionary spending jumped from \$182.5 billion to \$199.8 billion, an increase of \$17.3 billion, or 9.5 percent. In fiscal 1992, congressional spending in this category is projected to increase at least another \$12.2 billion. Over the two fiscal years 1991-92, domestic discretionary spending will increase 12 percent, one of its fastest growth rates on record.

¹² Floor statement by Representative Paul E. Kanjorski (PA), Congressional Record, October 26, 1990, pg. H 13078.

Table 2 -- Selected Outlays by Budget Enforcement Act Categories
(in \$ billions)

	Domestic Discretionary	Defense Discretionary	Mandatory**
1985	145.4	253.1	436.4
1986	147.4	273.8	448.3
1987	147.0	282.5	460.3
1988	158.2	290.9	482.2
1989	169.0	304.0	507.5
1990	182.5	298.5	546.8
1991*	199.8	307.8	614.4
1992*	212.0	300.4	659.0
1993*	223.2	293.3	702.5

*Estimate under Budget Act assuming discretionary caps.

**Total mandatory spending less deposit insurance outlays.

Source: Office of Management and Budget.

Mandatory outlay growth will also be strong under the budget deal. Taken as a whole, there is no evidence of restraint. The 1991 increase in this category amounts to \$67.6 billion, a rise of 12.4 percent. Less than one year into the budget agreement, intense pressure was rising for expanded outlays in unemployment insurance and for other social spending. A review of the data on domestic discretionary and entitlement spending makes it difficult to avoid the conclusion that Federal spending remains out of control.

The direction of discretionary defense spending under the budget agreement can also be seen in Table 2. The downward trend is clear, even as expressed in nominal terms. While the trend in real defense spending will obviously depend on the future inflation rate, it is evident that defense spending will probably fall at least 3 percent a year in real terms after fiscal 1991. Given recent international developments and the likely response of Congress to the changed military situation, defense spending will come under even more severe pressure in coming years. Despite an historic opportunity to reduce the burden of taxes and spending on the U.S. economy, Congress seems more disposed to change the composition of this burden than to remove it.

Of course, the Congressional Budget Office (CBO) and Office of Management and Budget, both promoters of the agreement, project declining deficits several years into the future, even as they revise the near-term deficit figures upward. According to the CBO, in the first year of the "deficit reduction" agreement the deficit soared from \$220 billion in 1990 to \$279 billion in 1991. In 1992, the deficit will shoot up again to a level of \$362 billion. Whatever else may be said about the consequences of the 1990 budget "enforcement" act, under its provisions the budget deficit has increased to record levels. In the face of these historically unprecedented deficits, the response of Congress has been to pass measures to increase deficit spending even further.

Of course, the picture is clouded somewhat by outlays to cover deposit insurance obligations. In the near term, outlays for this purpose are substantial, while the presumed sales value of assets in the out-years are projected to reduce the deficit in 1995 and 1996. However, once the fluctuating deposit insurance outlays are excluded, even the rosy CBO budget agreement projections show virtually no change in the deficit between 1991 and 1996, even assuming the so-called deficit reduction provisions remain in place and are not modified or violated. Table 3 below shows that deficits will actually be higher under the agreement than before.

Table 3 -- Deficit Spending Remains High* (\$ billions)

	Revenues	Outlays	Deficit
1990	1,031	1,194	162
1991	1,058	1,260	202
1992	1,141	1,389	248
1993	1,223	1,443	220
1994	1,299	1,502	203
1995	1,377	1,566	189
1996	1,449	1,649	200

*assumes discretionary caps.

Source: CBO.

Despite the claims made for the "deficit reduction" agreement by its proponents, the budget data show that the deficit will soar to a new high in 1992. In retrospect, it appears that the tax increase was large enough not only to stimulate new spending in 1991, but also to encourage additional domestic spending in future years. This demand for new spending now threatens to unravel even the weak spending constraints established by the budget pact.

Since enactment of the 1990 tax increase there has been a profound change in the substance of congressional debate on fiscal issues. There has been virtually no public discussion of the need for deficit reduction, but instead repeated calls for expanded social spending. To the extent the budget agreement hinders this policy direction, spending advocates have recommended invoking the budget law's emergency provisions, or repealing the spending restraints altogether. Needless to say, the Members of Congress who have urged that the budget deal be junked to accommodate new spending have not called for a rollback of taxes equivalent to those raised last year.

In promoting the alleged success of the "deficit reduction agreement," CBO has claimed that "the longer-run picture has improved."¹³ However, even newly available CBO

¹³ "The 1990 Budget Agreement: An Interim Assessment," CBO Papers, Congressional Budget Office, December 1990, pg. 5.

data show that the budget deficit in the long term will grow to a level of \$313 billion by 2001, assuming the spending caps work as intended.

In addition, given the current make up of Congress, there are clear signs that defense spending may not be used in coming years to rebate the peace dividend to the taxpayers or to reduce the deficit, but to finance even more domestic spending.

IV. EXPLAINING THE RESULTS: A COST-BENEFIT APPROACH

Spending and tax changes do not occur by chance out of the blue. Governmental decisionmakers are responsible for changes in taxation, spending and, residually, the Federal budget deficit. Although there are many participants in the decisionmaking process, including the President, bureaucrats in the Executive Branch, and possibly even the Federal judiciary, the prime decisionmakers are the Members of Congress who must approve the spending and tax plans of the Nation.

Dwight Lee and Richard Vedder have devised a model which is expositionally useful in explaining the proximate causes of the observed tax-spending relationship noted above.¹⁴ They assume that politicians, like other citizens, try to maximize their "utility" or satisfaction in life. While utility maximization involves behavior that enhances income and power, a prime consideration to lawmakers is job security. Therefore, a given tax or spending change is evaluated in part on its impact on voters and electoral prospects.

It is assumed that increased Federal spending confers what Lee and Vedder term "marginal political benefits" on legislators.¹⁵ While the total benefits increase as spending increases, the extra or marginal benefits from, say, another billion dollars in spending diminishes because of what is often called "the law of diminishing returns" (the first billion dollars in farm subsidies, for example, wins more added votes than the 21st billion dollars in spending).

Added spending must be financed, however, and taxation and borrowing, the two viable alternatives, both impose political costs on lawmakers. The greater the amount of taxation or deficit financing, the greater those marginal political costs become. This is often called the "law of increasing costs" by economists.

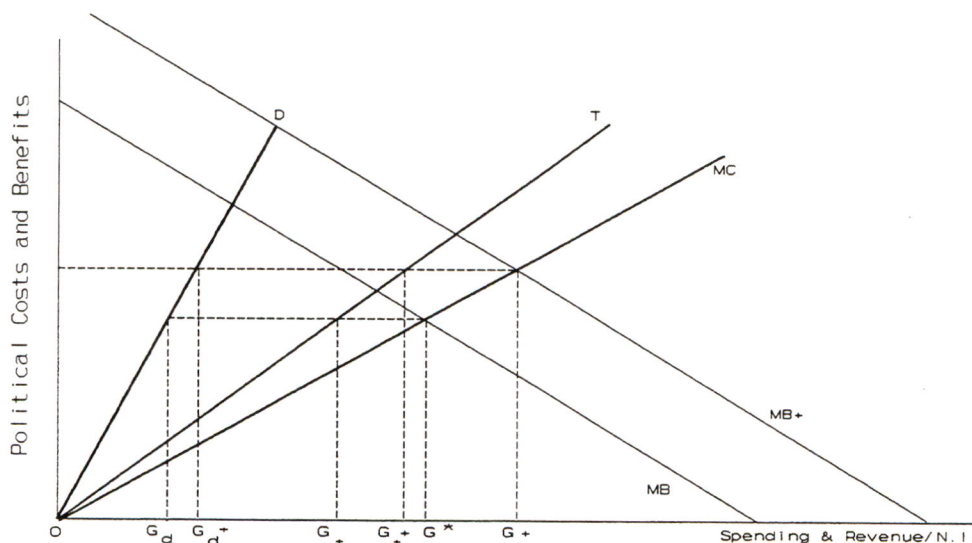
¹⁴ "Friedman Tax Cuts Vs. Buchanan Deficit Reduction As the Best Way of Constraining Government," unpublished paper (under editorial consideration by a professional economic journal) available from the authors upon request.

¹⁵ This assumption is commonly made by many economists, including some Nobel laureates. See, for example, Milton Friedman and Rose Friedman, Tyranny of the Status Quo (San Diego: Harcourt Brace Jovanovich, 1983), and James M. Buchanan and Richard E. Wagner, Democracy in Deficit: The Political Legacy of Lord Keynes (New York: Academic Press, 1977).

The Lee-Vedder model is shown in Graph 2. The MB line represents the marginal political benefits of spending, and can be called the "spending demand curve." The D line represents the marginal political costs of deficit spending, while the T line represents the marginal political costs of taxation. The D line lies above the T line since throughout history politicians have mainly resorted to taxation in Federal finance, suggesting the marginal political costs of financing a given level of spending, at least until recent decades, is higher by borrowing than by taxing. The growth of Federal spending to new highs, however, suggests that the optimal tax-deficit mix has moved toward borrowing as resistance to ever higher taxation has intensified.

The D and T lines can be added together horizontally to obtain the total marginal political cost of financing government, which is denoted as the MC (marginal cost) curve, but which can be viewed as the "revenue supply curve," just as its components D and T can be viewed as the "deficit supply curve" and the "tax supply curve" respectively. All the variables in Graph 2 are expressed as a percent of national income (or GNP), to abstract from shifts in the curves reflecting simple growth in income or output over time.

Graph 2 -- Political Equilibrium: Taxes, Spending, and Deficits



The intersection of the political demand curve MB and the revenue supply curve determines the equilibrium or stable level of spending, taxation and deficits. As drawn, total spending will be G^* , deficits will equal G_d , and taxes will equal G_t . At any other combination of taxes and deficits equal to G^* , politicians can increase their net benefits (utility) by moving to the combination indicated in Graph 2.

Suppose that the marginal political benefits of spending any given proportion of the national income grows over time. The MB curve will move to MB+, equilibrium spending

will rise to G_+ , deficits will grow to G_d+ , and taxes will rise to G_t+ . In other words, an increase in the marginal political benefits from spending Federal funds leads to higher levels of spending, higher levels of taxation, and higher levels of deficits -- exactly the experience of the postwar era.

Thus, if this model approximates reality, the proximate cause of rising levels of spending, taxation and deficits has been the increased political benefits of spending funds. Despite rhetoric about deficit reduction, the propelling factor in fiscal finance has been the growing political gains from spending over time.

By contrast, suppose the D curve had shifted to the left, meaning the marginal political costs of deficit spending had risen. That would lead to a corresponding shift to the left in the MC curve, and a new equilibrium situation where spending and deficits would fall, but taxes would rise. This is the stated objective of the 1990 budget agreement, yet that agreement was not signed in an environment in which the marginal political costs of deficits was rising. Indeed, contemporary history suggests the motivating factor in fiscal changes has come from the changing benefits of spending, not changing sensitivity to budget deficits. Unless the underlying political costs change, agreements such as the 1990 one are not sustainable over any long-run time horizon.

The evidence that defense spending falls with tax increases may seem hard to relate to the theoretical approach here, particularly since other forms of spending tend to rise considerably. This would suggest that the marginal political benefits of spending varies significantly with the type of spending. For many constituencies, higher defense spending represents a cost, not a benefit. It probably serves the rhetoric surrounding tax increases (usually couched in deficit reduction terms) to push for real, tangible defense cuts (which are often politically popular), while giving only lip service to politically unpopular (with some interest groups, at least) transfer payment cuts (which are often even explicitly ruled out of discussion in budget negotiations).

V. THE STATE AND LOCAL GOVERNMENTAL EXPERIENCE, 1947-90

While the postwar Federal experience has been characterized by increases in spending, taxation and deficits, how does that compare with the experience of state and local governments? Has a dollar in new revenue been associated with more than a dollar in new spending (meaning larger budget deficits), or less than a dollar (meaning smaller budget deficits)?

Using the same simple regression procedures as before, and the same control variables for comparison purposes, we regressed state and local spending against state and local revenues for the calendar years 1947-90.¹⁶ The results are:

¹⁶ The basic data are found in the 1991 Economic Report of the President, p. 382.

$$\begin{aligned}
\text{Spending} = & 17.463 & + & 0.927 \text{ Tax} & - & 1.328 \text{ Growth} \\
& (3.126) & & (182.871) & & (3.273) \\
& + 1.697 \text{ War} & - & 2.053 \text{ Unemployment} \\
& (0.645) & & (2.259) \\
& + 0.189 \text{ Inflation}, \bar{R}^2 = .999, \text{ D-W} = 1.903, \\
& (0.607) & & \text{R-Statistic} = 8523.35,
\end{aligned}$$

where again numbers in parentheses are t-values.¹⁷

The results, which are extremely robust statistically, suggest that each \$1.00 in new state and local revenues (primarily taxes) was associated with 93 cents in new state and local spending. Unlike with the Federal government, spending rose less rapidly than tax revenues, and tax increases improved, rather than worsened, the cash position of government.

Why the difference in results between the Federal, state and local governments? While a full discussion of this is beyond the scope of this paper, we would suggest that there are major differences in institutional budgetary constraints.¹⁸ State and local governments, excepting the state of Vermont, are subject to state-balanced budget amendments. While those amendments do not always include all forms of spending (e.g., capital expenditures), they do impose some constitutional constraints on spending. Accordingly, state and local politicians are typically constitutionally mandated to finance new expenditures immediately by spending reductions in other areas or by a tax increase, imposing political costs not generally observed at the Federal level. Other tax or spending limitations (e.g., California's Proposition 13) also exist. In addition, in most states governors possess line-item veto power.

The difference in results are significantly striking to suggest that perhaps the Federal authorities could learn a lesson from the state and local governmental components of the Union. While other differences may exist, the variation in constitutional frameworks is particularly striking and worthy of study.

VI. OTHER PERSPECTIVES ON THE ISSUE

One major potential criticism of the analysis above relates to causality. Demonstrating that taxes and spending are positively related does not "prove" that higher taxes "cause"

¹⁷ The tax and spending variables were not related to GNP as in the federal tax-spend equation, a factor that has no impact on any of the results except regarding the constant term.

¹⁸ Rati Ram has observed interesting international differences in the tax and spend relationship. See his, "A Multicountry Perspective on Causality Between Government Revenue and Government Expenditure," Public Finance, 1988, No. 2, pp. 261-270.

higher spending. It is possible that higher spending induces higher taxes, rather than the other way around.

The theoretical analysis above, however, suggests that the tax-spend relationship's causality really is best evaluated in terms of the underlying motivations for observed changes. The Lee-Vedder theoretical approach is highly consistent both with traditional microeconomic approaches to human behavior and the empirical evidence. It suggests that taxes and spending simultaneously increase because of inexorable pressures on politicians to increase spending that arise from the political benefits that spending confers. The genesis of the pressures seems to come from what Mancur Olson terms "distributional coalitions" who want funds not to enhance governmental services, but to increase incomes or what is termed by economists as "economic rent." If this view is correct, attempts to reduce the budget deficit will be futile until the "rules of the game" change in a manner that alters the political incentive structure, raising the political costs of deficits, lowering the political benefits of spending, lowering the political costs of taxation, or a combination of the three.

With that very major caveat in mind, it is possible by looking at lagged relationships between taxation and spending to draw inferences about causation. Our own limited efforts in this area, not reported here, are far more consistent with the view that tax changes induce spending changes. Others, however, have observed the opposite.¹⁹ There has been even a larger body of evidence, however, in support of the view that taxation causes spending changes rather than the other way around, at least at the Federal level.

Manage and Marlow used causality testing of the Granger variety to conclude that taxes promote spending.²⁰ Rati Ram, investigating the contradictory Manage-Marlow and Anderson-Wallace-Warner findings, concludes that Manage and Marlow are correct at the Federal level, namely that revenue changes induce expenditure change.²¹ In this regard, Ram also agrees with the econometric evidence presented by Paul Blackley on the American Federal experience.²² Interestingly recent evidence for Canada supports the hypothesis that causation goes from taxation to expenditures rather than the other way around.²³

¹⁹ George von Furstenberg, Jeffrey Green, and Jin-Ho Jeong, "Tax and Spend, or Spend and Tax?" Review of Economics and Statistics, May 1986, pp. 179-188, and William Anderson, Myles Wallace and John Warner, "Government Spending and Taxation: What Causes What?" Southern Economic Journal, January 1986, pp. 630-639.

²⁰ Manage, Neela and Michael L. Marlow, "The Causal Relation Between Federal Expenditures and Receipts," Southern Economic Journal, January 1986, pp. 616-629.

²¹ "Additional Evidence on Causality Between Government Revenue and Government Expenditure," Southern Economic Journal, January 1988, pp. 763-769.

²² Blackley, Paul R., "Causality Between Revenues and Expenditures and the Size of the Federal Budget," Public Finance Quarterly, April 1986, 139-156.

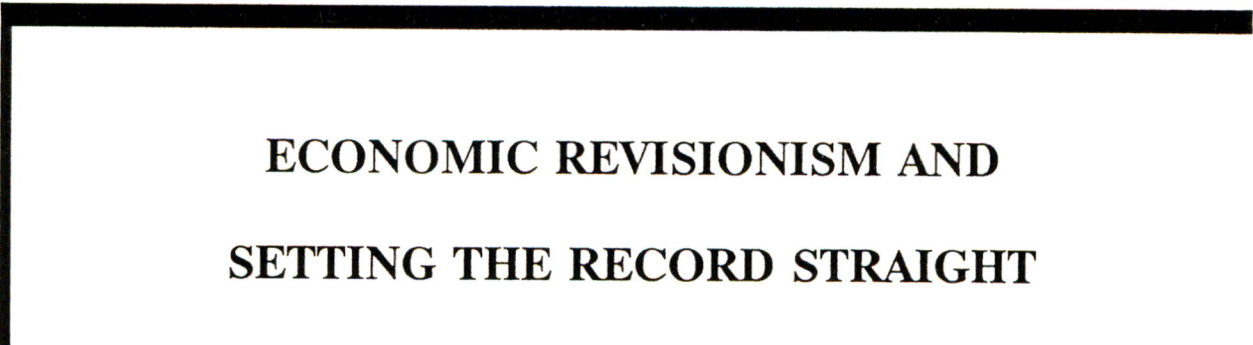
²³ Ahiakpor, James C.W. and Saleh Amirkhalkhali, "On the Difficulty of Eliminating deficits with Higher Taxes: Some Canadian Evidence," Southern Economic Journal, July 1989, pp. 24-31.

Concluding, a majority of the evidence supports the "tax and spend" hypothesis over the "spend and tax" one. Yet we wish to remind the reader that if the political benefits from spending are positive and continue to grow over time, often being greater than the political costs associated with financing that spending, the deficit problem cannot and will not be resolved through tax measures.

VII. CONCLUSIONS

Increases in Federal tax revenues continue to be associated with greater increases in Federal expenditures, leading us to conclude that tax increases do not reduce budget deficits. The historical experience under the Gramm-Rudman era (1987-90) was little different than in the decades preceding that experience. The evidence suggests that higher tax revenues are associated with massive increases in income redistribution activity of various forms, especially transfer payments. Indeed, redistributionist activities seem to have crowded out some traditional expenditures of government services, particularly defense.

The cause of the deficit problem does not appear to be inadequate taxes (which now are at a near record level in relation to total output) but rather the political gains from spending, gains that are rising over time, particularly to finance redistributionist activity. Historically, there was a time when tax increases meant deficit reduction, but that time passed in the early part of this century. State and local governments still are able to constrain spending increases to levels equal to or less than the taxes raised. Why? We would tentatively suggest that the answer may lie in different institutional constraints, such as balanced budget amendments, spending limitation amendments, line-item vetoes, etc., measures that lower the marginal political benefits of new spending to political decisionmakers. In any case, the Federal fiscal problem is not likely to be solved without significant behavioral change on the part of those decisionmakers, and those changes are not likely given the current system of political rewards and costs.



ECONOMIC REVISIONISM AND SETTING THE RECORD STRAIGHT

Excerpts from the Republican Views of The 1992 Joint Economic Annual Report, including sections on income trends, income mobility and the difference between fiscal year versus calendar year measures.

April 1992

EXECUTIVE SUMMARY

This section of the Republican Views in the **1992 Joint Economic Annual Report** uncovers the key procedures by which Democrats have attempted to distort the economic history of the 1980s to discredit Republican policies. JEC Republicans point out the assumptions and methods Democrats must apply to the positive economic data of the 1980s in order to rewrite the economic history of Republican economic stewardship, a time that brought the longest peacetime period of economic growth and job creation since World War II.

DISTORTING THE RECORD: CHOICE OF BASE YEARS. One scheme to discredit the 1980s economic record is to use 1977 or 1979 as a base year for comparison, in order to capture the disastrous years of the Carter presidency in a redefined "1980s." CBO and many Democrats do so, justifying the 1979-89 period as comparable points in consecutive business cycles. This argument is fallacious. There were also business cycle peaks in 1980 and 1981, but Democrats do not measure 1981-89 because of this period's impressive growth.

1980 Income Meltdown Dominates the 1979-89 Time Period. Including 1979 and 1980, years in which the Democrats had exclusive control of the presidency and Congress, in a review of the 1980s completely reverses the income trends reported from 1981 through 1989, the years in which a Republican president actually had some influence over economic policy.

The Democrat rhetoric that the Republicans caused the rich to get richer at the expense of the poor is based on this flawed "peak-to-peak" 1979-89 analysis. Using a different base year would produce vastly different results for every quintile of income:

- The decline in income of the bottom quintile in 1979-89 is more than explained by the one-year 1980 loss. The income loss of that group in 1980 accounted for 139 percent of the drop attributed to that group for the entire 1979-89 period. In other words, the bottom quintile spent the Reagan years making up for the loss of the last year of Carter's economic stewardship.
- If any of 1980, 1981 or 1982 were taken as a base year, there would be a net income gain for the bottom quintile, and for all other quintiles as well.
- There is no way to show a decline in income for any quintile, except to rely on at least one year of Carter administration economic performance.
- The error of including the late 1970s in with the 1980s is usually compounded by faulty analysis of pre-tax and after tax income, and average tax payments, errors centered around faulty measurement of capital gains by CBO and the Joint Committee on Taxation (JCT).

CBO, the JCT, Democrat Members and campaign committees of the House and Senate, and the media and liberal think tanks have used this data to create an essentially false picture of Republican economic policies.

Quintiles and Income Mobility. Studies of "the 1980s" often focus on income trends of quintiles, brackets of families or households ranked from top to bottom and divided by population into fifths.

Comparing these brackets of families over time is inherently misleading because it implies that these quintiles are fixed groups of persons locked into a caste or class system. Research has shown clearly that these quintiles are constantly changing. The people who comprise a quintile at any one point in time constantly move up and down between them to such an extent that even one-year quintile comparisons are deceptive. Comparisons of a decade or more of quintile change exponentially compounds the misleading nature of quintile comparisons, as it obscures the dynamic nature of individual and family income in the United States. Forcing a fluid, capitalist economy characterized by great income mobility into a rigid set of fixed quintiles has almost no scientific or analytical merit. Its use is perpetuated largely in political circles by critics of Republican policies.

Census Bureau data examining income mobility for just a few years of the 1980s shows:

- Between 1985 and 1986, fully one-third of all persons changed quintiles, with about the same proportion moving up one or more quintiles as moved down.
- In this one year, about 45 percent of those in the middle quintile moved up and down the distribution, and about 25 percent of those in the "richest" quintile moved down to a lower quintile and were replaced by an equal percent of new persons.
- Factors like age, education and family size dramatically affect income mobility. Age is the critical factor, as young people move up the quintile ladder as they gain work experience, while older Americans tend to move down a quintile as they move from labor income to social security and other retirement income.

The startling degree of income mobility is at least as interesting and important a subject as changes in average income by quintile. After all, what speaks more to the opportunity abundant in American society -- that the average income of a quintile rose or fell 1 percent in a given year, or that fully one-fourth of the top quintile arrived there in the same year?

Calendar Year Data. Another aspect of economic revisionism is to examine economic growth and job creation in the 1970s and 1980s in a futile attempt to argue that the fiscal policies pursued by President Carter were better for the country than those implemented in later Republican administrations. The key misrepresentation in such a case is to credit Carter with part of the Nixon/Ford record, and shift part of the Carter record onto Reagan/Bush shoulders.

For example, a recent House Democratic Study Group report used calendar year data (which gives Carter credit for about a year of the Nixon/Ford job record) showed that Carter's annualized job creation record was better than either prior or later Republican presidencies. Comparing the job creation record starting at the first fiscal year of each president's tenure entirely

reverses the picture. Doing so shows both the Nixon/Ford and Reagan administrations as better job creators than Carter. The same reversal of fortunes appears in examining annual economic growth rates.

When partisan distortions are factored out, policy choices are clear. A dispassionate review of the data shows the clear link between income trends and overall trends in the economy. Incomes fall with a weak economy and grow with a growing economy. To increase income, the economy must be strong; thus, the thrust of Federal policy should be directed towards encouraging new economic growth, not redistributing current income.

DICK ARMEY
Ranking Republican
Joint Economic Committee

ECONOMIC REVISIONISM AND SETTING THE RECORD STRAIGHT

Decisions on future economic policies are based on our interpretation of the past. Consequently, the debate over fiscal and economic policies for the 1990s is framed by our impression of the success or failure of policies in the 1970s and 1980s.

Democrats have made a concerted effort to redefine the economic history of the 1980s, even at times redefining when the 1980s began. Their goal is to recast Republican stewardship of the economy as inadequate, partly to resist current growth proposals and partly for election purposes. Democrat political consultant Stanley Greenberg was unusually frank about his party's goals in the Fall 1991 issue of *The American Prospect*:

For nearly a decade, Republicans ran against the Carter presidency, a period that embodied what was bad about Democrats and this country -- weakness before our enemies, things out of control, bad economic times for average Americans. Stagflation stripped away Democratic association with prosperity. It was around such images that Reagan brought together the affluent and the middle class.

To challenge the conservative hegemony, Democrats need to define the Reagan-Bush years--to create an imagery of Reagan-Bush America that supersedes the Carter years and impeaches the credibility of conservative governance for middle America.(...)

...The battle to define the Reagan-Bush years is a critical political arena where Democrats have the opportunity to disrupt the Republicans' hold on the middle class, contest again the issue of prosperity, and advance the welfare and values of middle America.

Greenberg's strategy to impose a new definition on the 1980s, or the "Reagan-Bush years," that proves advantageous to the Democrats has been adopted in many partisan quarters. The challenge confronting Democrats who seek to define politically the 1980s to their party's favor is overcoming the economic data from that decade, which are generally positive. Some of these partisans have met the challenge with a vigor unseen since mid-century when Joseph Stalin attempted to rewrite Soviet history.

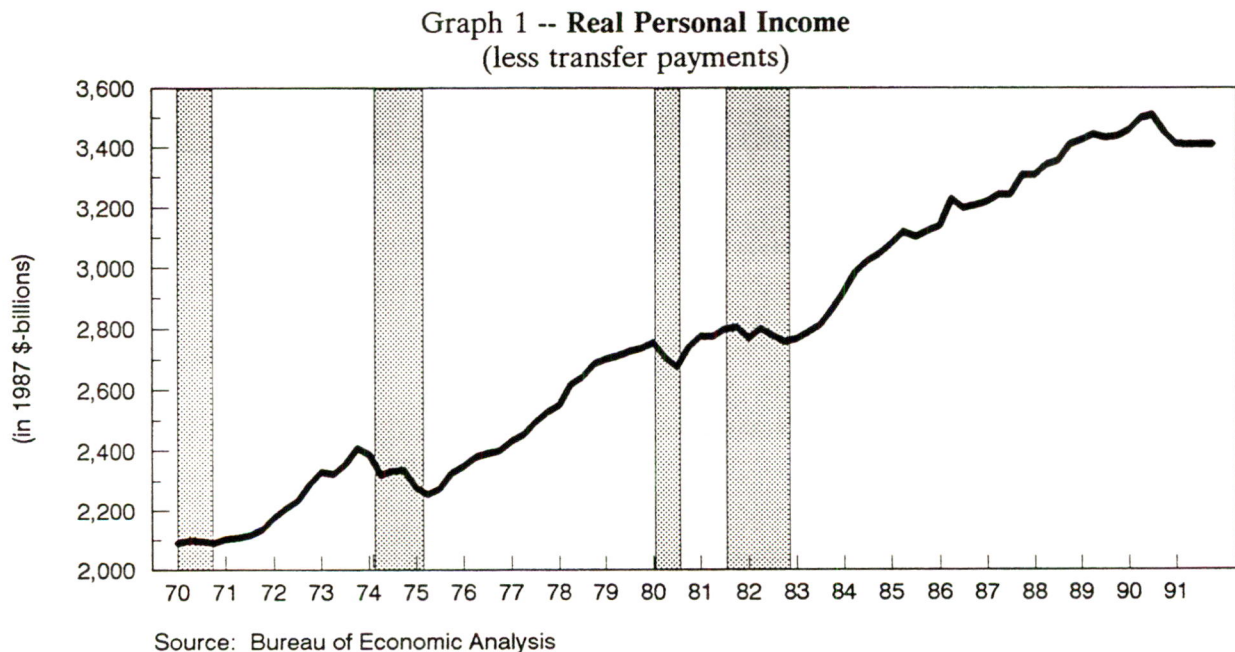
We look now at some tools of the revisionist trade, and Democrat efforts to rewrite the economic history of the 1980s.

Distorting the Record: Choice of Selective Base Years

In order to make a case against the economic progress of the 1980s, one must rely on defective inflation adjustments, biased or inappropriate base years, or faulty CBO family income data. One common ploy is to use 1977 or 1979 as a base year in order to capture the disastrous years of Jimmy Carter's presidency in "the 1980s."

Even if one forgets that 1980 is actually the last year of the decade of the 1970s, there is no justification for 1979 as a base year to measure the effects of policies implemented later. CBO and other partisan analysts have argued that 1979 and 1989 are comparable points in consecutive business cycles, thus providing a "peak to peak" perspective. This is untrue. There were two business cycle peaks between 1979 and 1982, before the 1982-89 expansion even got underway (see Graph 1). A true peak-to-peak analysis would have to start in 1981, the peak previous to 1989.

Graph 1 shows trends in personal income, with cyclical downturns reported by the Bureau of Economic Analysis and National Bureau of Economic Research shaded in grey. As can be seen there are actually two business cycle peaks, one in 1980 and one in 1981, after 1979 but before implementation of a new policy direction in 1981. The 1979-89 peak-to-peak argument is fallacious.



One can argue that annualized data are unavailable for the 1981 peak, but inconvenience of data collection or measurement does not justify analytical error. Confusion of measurement problems with substantive issues is simply a logical mistake. If a peak that should be measured cannot be measured in a desired way, this does not excuse selection of another peak which is more easily measured. In other words, just because something is worth doing does not mean it is worth doing badly.

Another problem with this argument is what it says about economic and income trends. Even if 1979 were the previous peak, then 1980-82 should be viewed as one long period of economic decline. If so, the trend which started in 1980 cannot be blamed on an Administration which took office only in 1981, and thus the income declines of 1980, 1981, and 1982 should logically be assigned to the previous Administration. This would free the incoming Administration from responsibility for the income declines. However, partisan critics want to blame 1980 on the Reagan Administration by invoking 1979 as a peak year, and by absolving the Carter Administration for the decline which began on its watch.

An illustration from another era might help show the fallacy of this approach. Imagine a partisan Republican report on the economy presenting real GNP for two data points, 1929 and 1939. From these data the GOP report could conclude that since real GNP between 1929 and 1939 grew less than 1 percent, Roosevelt Administration policies were associated with slow economic growth. Obviously this approach would be defective because the impact of the Great Depression would be included with the Roosevelt years. In large measure the Depression explains why Roosevelt was elected, just as the economic malaise of 1979-80 explains much of the reason for Reagan's election.

The data show that income trends follow overall trends in the economy. Sustained income growth is strongly linked to healthy economic growth. Evaluation of the income trends of the 1980s must be viewed in the context of the Carter economic legacy. While income growth during the 1980s expansion was not unprecedented, it was good by the conventional measures of median household and family income, and marked a turnaround from the years of "malaise." The record shows that what is now needed are policies to encourage short- and long-term economic and productivity growth to lay a solid foundation for income growth in the 1990s.

1980 Income Meltdown Dominates 1979-89 Time Period

The most serious issue raised by using 1979 as a base year is the misrepresentation of income changes for the 1979-89 period. Essentially, the effects of a single year, 1980, are inappropriately used to represent a 10-year trend during the 1980s, or "Reagan-Bush years." The usual political misuse of this approach misleads the reader into assuming that the income effects of 1980 are related to policies implemented years later.

According to this view, during that period the rich got richer and the poor got poorer. The average real household income of the top quintile, those earning over \$55,000, did increase during this period, though many of the two-earner couples in this quintile might be surprised to learn they are considered "the rich." On the other hand, the decline in income for the bottom quintile during 1979-89 is entirely explained by 1980, the last year in which Democrats controlled both the White House and the Congress. This was the worst year for family income in the entire postwar period, with real median family income plunging by \$1,209, or 3.5 percent, in 1980 alone.

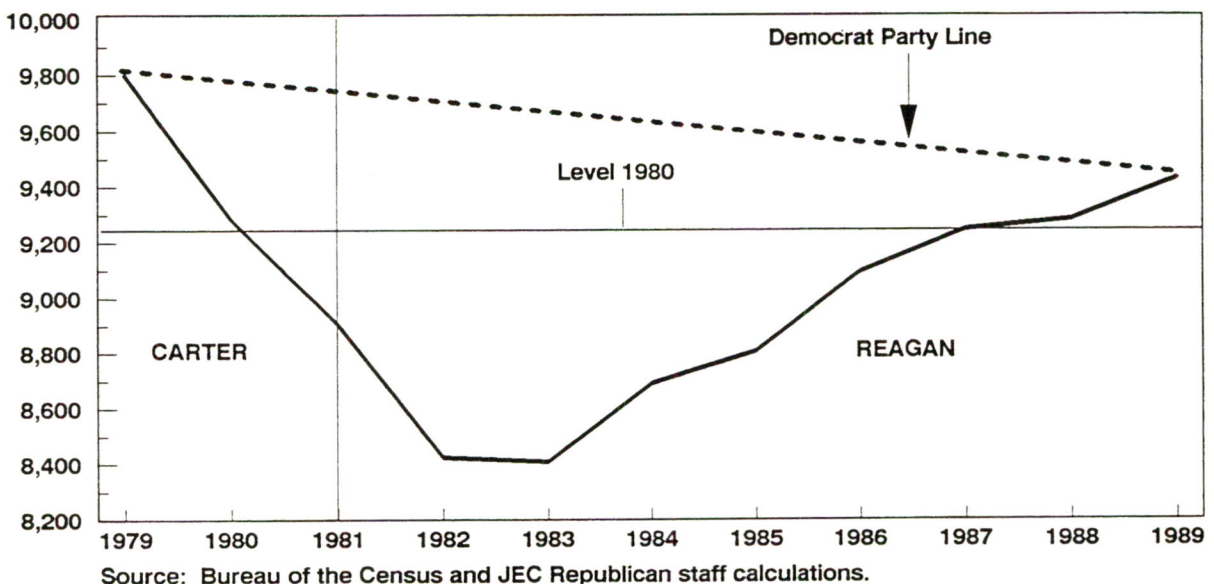
It is difficult to describe this as anything other than intellectual dishonesty, though some might consider a lack of sound training in the use of statistics a plausible explanation. If a 10-year period of income growth in the lowest quintile were claimed by one political party when all the net

growth in the period were explained by the one year the other party were in office, this would be exposed as misleading and unethical or intellectually beneath contempt.

In these Republican Views, we present annual income data to permit readers to examine the evidence and reach their own conclusions. There is nothing legitimate to be gained by selective choice of base years which eliminates important information and distorts income trends.

A review of the data shows that the 1980 drop in income for the bottom quintile comprises 139 percent of the income decline attributed to the whole period (see Graph 2). However, the average income of this group increased between 1980 and 1989. The scenario that there was a straight drop in this quintile's income between 1979 and 1989 is what we call "the Democrat Party Line," since this fallacious assertion is usually made to score partisan points.

Graph 2 -- "Democrat Party Line"
Real Average Income of the Bottom Fifth, 1979-89
(in 1989 dollars)



In other words, of the much touted income decline of the bottom fifth breathlessly reported in innumerable Democrat reports from the JEC, Budget, and House Ways and Means Committees, among others, Census data show that all of it occurred in one (Democrat) year. The 1980 Democrat decline is not only large enough to explain all, or 100 percent, of the decline over the 10-year period, but amounts to about 140 percent of the income decline over 10 years. Without the rest of the decade of net income growth, this one Democrat year would have produced an income decline 40 percent larger. The other nine years produced enough income gain to erase this income deficit and produce a net gain whether 1980, 1981, or 1982 are selected as base years.

A recent report on "Work and Income in the 1980s,"¹ released by JEC Democrats, used the endpoints 1979 and 1989. An earlier election year report using the same years was released by JEC Democrats on November 2, 1990. Similar selectivity has been used by CBO in preparing income data for political use by Ways and Means Democrat Members and staff, duly released to media and blown up in extensive graphs in newspapers and television news.

Such income data always portray the decade of the 1980s as one in which the average income of the bottom fifth of families declined while that of the top fifth advanced, thus landing the desired headline of "Rich richer, poor poorer." The 1990 Democrat JEC release went further in asserting that "the average real incomes of the bottom 40 percent of families are lower now that they were in 1979," even though the "economic pie grew during most of the 1980s." Unfortunately, CBO data used in the report to illustrate the evils of the 1980s contained a \$134 billion error, selective and biased measures of income, and a miscalculation of real capital gains. Of course, these were never acknowledged nor corrected by JEC and Ways and Means Democrats, who proceeded to use the faulty data for political purposes in 1990, and as late as 1992.

The latest Democrat JEC report also contains numerous factual errors in its presentation of average income data of the 1970s and 1980s. A partial explanation, though hardly conceivable, would be the possibility that the Democrat staff report suffers from the elementary but fundamental error of confusing mean and median values. It hardly seems possible that an organization of economists could make such a rudimentary error, especially in a report that was also reviewed for accuracy by the Congressional Budget Office prior to its release. However, the presence of so many errors in one report is puzzling. A close examination of the movement of real family income in recent decades is needed.

Family Income Since 1973

In reviewing family income data it will be recalled that the composition of each quintile is constantly changing as families move between quintiles. This means the changes in income do not represent the changes of income of actual families, many if not most of whom are only temporarily in a given quintile. Furthermore, average income measures are subject to distortion by changes in the income of relatively small subgroups. Given the degree of income mobility in our society, one cannot reach conclusions about the economic well being of actual persons or gauge how broadly changes in average income of quintiles affect the population from these data.

These qualifications, although important in avoiding misleading and simplistic results, are usually ignored. (This aspect of mismeasurement is discussed in the subsection that follows.) In this section we will take the quintile income data at face value to examine how they can be manipulated to arrive at preconceived results. This narrow examination of these income data is for illustrative purposes only: Income mobility alone makes their use in describing the changing economic welfare of actual families statistically meaningless.

¹ "Families on a Treadmill: Work and Income in the 1980s," A Democrat JEC staff study prepared for the use of Members of the Joint Economic Committee, January 17, 1992.

Table 1 shows real average income levels for each quintile from 1973 to 1989. In general, movement in family income follows that of the business cycle. The income data shown below tend to move in the same direction as the economy. When the economy is performing well, income increases, and when the economy is in decline income tends to fall. For example, average income for all quintiles fell during the 1974-75 recession, and climbed during the subsequent expansion.

Table 1 -- Real Average Family Income Since 1973
(in constant 1989 dollars)

Year	Lowest Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Highest Fifth
1973	9,783	21,351	31,370	42,872	73,557
1974	9,636	21,035	30,783	42,172	72,121
1975	9,291	20,235	30,153	41,288	70,541
1976	9,509	20,740	31,017	42,379	72,440
1977	9,361	20,817	31,394	43,325	74,276
1978	9,650	21,475	32,319	44,530	76,566
1979	9,801	21,623	32,657	44,970	77,922
1980	9,286	20,852	31,588	43,828	75,049
1981	8,906	20,144	30,916	43,411	74,419
1982	8,427	19,834	30,381	43,093	75,903
1983	8,409	19,869	30,634	43,668	76,823
1984	8,692	20,406	31,554	45,123	79,518
1985	8,808	20,677	31,985	45,845	82,510
1986	9,095	21,396	33,204	47,447	86,423
1987	9,248	21,734	33,749	48,301	88,271
1988	9,284	21,712	33,787	48,524	89,033
1989	9,431	22,018	34,206	49,213	92,663
Change					
1979-80	-515	-771	-1,069	-1,142	-2,873
1979-89	-370	395	1,549	4,243	14,741
1981-89	525	1,874	3,290	5,802	18,244
1982-89	1,004	2,184	3,825	6,120	16,760
Percent Change					
1979-80	-5.3%	-3.6%	-3.3%	-2.5%	-3.7%
1979-89	- 3.8	1.8	4.7	9.4	18.9
1981-89	5.9	9.3	10.6	13.4	24.5
1982-89	11.9	11.0	12.6	14.2	22.1

Source: Bureau of the Census and JEC Republican staff calculations.

This expansion ended in the first half of 1980, with renewed, albeit weak growth starting in July 1980 and continuing through July 1981. The slow nominal income growth and high inflation of this period caused a sharp across-the-board decline in real income in 1980, with further declines spilling over into 1981 and 1982 as the Federal Reserve tightened monetary policy. The absence of sustained economic growth along with high inflation proved a damaging combination for families at all income levels.

The pivotal year of 1980 merits especially close examination. As shown in Table 1, the average real income of the bottom quintile declined by \$515 in 1980 alone, a decline of 5.3 percent. Meanwhile, the average real income of the middle quintile fell \$1,069, or by 3.3 percent. The income decline of 1980 was more than enough to erase all income growth in the bottom quintile occurring in the previous two years. The setback to income growth of other quintiles was also severe. The data are for "all families" since annual two-parent family income averages for quintiles are not published. However, the changes in income shown in Table 1 would essentially mirror changes for two-parent families, the group used in the latest Democrat JEC study.

Table 1 shows income growth for every quintile in the 1980s whether 1980, 1981, or 1982 is used as a base year. While the choice of any of these three years does change the amount of income growth, there is no way to show declines for any quintile without relying on the last year of the Carter Administration. This explains the insistence of partisan analysis to rely on the income meltdown of 1980 to taint the income growth under policies adopted later.

Quintiles and Income Mobility

Analyses of "the 1980s" and other periods often focus on the income trends of "quintiles," brackets of families or households ranked top to bottom by income and divided by population into fifths. Such analyses serve as the statistical fodder for the politics of class warfare, and often get condensed into headlines like "the rich got richer and the poor got poorer."

However, the people who comprise a quintile at any one moment constantly move up and down between them, or "permeate" quintiles, to an extent that invalidates the ostensible purpose of comparing average incomes of quintiles over time -- to accurately measure changes in the well being of persons in the quintiles.

The constantly changing mix of individuals and families who make up the quintiles wreaks statistical havoc on the income averages, calling into question not only the notion of superimposing a rigid class structure on a dynamic society but the extent to which quintile measures accurately reflect the quality of life of those who pass through different income brackets.

Forcing a fluid, capitalist economy characterized by remarkably high levels of income mobility into a rigid artifice of income quintiles allows some to paint a scenario of the U.S. economy as a caste system wherein "the rich get richer and the poor get poorer." The statistics tell a different, much more complicated and less easily measured story of an economy where some poor get poorer, some rich get richer, some rich get poorer and some poor get richer.

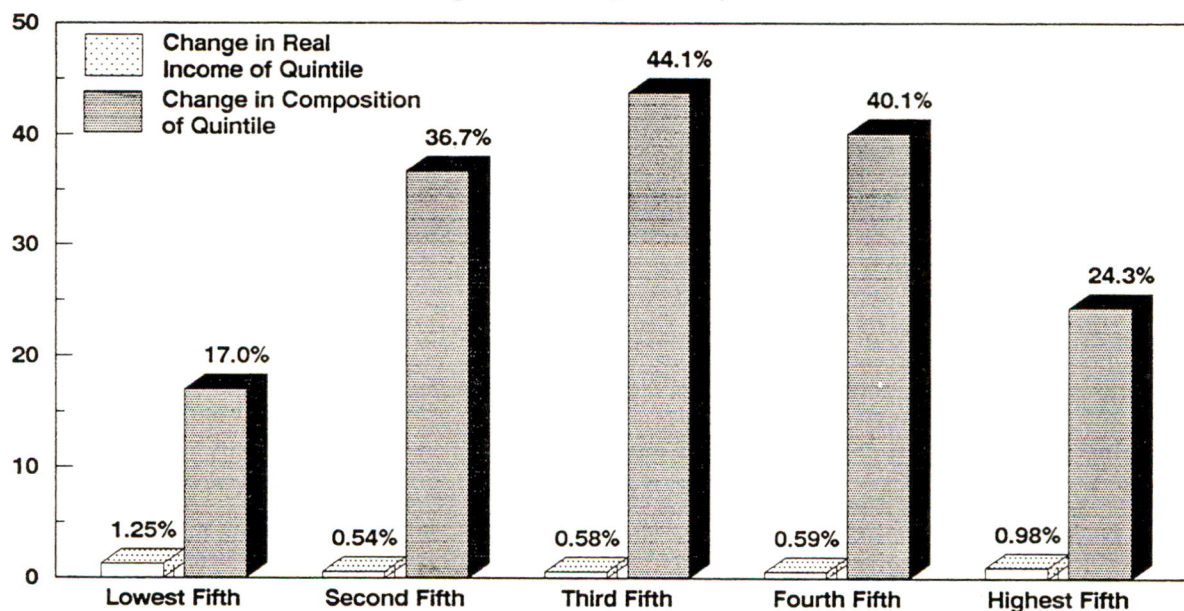
Census Bureau data from 1985 to 1986, and 1987 to 1988, reveal a great deal of income mobility in the U.S. economy.

- Between 1985 and 1986, fully one-third of all persons changed quintiles, with nearly 18 percent declining one or more quintiles and nearly 16 percent increasing one or more quintiles.
- In the same period, about 45 percent -- almost half -- of those in the middle quintile moved to another quintile. About one quarter of those in the top quintile dropped down one or more quintiles and were replaced by others who moved up one or more quintiles.
- Factors like age, education and family size dramatically affect income mobility. For example, young people move up through quintiles as they gain work experience, while older Americans tend to move down in quintiles as they reach full retirement.

The extent to which Americans freely move from one income quintile to another is important to understanding the nature of our economy. Change in average income among quintiles actually reveals very little about the well being of the individuals passing through a given quintile at a given time.

As Graph 3 illustrates, the startling degree of change in quintile composition is at least as interesting and important a subject for research as changes in average income by quintile. Curiously, the Congressional Budget Office, a frequent source of quintile comparisons, provides virtually no information on this vital subject. Consequently, there is a great need for unbiased statistical agencies to explore the remarkable upward and downward income mobility in American society. While the Census Bureau's Survey of Income and Program Participation (SIPP) is a very good start, a much larger effort to collect and publish longitudinal data for extended periods is urgently needed.

Graph 3 -- Changes in Income Levels and Composition of Quintiles, 1987-88



Source: Bureau of the Census.

A Closer Look at Quintile Permeability

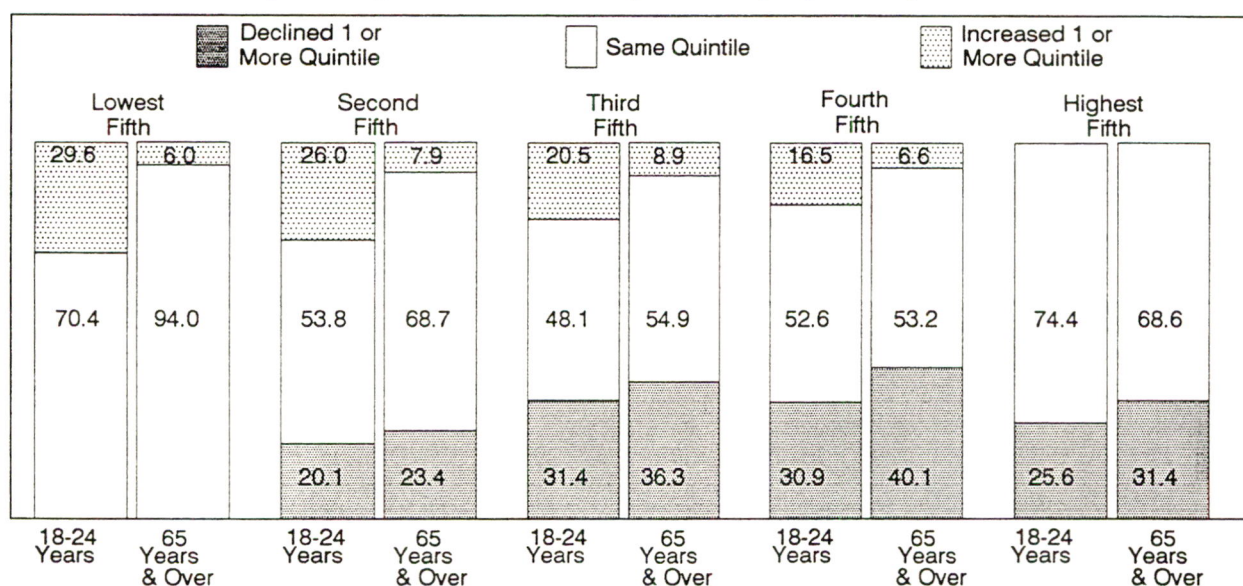
As startling as overall quintile permeability may be, a closer look at factors such as age, family size, and education reveal even higher degrees of income dynamism for specific groups. The degree of permeability varies considerably according to demographic and other characteristics. Under the surface, permeability for some is even more dynamic than the overall statistics would indicate. (It is important to note that these data reflect income changes within specific groups that are unevenly dispersed among the income quintiles.)

Age and Quintile Permeability

One of the most obvious reasons for income dynamics is demographic. For example, younger workers tend to start in the lower quintiles and work their way up as they acquire more education and experience. A typical young adult over the last 10 years could well have moved from the lowest into the middle quintile. This person's income would be included in the lowest quintile in 1980 but excluded in 1990. The average income levels of the bottom quintile between 1980 and 1990 do not accurately reflect changes in the standard of living for those who started at the bottom but have since moved to different quintiles. They are also irrelevant for those in the bottom quintile in 1990, but who were not in the bottom quintile, or perhaps in any quintile, 10 years before.

The 1987-88 SIPP report presents the permeability data by age group. Graph 4 displays some of these data for young adults (18-24) and the elderly (over 65). Not surprisingly, the young permeate upward at a greater rate than the elderly, most of whom are not working full time. In addition, the quintile share of young adults falling into a lower quintile is less than that of the elderly. The most dynamic quintile is the middle quintile of young adults, 51.9 percent of whom exited by 1988. In other words, most of the young adults in the middle quintile in 1987 were gone by 1988.

Graph 4 -- Quintile Permeability Varies by Age Group, 1987-88



Source: Bureau of the Census.

These data show the sharp contrast in patterns of quintile permeability by age group. As noted, the majority of young adults in a quintile can actually leave in as little as one year. The assumption of static class structure ignores not only overall income dynamics, but different degrees of permeability in various demographic groups.

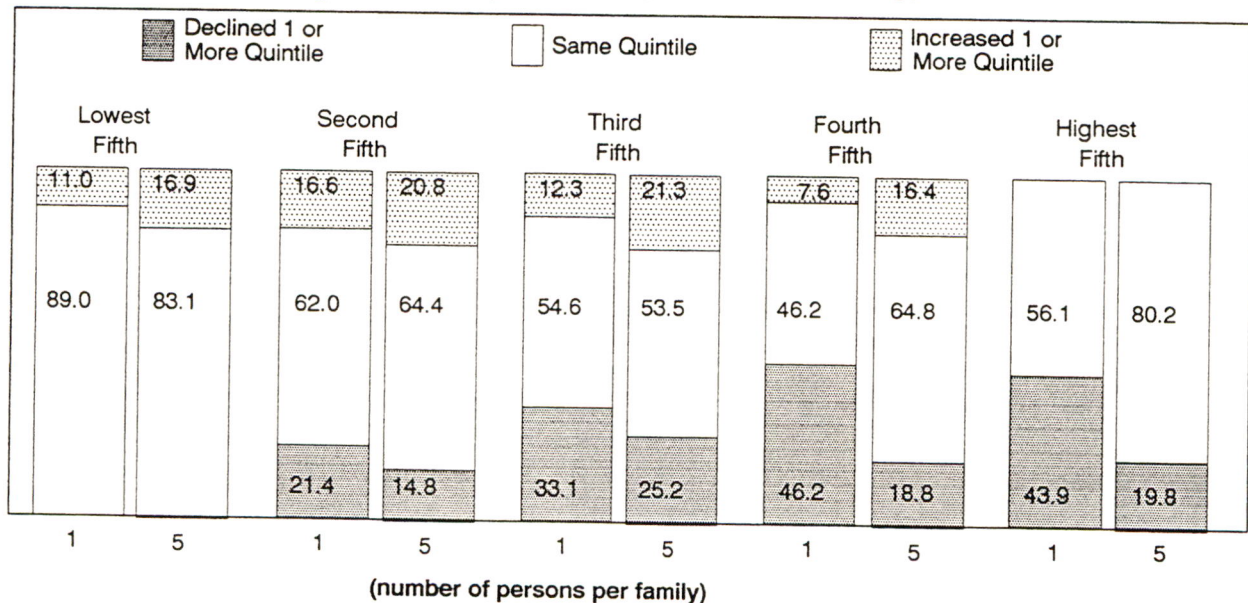
Family Size and Quintile Permeability

An examination of quintile permeability by family size further illustrates how superficial the concrete class assumption is. There are wide disparities in the permeability of families based on family size. These are especially noticeable when comparing one person "families" with others. Here we will contrast one and five person families, as classified by the SIPP.

Of one person families, 72.6 percent remained in the same quintile during 1987-88, compared to 67.6 percent for all persons. However, single persons in the top two quintiles tended to drop into lower quintiles more than other kinds of families. The portion of one person families

falling from the top quintile was 43.9 percent, relative to 19.8 percent for five person families. Graph 5 compares the changes in the income of single families with that of five person families.

Graph 5 -- Family Size and Quintile Permeability, 1987-88



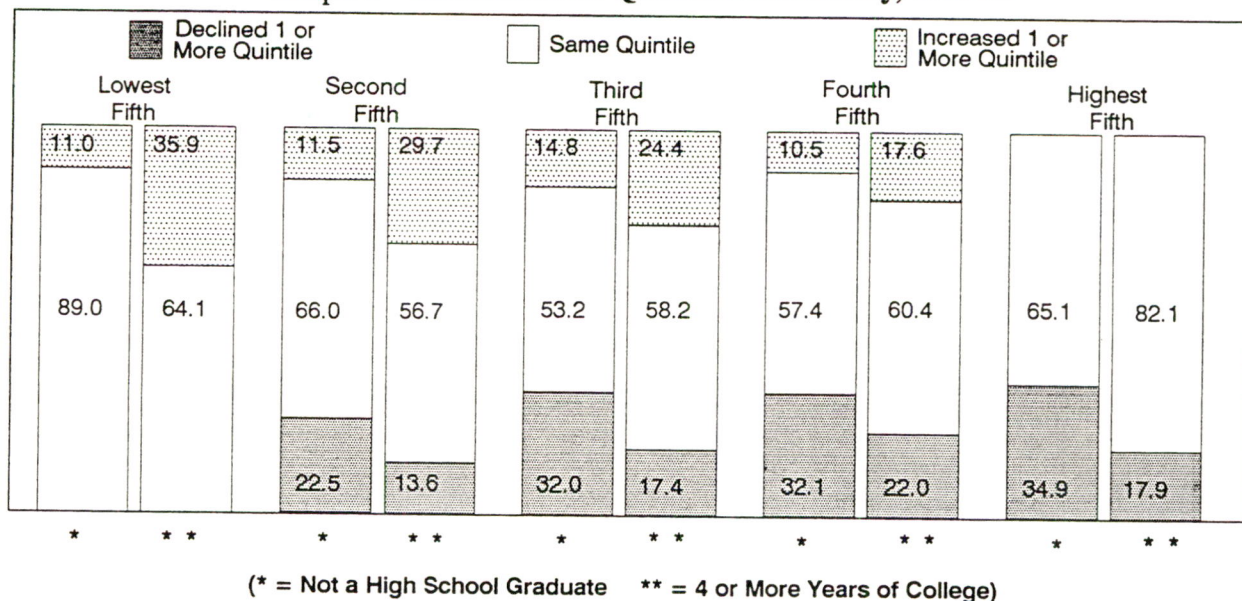
Source: Bureau of the Census.

Note that 53.8 percent of single person families exited from the fourth quintile in 1988, while turnover in the third and top quintiles were also well over 40 percent. While the third quintile of five person families shows a 46.5 percent turnover, the other quintiles in this family size reflect more stability. The data show that income dynamics varies by family size, another important fact obscured by the assumption of class stability. Changes in average income by quintile is even more meaningless for some groups than for others.

Education and Quintile Permeability

The SIPP data show that those with more education tend to move up through quintiles at a faster rate than those without benefit of a high school diploma. The data also reflect the fact that those without high school educations have a much higher risk of sudden income declines. Graph 6 shows that 34.9 percent of these persons in the top quintile fell into lower quintiles between 1987 and 1988, relative to 17.9 percent of those with four or more years of college.

Graph 6 -- Education and Quintile Permeability, 1987-88



Source: Bureau of the Census.

The graph reflects the superior economic progress of those with college educations. Not surprisingly, their upward mobility in all quintiles is much greater than for those without high school diplomas. Of course, in the overall population, more of the top fifth quintile is comprised of these college-educated persons than those without high school degrees.

The high rates of change in the composition of quintiles radically affect income averages, altering them to the point that they do not accurately reflect changes in our economy.

To illustrate this point, imagine a tiny country of 50 people, spread evenly over five hypothetical quintiles with the average income for the bottom quintile set at \$14,500, the average for the second \$24,500, the third \$34,500, the fourth \$44,500 and the top quintile having an average income of \$54,500.

In the bottom quintile is Private Smith, earning \$18,000. In the second quintile is Ann Waitress, earning \$27,000. Joe Salesman has an income of \$35,000 per year, putting him in the middle of the middle quintile. Ted and Jane Suburban have a combined income of \$45,000 per year, which puts them in the fourth quintile. And Bob Sportscaster makes \$51,000 per year covering football games for the network, placing him in the top quintile.

In the course of the year Private Smith is promoted to corporal, increasing his salary to \$21,000, pushing him into the second quintile. Ann Waitress finally gets her break in acting, landing a part in a national commercial which propels her into the top quintile with an annual income of \$56,000.

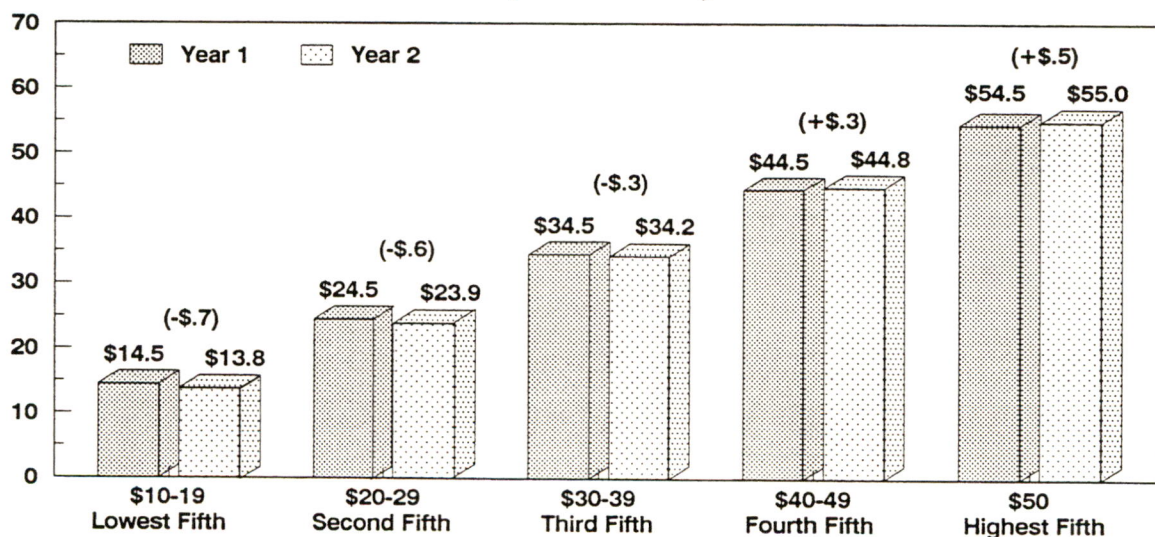
Joe Salesman's wife starts a small catering business, and her second income is enough to edge them from the middle of the third quintile to the bottom of the fourth at \$48,000. On the other hand, Jane Suburban decides to leave the labor force to stay home with her infant child, which causes their household income to drop from the top of the fourth quintile to near the bottom of the third with an income of \$32,000.

When the network is disappointed by Bob Sportscaster's ratings, he's sent to an affiliate in the Midwest, and his salary declines to \$45,000, dropping him from the bottom of the top quintile to the top of the fourth. In this same year, Dean Teen graduates from high school, leaves home, and begins working full time at the pizzeria, entering the work force and the bottom quintile with annual wages of \$11,000.

Now, all these vignettes are natural occurrences in this country's tiny economy. Most of the households gained income in the course of this year (Private Smith, Ann Waitress, Joe Salesman and Dean Teen), and those who lost income either made rational choices (the Suburbans) or didn't drop too severely (Bob Sportscaster).

Assuming no significant change in the income of other households, the effect, however, would be to decrease the average incomes in the bottom three quintiles while the top two quintiles see an increase in average annual income (see Graph 7).

Graph 7 -- Changes in Average Income
Hypothetical Quintiles, Year 1 to Year 2
(in \$-thousands)



Note: Numbers in () represent differences in average income in Year 1 & Year 2.

If CBO were to measure annual income gains and losses in this model economy, however, the next day's headline would be "Rich Get Richer, Poor Get Poorer."

This illustration is not to say that in America poor people never get poorer and rich people never get richer in America, only to demonstrate that the income quintile measures are not only incompatible with the changing nature of our economy, but that the changing nature of our economy can render the quintile measures meaningless. The oversimplification of the headlines tells us nothing about the quality of life of those passing among the quintiles of this tiny country of 50 people.

The validity of any concept relies on its accurate representation of its subject. A concept, even a seemingly empirical one, which expresses a meaning at variance with its subject provides a false view of reality. As physicist and philosopher Stanley Jaki has pointed out, "without securing reality, the so-called scientific objectivity or empirical objectivity has no secure foundation."² The common usage of the quintile as a monolithic block of inextricably linked families whose fortunes rise or fall in unison distorts economic and social reality.³

Data for 1985-86 show that nearly half the population in the middle quintile moved to a different quintile in the course of a year. Over 18 percent of those in the bottom quintile moved up, and nearly 24 percent of those in the top quintile moved down in a year's time. In other words, it is accurate to say that ours is an economy where some rich get richer, some poor get poorer, some rich get poorer and some poor get richer.

Furthermore, the income gained by a new invention, innovation, investment, or artistic success adds to the well being of all, and is not taken from anyone. If a professional athlete doubles his income over 5 or 10 years, he does no harm to others at a lower level of income.

While it is easy to measure the average incomes of a given quintile over time, this measurement's relationship to economic reality is usually overstated. The truth is that understanding of our market economy is hindered by this approach. In the market economy there is no finite, common pool of income to be distributed, and there is no Distributor of Income. As such, there is no "income distribution" per se, but only the income of millions of persons from a wide variety of sources (including business, self employment, and government) which can be summed up.

The most common use of family income data is to provide a pseudoscientific rationale for the policies of income redistribution based on notions of social or distributive justice. The only problem is that advocates of this approach cannot define what a socially just outcome would look like. As Nobel Laureate F.A. Hayek has pointed out, "so long as the earnings of particular individuals or groups are not determined by the decision of some agency, no particular distribution of incomes can be meaningfully described as more just than another. If we want to make it

² Jaki, Stanley L., Chance or Reality and Other Essays, Lanham, 1986, pg. 33.

³ See also Bruce Bartlett, "A Class Structure That Won't Stay Put," Wall Street Journal, November 20, 1991.

substantively just, we can do so only by replacing the whole spontaneous order by an organization in which the share of each is fixed by some central authority."⁴

Misleading the American public into believing our society is an arbitrary zero-sum class system controlled and exploited by an elite is a very dangerous brand of class warfare. Reducing the free and spontaneous adjustments of the market process to a bipolar system of victims and villains threatens our inextricably intertwined economic and political freedoms. Responsible government requires accurate measures of the changes in our economy.

Government statistical agencies should place greater emphasis on income mobility, or what can also be termed "quintile permeability," a telling economic trait which is often ignored in public debate. After all, what tells us more about our economy and the opportunities it presents: that the average income of the top quintile increased 1 percent in a given year, or that fully one-quarter of those in the top quintile arrived there in the past year?

In the future, data on changes in average income among quintiles should be presented next to changes in quintile composition to portray an accurate picture of our economy. Income quintiles are not monolithic blocks of inextricably linked households whose fortunes rise and fall in unison. Government agencies should not disseminate statistics which lend credence to the notion that ours is a caste society where there exists a permanent class of "rich" who get "richer" by somehow making the permanent class of "poor" get "poorer."

Calendar Year Data

One aspect of the economic revisionism currently in vogue is the assertion that the late 1970s, contrary to popular perception, were actually better years in terms of economic growth and job creation than were the mid-to-late 1980s. In this scenario, the fiscal policies pursued by President Jimmy Carter were better for the country than those pursued by President Ronald Reagan.

As is often the case with revisionist history, these reports are based on flawed evidence and distorted methods. These retrospective economic "analyses" consistently measure a president's fiscal performance from the time he was sworn into office (if not before), even though a president's fiscal policies usually do not take effect until the beginning of the first fiscal year in which he presides. The analysis here on the other hand, examines the average annualized rate for three important economic factors affecting all Americans (job creation, growth in the real gross national product (GNP), and inflation) by extracting data from the fiscal years during which a president served.

The first necessary adjustment for data is to adjust calendar year data to fiscal year end points. One cannot accurately measure gallons with a ruler, and one cannot accurately measure a president's fiscal performance with calendar year data. The proper data base with which to hold

⁴ Hayek, F.A., Law, Legislation and Liberty, Volume 2, The Mirage of Social Justice, Chicago, 1976, pg. 142.

a president accountable for fiscal performance is to use data from the fiscal years during which he served.

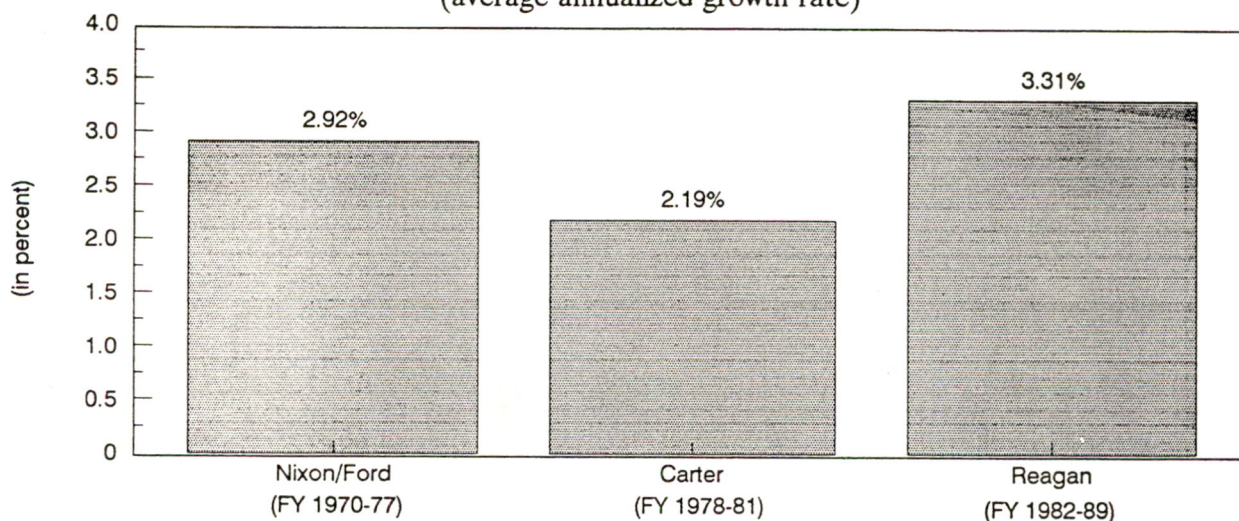
The results are interesting. A recent House Democratic Study Group report based on calendar year data show Jimmy Carter's annualized job creation percentage standing as a peak between the Nixon/Ford and Ronald Reagan administrations, but fiscal year analysis shows his job creation percentage as a valley between the two. And rather than showing a steady rise in real GNP from 1970 to 1989, Carter's fiscal year picture appears as a GNP "Death Valley" between his predecessor and successor (see Table 2 and Graph 8).

Table 2 -- Real Gross National Product Growth
During Presidents' Fiscal Years

President	Oct. 1	to	Oct. 1	Real GNP (in 1982 \$-billions)	Annualized Percentage Increase
Nixon/Ford	1969 (FY'70)		1977 (FY'78)	2,433.2 to 3,001.8	2.92%
Carter	1977 (FY'78)		1981 (FY'82)	3,001.8 to 3,264.6	2.19%
Reagan	1981 (FY'82)		1989 (FY'90)	3,264.6 to 4,129.7	3.31%

Source: Department of Commerce, Bureau of Economic Analysis, and fiscal year calculations by JEC Republican staff.

Graph 8 -- Real Gross National Product
(average annualized growth rate)



Source: Department of Commerce, Bureau of Economic Analysis, and JEC Republican staff calculations.

When the partisan distortions are factored out and the improved data are examined through fiscal year analysis, the implications for policy makers are clear. The policies of low marginal tax rates, restrained growth in Federal spending and deregulation offer the best path out of economic stagnation to GDP growth and job creation.

THE ECONOMY IN THE 1980S: SETTING THE RECORD STRAIGHT

Income in the 1980s

During the economic expansion of the 1980s (November 1982 through all of 1989 and part of 1990) family and household income increased across the board. While this growth was not the most rapid in the postwar period, it marked a recovery from the declines in income growth which began in 1979. The poor economic climate at the end of the 1970s was produced by slow growth and accelerating inflation, a combination ("stagflation") which produced the largest single-year decline in real family income on record in 1980, the last year of the Carter Administration. In 1980 alone, real median family income plunged over \$1,200, or over 3 percent, with an even more severe pace of decline among lower income groups. There were many, including liberal economist Lester Thurow and President Carter, who expressed the view that economic growth had ended and was not a realistic policy goal.

Income growth during the 1980s is also reflected below in Table 3 on real median household and family income. During the expansion, real median family income increased 12.6 percent. The gray band in the table marks the years of economic malaise which began in 1979 and spilled over into the early 1980s.

Household income reached a 1970s peak in 1978, and then fell in the four following years. This collapse was a painful result of the inflationary excesses of the 1970s evidenced in double-digit inflation and prime interest rates over 20 percent. However, the implementation of new policies in 1982 and 1983 proved a sound foundation for economic growth, with the longest peacetime expansion in U.S. history pushing family and household income to record highs. This upward movement stalled with the onset of the recession which began in 1990.

Table 3 -- Income Trends
(in constant 1990 dollars)

Year	Middle American Family Income*	Change From Previous Year	Middle American Household Income*	Change From Previous Year
1973	\$33,370	\$648	\$29,108	\$563
1974	32,491	-879	28,197	-911
1975	31,905	-586	27,442	-755
1976	32,913	1,008	27,913	471
1977	33,107	194	28,067	154
1978	34,156	1,049	29,168	1,101
1979	34,595	439	29,074	-94
1980	33,386	-1,209	28,125	-949
1981	32,476	-910	27,669	-456
1982	32,037	-439	27,577	-92
1983	32,378	341	27,581	4
1984	33,251	873	28,197	616
1985	33,689	438	28,688	491
1986	35,129	1,440	29,690	1,002
1987	35,632	503	29,984	294
1988	35,565	-67	30,079	95
1989	36,062	430	30,468	389
1990	35,353	-709	29,943	-525

Source: Bureau of the Census.

*CPI-U-X1 used for inflation adjustment.

Economic progress in the Reagan-Bush Administrations was evident among all income groups. The advances of middle class Americans has sometimes been misinterpreted. As we have pointed out in several previous reports, during the 1980s the middle class did indeed shrink, as more became affluent. Between 1980 and 1989 the portion of households earning over \$50,000 annually jumped from 20.0 percent to 25.7 percent (see Table 4). Meanwhile, the shares of those in the lower and middle income ranges declined with the general improvement in the standard of living.

Table 4 -- Percent of Households by Income Group
(in 1990 dollars)*

	Low Income (under \$15,000)	Middle Income (\$15,000-\$50,000)	High Income (over \$50,000)
1977	26.4%	54.2%	19.6%
1978	25.3	53.8	20.8
1979	25.0	53.8	21.1
1980	25.9	54.0	20.0
1981	26.9	53.4	19.7
1982	26.9	53.4	19.8
1983	26.8	52.8	20.5
1984	26.0	52.0	22.0
1985	25.8	51.7	22.5
1986	25.1	50.8	24.1
1987	24.9	50.4	24.7
1988	24.6	50.4	25.0
1989	24.1	50.2	25.7
1990	24.4	51.0	24.6

Source: Bureau of the Census.

*Adjusted with the CPI-U-X1.

Table 5 shows the real average income of each household income quintile since 1973. As the earlier discussion of income mobility pointed out, these quintile data should be used with the utmost caution, since the composition of the quintiles is markedly different even on an annual basis. Even when taken at face value, however, these data reflect a general increase in household income during the 1980s expansion.

Table 5 -- Real Average Household Income
(in constant 1990 dollars)

Year	Lowest Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Highest Fifth
1973	\$7,039	\$17,628	\$28,804	\$41,409	\$73,438
1974	7,008	17,419	28,072	40,542	71,830
1975	6,765	16,619	27,266	39,619	69,950
1976	6,935	16,980	27,924	40,552	71,773
1977	6,897	16,977	28,082	41,146	73,374
1978	7,135	17,523	28,934	42,386	75,672
1979	7,075	17,599	29,015	42,580	76,415
1980	6,845	17,035	28,111	41,414	73,842
1981	6,676	16,630	27,549	41,065	73,354
1982	6,549	16,571	27,431	40,796	74,823
1983	6,631	16,656	27,539	41,325	75,873
1984	6,838	17,033	28,226	42,498	78,145
1985	6,819	17,281	28,685	43,148	80,598
1986	6,886	17,712	29,640	44,651	84,515
1987	7,055	17,930	29,977	45,311	86,171
1988	7,143	18,027	30,152	45,578	87,014
1989	7,372	18,341	30,488	46,117	90,150
1990	7,195	18,030	29,781	44,901	87,137
Percent Change					
1973-80	-2.8	-3.4	-2.4	.0	.6
1979-80	-3.3	-3.2	-3.1	-2.7	-3.4
1981-89	10.4	10.3	10.7	12.3	22.9
1982-89	12.6	10.7	11.1	13.0	20.5
1989-90	-2.4	-1.7	-2.3	-2.6	-3.3

Source: Bureau of the Census and JEC Republican staff calculations.

Tax Burdens

In the years leading up to its passage, proponents of the 1981 Roth-Kemp tax cut argued that a 30 percent across-the-board reduction in personal marginal tax rates would lower the tax barriers to the flow of resources into production. According to this view, these resources already existed in the forms of inefficient tax-sheltered investments, underutilized capital, consumed leisure, unexploited entrepreneurial opportunities, and unrealized capital gains. Lower tax rates, it was argued, would improve economic growth by reducing the after-tax price of productive resources and improving the efficiency of redeployed resources.

It was also argued that shifting these resources from the untaxed to the taxable economy would actually increase the tax payments of those most affected by punitive tax rates. In practical

terms, this means that high income taxpayers would be expected to pay more of the income tax burden while middle and lower income taxpayers would assume less. This view was disputed by the Congressional Budget Office and Joint Tax Committee, both of which projected that average tax payments of upper income taxpayers, expressed in nominal terms, would fall after 1981, producing, in the words of then House Speaker Tip O'Neill, a "giveaway to the rich."

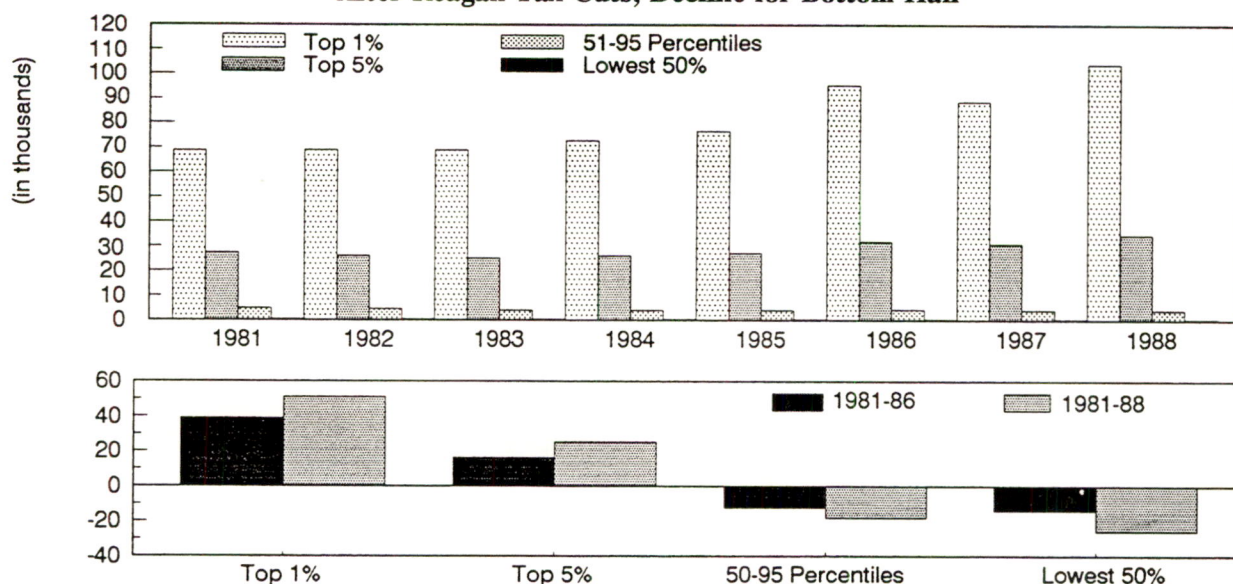
The IRS data reported in Table 6 and Graph 9 prove conclusively that CBO and JCT were completely wrong about the impact and even the direction of the tax rate cuts' effects. Actual income tax payments by the top 1 percent increased sharply, even after adjustment for inflation. Oddly, CBO simulations of tax payment declines for upper income groups continued to be released in the face of contradictory IRS data on actual returns, a classic example of scenario versus science.

**Table 6 -- Average Income Tax Payments,
by Taxpayer Group (1988 dollars)**

Year	Top 1%	Top 5%	51-95 Percentiles	Lowest 50%
1981	\$68,725	\$27,415	\$4,995	\$583
1982	68,977	26,199	4,553	533
1983	68,899	25,272	4,187	486
1984	72,723	26,161	4,184	507
1985	76,750	27,296	4,227	504
1986	95,462	31,896	4,377	500
1987	88,685	31,022	4,068	438
1988	104,008	34,446	4,097	433
Percent Change				
1981-86	39.0%	16.3%	-12.4%	-14.2%
1981-88	51.3	25.6	-18.0	-25.7

Source: IRS and JEC Republican staff calculations.

**Graph 9 -- Income Tax Payments of Affluent Rise
After Reagan Tax Cuts, Decline for Bottom Half**



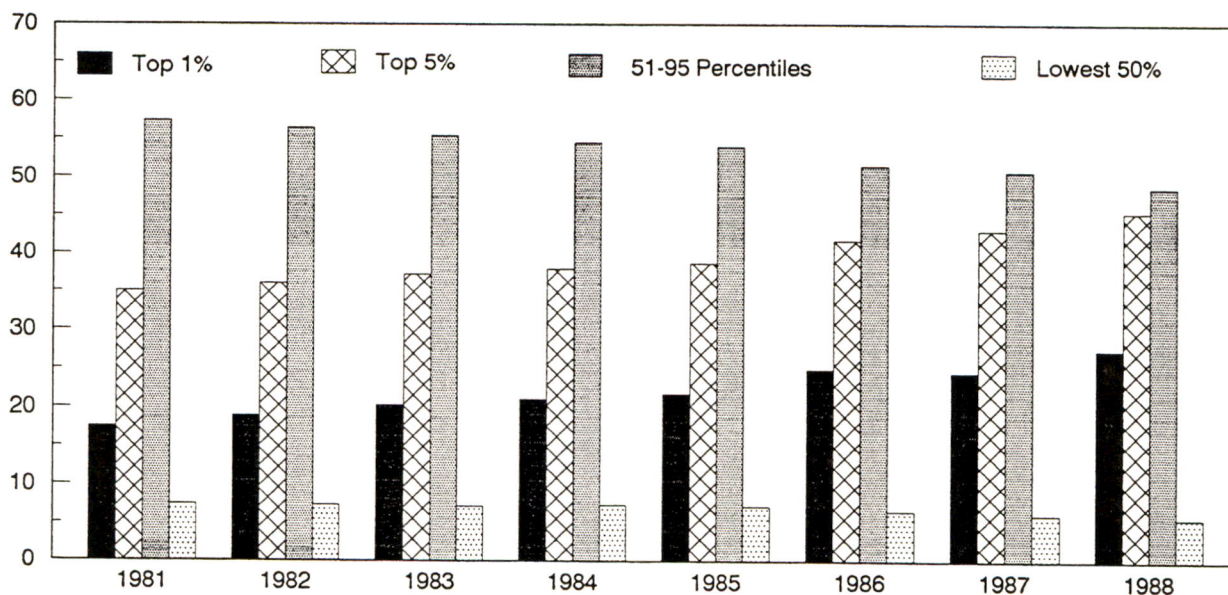
The IRS data clearly show that average income tax payments of the top 1 percent of taxpayers jumped 51.3 percent between 1981 and 1988. Meanwhile, the average tax payment of the lowest 50 percent fell 25.7 percent. Of the \$411.8 billion in personal income taxes collected in tax year 1988, \$113.2 billion, or 27.5 percent, was contributed by the top 1 percent of taxpayers. Over one-fourth of all personal income tax revenue came from the top 1 percent, while the top 5 percent accounted for 45.5 percent. Table 7 and Graph 10 show a massive shift in the tax burden, but its direction is upward onto the shoulders of the high income earners.

Table 7 -- Income Tax Burden Shifted Towards Wealthy

Year	Top 1%	Top 5%	51-95 Percentiles	Lowest 50%
1981	17.6%	35.1%	57.4%	7.5%
1982	19.0	36.1	56.5	7.4
1983	20.3	37.3	55.5	7.2
1984	21.1	38.0	54.6	7.4
1985	21.8	38.8	54.1	7.2
1986	25.0	41.8	51.6	6.6
1987	24.6	43.1	50.8	6.1
1988	27.5	45.5	48.7	5.7

Source: Internal Revenue Service.

Graph 10 -- Wealthy Shoulder More of
of the Income Tax Burden



Source: Internal Revenue Service JEC Republican staff calculations.

Last year the Republican Members of the Joint Economic Committee introduced the Fairness Ratio in our annual report. This measure is the ratio of the average income tax payment in the top 1 percent for every dollar paid on average in the bottom 50 percent. In 1981 the average income tax payment in the top 1 percent was \$117.89 for every dollar of average tax payment in the bottom 50 percent. By 1988 the fairness ratio had jumped to \$240.2, an increase of 103.7 percent (see Table 8 and Graph 11).

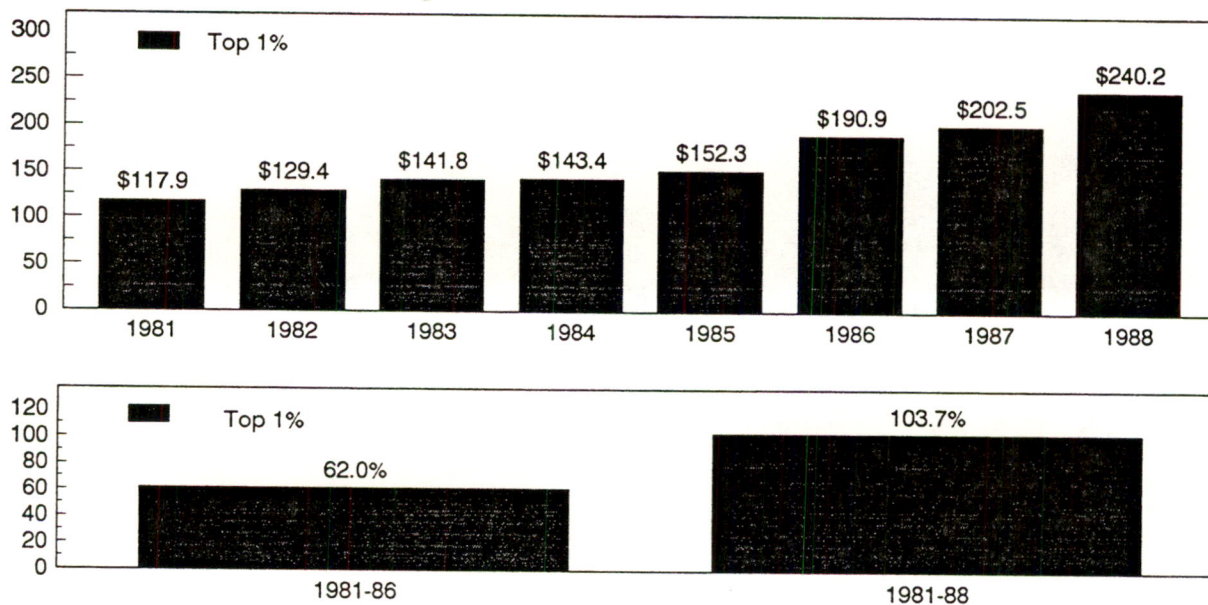
Table 8 -- Fairness Ratio* in Tax Payments

1981	\$117.78
1982	129.41
1983	141.77
1984	143.44
1985	152.28
1986	190.91
1987	202.48
1988	240.20
Percent Change	
1981-86	62.0%
1981-88	103.7%

Source: JEC Republican staff calculations.

*Average tax payment of taxpayer in top 1 percent for each dollar of tax paid by each taxpayer in the bottom 50 percent.

Graph 11 -- Tax Fairness on the Rise



Internal Revenue Service and JEC Republican staff calculations.

Among the best evidence for the rise in average income tax payments of the affluent in the 1980s is the fact that the CBO no longer publishes these data. Since 1987 a new methodology has been developed. The Democrat majority in Congress derives from CBO a warped income and tax methodology to generate huge estimation and analytical errors. It includes the absurd assumption that the extra income elicited by the 1981 tax cuts can be subjected to 1977 tax rates. The wealth and growth unlocked by the Reagan tax cuts are thus retroactively taxed at 1977 marginal rates. This fantasy "lost revenue" from income that was sheltered from taxes or otherwise would never have been created is labeled a "giveaway" to upper income groups to justify new attempts to raise marginal tax rates. These scenarios are presented instead of average income tax data which dispute class warfare rhetoric. Given the choice between actual IRS data and CBO fabrications, many seem to prefer simulations, even when components of income are mismeasured by over 100 percent.

During the Reagan years the share of the tax burden borne by low and middle income groups declined. By 1988 the bottom 50 percent of taxpayers bore only 5.7 percent of the income tax burden, not counting those removed entirely from the tax roles. Unfortunately, this group is subject to a heavier tax load courtesy of the social security tax increase of 1977, passed by a Democrat Congress and signed into law by President Carter. To the extent aggregate tax burdens have increased for low income groups, the overwhelming proportion is accounted for by these stiff increases in the payroll tax. From 1977 to 1990, the social security payroll tax rate rose by nearly one-third, from 11.7 to 15.3 percent. The current level of the payroll tax was set in the 1977 legislation, though some try to attribute its painful effects to the 1981 tax legislation, which cut personal income tax rates for all groups.

Tax Cuts and Revenue

After the full implementation of the Roth-Kemp tax cuts, Federal revenues increased, contradicting the scenario of a Treasury starved of revenue. Between 1980 and 1989, personal income tax revenues increased 22 percent (after adjustment for inflation). While one can argue about the degree of revenue growth that would have occurred without the rate cuts, the bottom line is that actual personal income tax revenues expanded with the tax base in the 1980s, as did Federal revenues in general. Federal spending, however, outstripped this growth in revenue.

Upper income taxpayers paid more taxes after the rate cuts, while middle and lower income taxpayers got tax relief, lowering their income taxes relative to projections. When Washington politicians deplore the \$750 billion in lost revenue allegedly resulting from tax cuts in the 1980s, they are really saying that the average taxpayer should have paid \$7,500 more to fund the wasteful growth in Federal spending. This is why liberals tried to block the third year of the Roth-Kemp tax cut and bracket indexing, both of which benefitted primarily middle income taxpayers. Those on the left who now posture in support of temporary middle class tax relief continue to criticize the real middle class tax cut of 1981 because they want to spend even more taxpayer money.

Following the passage of lower marginal tax rates in 1981, annual IRS data confirmed the view that average income tax payments were increasing at the top end. Meanwhile, the third installment of the tax cut as well as tax indexing, both beneficial primarily to the middle class, survived repeated attempts at repeal launched by congressional Democrats. In the end, the Roth-

Kemp personal income tax cuts were permitted to reduce income tax payments on middle income taxpayers.

In the absence of Roth-Kemp, families earning \$20,000 per year would pay \$1,600 more in income taxes and families with incomes of \$45,000 would pay \$5,100 more to the Federal government.

Senator Phil Gramm's office recently devised a form that allows taxpayers to compare their individual tax burden under current law (reflecting the dramatic changes in individual taxes under the 1981 and 1986 tax acts) with what they would be paying today if the 1980 rate structure were still in effect. We reproduce his "Fairness 1040 Form" on pages 27 and 28 and invite readers to fill it out before accepting baseless assertions that "the middle class did not benefit from the Reagan tax cuts."

1040**Do-It-Yourself Tax Fairness Test****U.S. Individual Income Tax Return 1980 vs. 1991**

Social Security Number

- -

For Comparing 1980 Income Taxes against 1991 Income Taxes

Label

N
A
M
E

First Name

Last Name

Spouse

Address

City

State

Occupation

Filing
Status☐

Single

☒

Married filing joint return

☐

Head of household

Exemptions

☐

1 Yourself

☐

1 Spouse

☐

Dependents

(Number of kids under 18)

Names

Total number
of exemptions
claimed

Income	1	List your total income here	1		
COMPARE 1980 TAX CODE VS. 1991 TAX CODE Column A for 1980, Column B for 1991				1980 Tax Code Column A	1991 Tax Code Column B
Standard Deduction	2	Family's Standard Deduction in 1980	2	\$3,400	
	3	Family's Standard Deduction in 1991	3		\$5,700
Personal Exemption	4	Multiply your number of exemptions by \$1,000	4		
	5	Multiply your number of exemptions by \$2,150	5		
Taxable Income	6	Subtract your standard deduction amount and exemption amount from your income	6		
YOUR TAX BILL	7	See 1980 tax table on back to determine TAX OWED UNDER 1980 CODE	7		
	8	See 1991 tax table on back to determine TAX OWED UNDER 1991 CODE	8		
AMOUNT YOU KEPT FROM TAX CUT OF THE 1980'S Subtract amount on line 8 from line 7					

1980 Income Tax Schedule

- 1 Enter taxable income from line 6, column A.

- 2 Find corresponding income bracket in table below

For income over -	but not over -	the tax is -	of the amount over -
\$0	\$2,099	14%	\$0
\$2,100	\$4,199	\$294 + 16%	\$2,100
\$4,200	\$8,499	\$630 + 18%	\$4,200
\$8,500	\$12,599	\$1,404 + 21%	\$8,500
\$12,600	\$16,799	\$2,265 + 24%	\$12,600
\$16,800	\$21,199	\$3,273 + 28%	\$16,800
\$21,200	\$26,499	\$4,505 + 32%	\$21,200
\$26,500	\$31,799	\$6,201 + 37%	\$26,500
\$31,800	\$42,399	\$8,162 + 43%	\$31,800
\$42,400	\$56,599	\$12,720 + 49%	\$42,400
\$56,600	\$82,199	\$19,678 + 54%	\$56,600
\$82,200	\$105,999	\$33,502 + 59%	\$82,200
\$106,000	\$158,999	\$47,544 + 64%	\$106,000
\$159,000	\$211,999	\$81,464 + 68%	\$159,000
\$212,000		\$117,504 + 70%	\$212,000

- 3 Compute tax and enter \$ amount here and on line 7 on front of this form

Calculation Hint in using percentages:
 $14\% \text{ of } \$1,000 = .14 \times \$1,000 = \$140$

Note: In 1980, the present standard deduction was called a "zero bracket amount". While the effect on taxes is the same, the standard deduction prevents an amount of income from being taxed, while the zero bracket amount applies a zero percent rate on an amount of income. For comparison purposes, the zero bracket amount is shown as a standard deduction, and the 1980 tax schedule is adjusted accordingly.

1991 Income Tax Schedule

- 1 Enter taxable income from line 6, column B.

- 2 Find corresponding income bracket in table below

For income over -	but not over -	the tax is -	of the amount over -
\$0	\$33,999	15%	\$0
\$34,000	\$82,149	\$5,100 + 28%	\$34,000
\$82,150		\$18,582 + 31%	\$82,150

- 3 Compute tax and enter \$ amount here and on line 8 on front of this form

Calculation Hint in using percentages:
 $14\% \text{ of } \$1,000 = .14 \times \$1,000 = \$140$

Special Note on Earned Income Tax Credit (EITC) for Low-Income Families

The 1980 EITC was 10% on earnings for a maximum credit of \$500. At \$6,000 of earnings, the credit is phased-out by 12.5%, with the total credit eliminated by \$10,000 of earnings

The 1991 basic EITC for 2 or more children was 17.3% on earnings for a maximum credit of \$1,235. At \$11,250 of earnings (or AGI), the credit is phased-out by 12.36%, with the total credit eliminated by \$21,242.

The average poor family of four with earnings of \$9,833 would have received a \$20 credit in 1980 but a \$1,235 credit in 1991. Thus a \$327 tax on an average poor family under the 1980 code is now a rebate of \$1,235 in 1991.

Labor and Earnings

Partisan claims about recent wage and employment trends are another element in revisionist economics. The media have extensively echoed charges that real wages have not grown, productivity is lagging, and living standards in the United States have stagnated, basing stories on partisan data. For example, the Senate Majority Leader recently painted a scenario where "average wages" of American workers have been virtually flat for the past 30 years. Any look at the real world, however, shows that the well-being of the average worker today is far better than it was in 1960. This immediate observation calls into question both the measure of worker well-being used, and the method in which it is applied.

Wages and Compensation

There are several different measures of worker income, each of which presents a different picture of the recent situation of the American worker. The "real weekly wage" measure presents the worst possible picture of worker well-being. We present here annual data of several measures of worker wages and benefits, allowing the reader to decide the relative circumstances of the American work force.

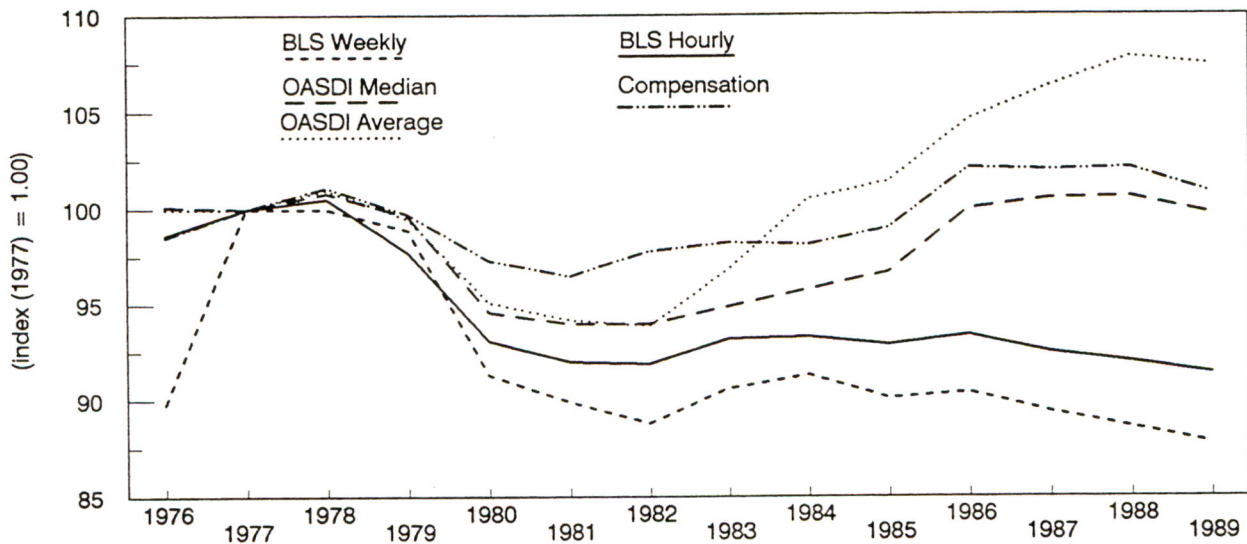
Table 10 and Graph 12 portray annual data on five different measures of worker well being. The data are from two different Federal government sources. Three measures -- hourly wages, weekly wages and real compensation -- are derived from the Bureau of Labor Statistics (BLS) of the Department of Labor. Two measures, average (mean) and median annual wages are derived from Social Security Administration data based on Old Age, Survivors and Disability Insurance (OASDI) collections. The graph translates these data into indexes, setting the year 1977 at 1.00 for each measure and the other years as ratios of the 1977 base year.

**Table 10 -- Total and Per Capita Disposable Personal Income
and Personal Consumption expenditures, 1976-91**

Year	Real Weekly Wages (\$-1982)	Real Hourly Wages (\$-1982)	Real Per Compensation per Hour (\$-1982)	Real Average Social Security (\$-1987)	Real Median Social Security (\$-1987)
1976	\$297.37	\$8.24	100.8	\$13,009	\$12,440
1977	300.96	8.36	102.3	17,012	12,428
1978	300.89	8.40	103.4	17,178	12,527
1979	291.66	8.17	102.0	16,932	12,381
1980	274.65	7.78	99.5	16,171	11,757
1981	270.63	7.69	98.7	16,029	11,686
1982	267.26	7.68	100.0	15,969	11,683
1983	272.52	7.79	100.5	16,468	11,797
1984	274.73	7.80	100.4	17,099	11,879
1985	271.16	7.77	101.3	17,255	12,023
1986	271.94	7.81	104.4	17,788	12,424
1987	269.16	7.73	104.3	18,080	12,491
1988	266.79	7.69	104.4	18,342	12,497
1989	264.22	7.64	103.1	18,265	12,397
1990	259.72	7.53	103.1	18,006	0
1991	255.89	7.46	0.0	0	0

Source: Economic Report of the President, February 1992. Tables B-5, pg. 305; U.S. H.H.S. Social Security Bulletin, Annual Statistical Supplement, 1991. Tables 4.B.1, 4.B.3, and JEC-GOP staff calculations.

Graph 12 -- Measures of Worker Wages and Salaries
(variation among five common measures)



Several factors reduce the validity of BLS real weekly wage data. First, average earnings estimates that incorporate the 1970s are based on a flawed Consumer Price Index that is usually discarded in serious analyses of historical trends. The old, flawed index (which was revised in 1983) overstated the increase in housing costs. Its use results in a cumulative overstatement of inflation in the 1970s and early 1980s, and a related 9 percent understatement of real wage growth in the same period.

The weekly earnings estimate is also flawed because the average hours worked per week has declined from 36 hours in 1977 to 34.3 in 1991. A decrease in hours worked per week reduces weekly wages at any given wage rate. The decline in average hours worked is a long-term trend of the last several decades, and reflects the ability of employers to offer workers leisure time in response to employee preference.

The data in Graph 12 also illustrates the importance of distinctions between partial and more comprehensive measures of worker income. The most comprehensive wage and earnings measure is real compensation per hour, which is a broad average of the total cost to employers in the private sector for wages, salaries and noncash benefits per hour of work. According to the U.S. Chamber of Commerce, fringe benefits (notably health insurance) accounted for 30.6 percent of the value of a worker's compensation in 1990, up from 25 percent in 1975.

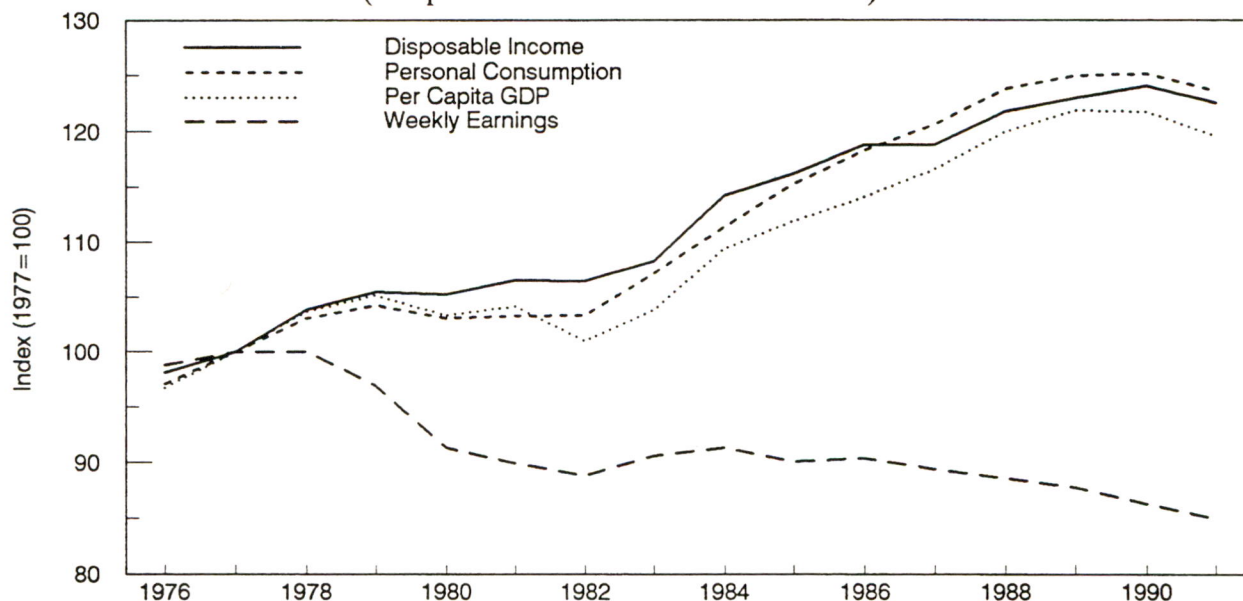
The BLS hourly and weekly earnings measures differ in two important ways from hourly compensation in that they cover only production and nonsupervisory workers, not all workers in the work force. Production and nonsupervisory workers tend to be less skilled than other workers. The

divergent trends of wages and compensation suggests a stratification of the labor market, but it does not make any reliable statement about worker earnings in any set of years. The disparity between wages and compensation reflects the additional fringe benefit mandates imposed by Federal, state and local governments. Employers have been forced to alter the total compensation package to workers to include relatively more mandated benefits and relatively less money (often overriding worker preferences in the process).

The measure of hourly wages comes from a monthly BLS survey in which payroll information is collected from private business establishments. Other sources of similar information, such as Federal and state tax records, can be used for comparison purposes. The Social Security Administration OASDI data in Table 2 and Graph 10 measure average annual wages per worker. OASDI data reflect wages of nearly all workers, in contrast to BLS data. The only reason not to use OASDI data is, apparently, partisan, since both the average and median OASDI measures indicate a rise in real wages far higher than the BLS wage data. A portion of the OASDI increase is attributed to the fact that higher skilled workers received relatively higher wage increases in the late 1970s and early 1980s. However, because the OASDI data are more comprehensive, they more reliably indicate workers' real wage trends since the mid-1970s.

Measures of real wages or real compensation include only earnings from work. Many Americans have additional sources of income from investments, savings and other sources. Graph 12 displays three measures of broader economic well being -- per capita disposable income, per capita consumption, and per capita GDP -- and compares them to the BLS weekly earning measures of which the Democrats are so fond. Graph 13 indexes the four measures, with the 1977 value for all measures set at 1.00, in the same manner as Graph 12.

Graph 13 -- Measures of Well Being
(comparison of four common measures)



Again, the contrast between the BLS weekly earnings measure and the other measures are striking. The three new measures are the most comprehensive measures available to describe changes in the relative wealth of all Americans. These measures obviously include much that is useful in describing the changing economic fate of Americans in the 1970s and 1980s. The sharp rise in personal consumption is perhaps most telling, since consumption is the ultimate goal of earnings anyway.

Several conclusions about worker wages and total compensation can be drawn from even this brief presentation. First, a careful review of the evidence shows that the work force as a whole increased real wage earnings in the 1980s. The debate is only over the size of the gain. Second, real compensation grew at quite an impressive rate during the 1980s, far surpassing the growth in real wages but adding no less to the well-being of the typical American worker and family. Third, the display of annual data shows how important the fate of the economy is to the fate of worker wages and compensation. Recessionary periods cause real decreases in worker earnings, but economic growth correlates strongly with increased wages and benefits, even for the least skilled workers.

Finally, the data make obvious the importance of getting the starting date right for any comparisons of wage and compensation trends. The recession and dislocation of the late 1970s Carter recession, before President Reagan took office in 1981 and his economic policies became effective later that year, severely harmed the well being of American workers. Most of the wage and compensation gains of the 1980s simply repaired prior damage from a Democrat administration.

There are also several political observations to make from their data, and the way they are usually presented by Democrats in Congress. First, the graphs and tables show clearly that to distort the trends in wages, compensation, and well-being trends, three critical and disingenuous assertions need to be made. The first assertion is to claim that the 1980s began early, preferably in 1978 or 1979, the first relative peak in worker wages, because picking a "peak" year makes the relative gains in later years appear smaller. Second, it is important to truncate the 1980s early, probably at 1987, to end the surge in wages and compensation before their peak. The third and most problematic assertion is to claim that real weekly wages of production and non-supervisory personnel as measured by BLS is the best indicator of worker well being.

If all these assertions are made and not questioned, "the '80s" can be made to "create an imagery of Reagan-Bush America that supersedes the Carter years and impeaches the credibility of conservative governance for middle America," just the scenario Mr. Greenberg suggests. It is no surprise that most Democrat economic analyses make all three of these assertions. It is, perhaps, more surprising that "nonpartisan" researchers inside and outside Congress often make many of the same assumptions.

The bias in these assumptions has been pointed out before. The defenders of distortion respond that the "business cycle" or some other hegemonic economic trend requires certain cut-off years in examining trends in income and wealth, but this response raises more questions than it answers.

As noted earlier, there were business cycles in 1980 and 1981, refuting any justification for lumping the late 70s into the 1980s for "peak-to-peak" measurement purpose. Even so, if all-powerful economic cycles force one to, for example, include 1978 and 1979 in the 1980s, then these trends must transcend control by politicians and governments. Changes in wages, compensation, disposable income and gross domestic product must all be caused by powerful forces beyond the control of political institutions. If these cycles are uncontrollable by government policy, there is no partisan advantage to tracing the paths of economic statistics. Obviously, however, partisan opponents of growth-oriented economics have invested a great deal of time and resources into painting a particularly bleak picture of the "1980s," attempting to attach responsibility for that picture to Republican economic policies. The frenzied nature of these attacks and the mountain of contrary evidence lead one to question whether critics of the "1980s" are truly interested in restoring economic growth and worker earnings, or would prefer to further damage our economy for short-term partisan gains.

This study was prepared by the JEC-GOP: Christopher Frenze (real family income, income mobility, and tax burdens), Douglas Koopman, Ph.D. (labor and earnings), Paul Taylor, Ph.D. (calendar year data), Edward Gillespie (editing), and Nita Morgan (graphics).

INCOME MOBILITY
AND
ECONOMIC OPPORTUNITY

Prepared for
Representative Richard K. Armey (R-TX)
Ranking Republican
Joint Economic Committee

June 1992

INCOME MOBILITY AND ECONOMIC OPPORTUNITY

"You could not step twice into the same river; for other waters are ever flowing on to you."

—Heraclitus, 540-480 B.C.

INTRODUCTION

Great attention has been given recently to changes over time in the average incomes of "quintiles," families or households ranked top to bottom by income and divided into fifths. However, such time line comparisons between rich and poor ignore a central element of the U.S. economy, which is the extent to which individuals move from one quintile to another. Figures on income mobility are more characteristic of the nature of our fluid society than comparisons of average incomes by quintile, which would only be statistically meaningful if America were a caste society where the people comprising the quintiles remained constant over time.

Unfortunately, while data on average income by quintile has been plentiful, however misleading, data on income mobility has been scarce. Until now.

This study is an analysis of newly available panel data based on income tax returns filed from 1979 through 1988, which were tabulated by the U.S. Department of the Treasury. The Treasury sample consists of 14,351 taxpayers filing returns in all of the above years. This sample tends to understate income mobility to the extent the movement of younger and older filers in and out of the population of taxpayers is missed by the requirement that returns be filed in all years. On the other hand, this understatement is at least somewhat offset at the low end of the income scale by the presence of an underclass which does not file tax returns year after year. For the purposes of this report, the bottom quintile consists of those who earn enough income to at least file income tax returns, if not to actually pay taxes.

Earlier studies of income mobility have demonstrated a startling degree of income mobility in as short a period as one year. However, as a January 1992 study noted¹, additional data over more extended periods were needed to draw more precise conclusions about income mobility over the longer term. This need has now been largely satisfied by the provision of longitudinal panel data from tax return files. However, much more data and research on income dynamics in coming years is needed.

¹ JEC/GOP staff study, "Income Mobility and the U.S. Economy: Open Society or Caste System?", released by Congressman Dick Armey, Ranking Republican, January 1992.

LEVEL OF INCOME MOBILITY BY QUINTILE

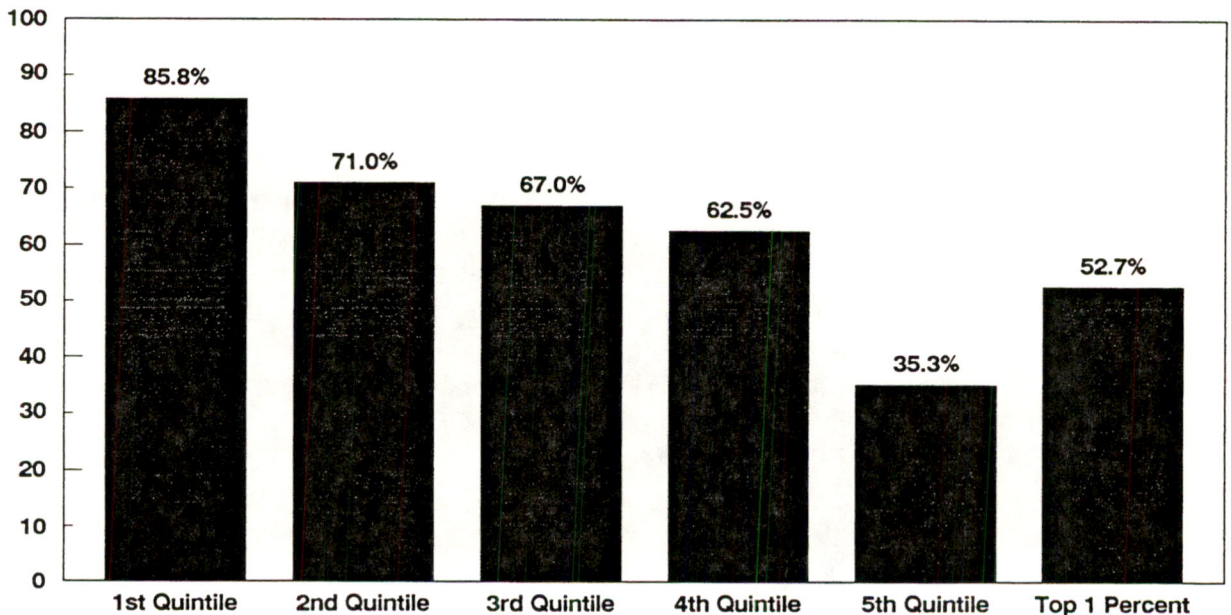
"All is flux, nothing stays still."

— *Heraclitus*

The new tax return data support the conclusion of earlier research which concluded that the degree of income mobility in American society renders the comparison of quintile income levels over time virtually meaningless. According to the tax data, 85.8 percent of filers in the bottom quintile in 1979 had exited this quintile by 1988. The corresponding mobility rates were 71 percent for the second lowest quintile, 67 percent for the middle quintile, 62.5 percent for the fourth quintile, and 35.3 percent for the top quintile.

Of those in the much discussed top 1 percent, over half, or 52.7 percent, were gone by 1988. These data understate income mobility in the top 1 percent to the extent mortality contributes to mobility and the diffusion of income. Graph 1 displays the income mobility of the various groups.

Graph 1 -- Proportion Moving to Different Quintiles or From Top Percentile, 1979-88



Source: United States Treasury.

In all but the top quintile, at least 60 percent of filers exited their 1979 income quintile by 1988, with two-thirds or more exiting in the bottom three quintiles. Though much more stability was observed in the top fifth, over one-third had slipped downward to be replaced by others moving up. Even most of the top 1 percent had exited by 1988, to be replaced by others.

The very high degree of income mobility displayed above shows that the composition of the various quintiles changes greatly over time. A majority of filers have indeed moved to different quintiles between 1979 and 1988. Thus intertemporal comparisons of average wages, earnings, or private incomes of quintiles cannot provide meaningful measures of changes in the income of actual families and persons only temporarily in a given quintile or percentile. Quintiles may be a convenient way of presenting snapshots of income data for a group of people at a certain point in time. Nonetheless, the notion of a quintile as a fixed economic class or social reality is a statistical mirage.

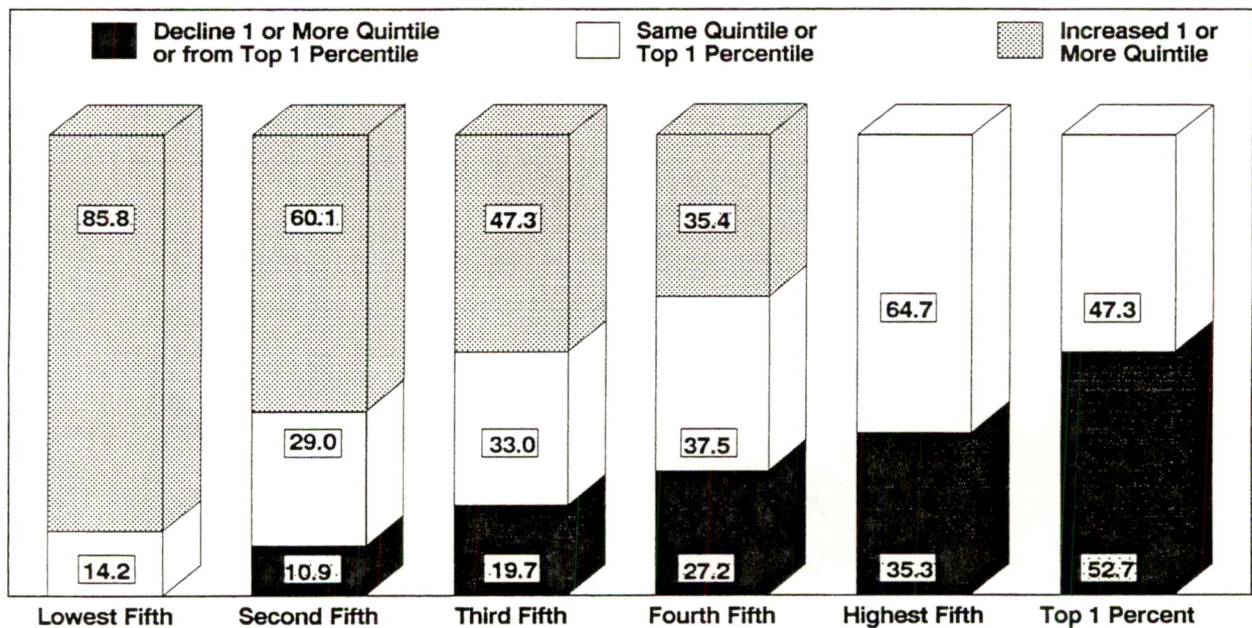
DIRECTION OF INCOME MOBILITY

"Nothing endures but change."

— Heraclitus

Movement is important, but the direction of that movement is more important. While a strong argument can be made for a flexible and open market economy which presents opportunities to lower and middle income workers, instability alone is not necessarily a virtue. Graph 2 summarizes the income mobility data to display the direction of movement between 1979 and 1988. For example, in the third, or middle 1979 fifth, 47.3 percent had moved to a higher quintile by 1988, while 33.0 remained in this same quintile, and 19.7 percent fell into a lower quintile.

Graph 2 -- Net Progress in the Bottom Four Quintiles, 1979-88



Source: United States Treasury.

Given the relative starting position, the very high mobility from the bottom quintile obviously reflects improvement. In addition, the upward movement in the second, third, and fourth quintiles is much larger than downward movement. For example, 60 percent of the second quintile had moved to one of the higher three quintiles by 1988. Over this same time, only 10.9 percent had fallen from the second into the lowest quintile.

In the long overdue debate over the significance of income mobility, some may argue that mobility would tend to reflect slippage, especially among the middle class. The data contradict this contention. Of those in the middle quintile in 1979, nearly half moved upward to the fourth or fifth quintiles by 1988. Overall, in the bottom four quintiles, net improvement was the rule, not the exception.

Detail on Income Mobility, 1979-88

Table 1 displays the movement of filers from 1979 quintiles to their positions in 1988. Each row can be read across: of 100 percent of each 1979 quintile, the table shows their dispersion among the various fifths by 1988.

Table 1 -- America on the Move

Quintile	Percent in Quintile in 1979	Percent in Each Quintile in 1988				
		1st	2nd	3rd	4th	5th
1st	100%	14.2%	20.7%	25.0%	25.3%	14.7%
2nd	100	10.9	29.0	29.6	19.5	11.1
3rd	100	5.7	14.0	33.0	32.3	15.0
4th	100	3.1	9.3	14.8	37.5	35.4
5th	100	1.1	4.4	9.4	20.3	64.7

Source: United States Treasury.

About 86 percent of those in the bottom quintile in 1979 had managed to raise their incomes by 1988 enough to have moved up to a higher quintile. The data show that these were not all grouped at the bottom at the second quintile. While 20.7 percent were in the second quintile, 25.0 percent had made it into the middle fifth, and another 25.3 percent into the second highest quintile. The 14.7 percent in the top quintile was actually higher than the 14.2 percent still stuck in the bottom fifth. **In other words, a member of the bottom income bracket in 1979 would have a better chance of moving to the top income bracket by 1988 than remaining in the bottom bracket.**

In the second quintile, 71 percent had exited between 1979 and 1988. Though 29.0 percent still remained in the second quintile in 1988, 29.6 percent had moved up to the third quintile, 19.5 percent to the fourth, and 11.1 percent to the top quintile. Only 10.9 percent had moved down to the lowest quintile.

Of those in the middle quintile in 1979, 32.3 percent had moved to the fourth quintile and 15.0 percent to the fifth quintile by 1988. **Over this period, 47.3 percent had moved up, while 19.7 percent had moved down. The net effect of income mobility in the middle range clearly reflected net overall improvement.**

While the fourth quintile exhibited powerful income mobility, the top quintile is the most stable. However, all income mobility from the top quintile is by definition downward mobility. The share of this group dropping into lower quintiles was 35.3 percent, while 27.2 percent of the fourth quintile also dropped at least one quintile. Many of these with declining fortunes are still better off than many of those with upward mobility from a low quintile, however, the overall pattern is that there tends to be strong upward mobility from the lower quintiles, while income mobility from a high level often reflects economic reversals. Without income mobility, many in the top fifth would be better off, and the great majority of those in the lower quintiles would be worse off. Income mobility reflects improvement in the lower four quintiles, but this fact has been virtually ignored in public discussion of income trends.

While 35.3 percent fell from the top quintile into the fourth quintile or below, 40.0 percent of the bottom quintile had moved into the fourth or fifth quintiles by 1988. Of all of those in the bottom quintile in 1979, about two-thirds, or 65 percent, had moved to the middle or higher quintiles by 1988. These data demonstrate that the U.S. economy, not without problems over this period, still remains dynamic, open, and productive enough to permit most Americans in the bottom three-fifths to work their way up the economic ladder. What is needed are policies to ensure that this flexibility and opportunity are extended as widely as possible, especially to those who actually fall below the bottom fifth of taxpayers.

CONCLUSION

"Much learning does not teach understanding."

— Heraclitus

Currently there are two models of the American economy, one static, and the other dynamic. The first portrays the United States as a caste system and misapplies the characteristics of a permanent income strata to those only temporarily moving through income brackets. The alternative view portrays a much more complex and interesting social reality in which the composition of income classes are in constant flux. According to this latter point of view, simplistic generalizations about actual persons and families (or "the rich" and "the poor") cannot be drawn from data on a conceptual artifice which does not exist as such in reality.

The empirical data support the view of the market economy as a dynamic and open society which provides opportunity to those who participate. There is no evidence of stagnation, with the turnover rate in the most stable quintile -- the top fifth -- exceeding 35 percent. The turnover rates in the bottom four quintiles were at least 60 percent over the period, with most of this reflecting upward progress. Analysis which assumes or suggests stable composition of family or household income quintiles rests on invalid assumptions. It makes no sense to draw sweeping conclusions such as "the income of the bottom 20 percent of families fell" in a 15-year period when most of the people originally in that category have long since improved their standard of living enough to have moved up from the bracket entirely.

This study was prepared by JEC/GOP staff: Senior Economist Christopher Frenze (author); Staff Director Edward Gillespie (editor); and Staff Assistant Nita Morgan (graphics).

Health

PROBLEMS WITH HEALTH EXPENDITURE NUMBERS

o THE DATA ARE NOT TIMELY.

--Due to delays in reporting, current methods for estimating national health expenditures do not allow for a precise estimate for a current year. For example, 1992 expenditures will not actually be known until 1995 and could only be estimated in 1992 based primarily on assumptions. The Office of National Cost Estimates makes an initial estimate for a current year and then continues to revise that estimate as data become available for up to 3 years after that year.

--The last HHS estimate of State spending was for the year 1982 --10 years ago. For some categories of expenditure, State estimates are based on extremely sketchy or out-of-date data. For example, the last survey of nursing homes was conducted in 1977. State data on drugs and drug sundries and eyeglasses and appliances are only collected every five years.

o SOME NEEDED DATA ARE UNAVAILABLE.

--Spending for non-Medicare certified home health agencies is currently not included. Thus, the amount currently spent for home health care is underreported.

--Some categories of expenditures would need to be disaggregated, yet the data are either nonexistent or the current sample size is insufficient. For example, the expenditure figures for occupational therapists, midwives, audiologists, psychologists, etc. are currently lumped together. The data on these categories are based on a sample that is likely to be too small to accurately project each category separately, even on a national basis. It would be still more inaccurate on a State basis.

--Some categories of expenditure might have to be disaggregated by diagnosis, depending on the benefit package. For example, drugs for treatment for mental illness might be considered separately from drugs for treatment of medical conditions. The data are currently not disaggregated in that manner.

--Data on drugs and drug sundries are reported in three categories: prescription drugs, nonprescription drugs and sundries (heating pads, bandages, etc.). Similarly, hearing aids, crutches, and wheelchairs are currently all lumped together. It would be difficult, at best, to set budgets or prices for individual items within those categories yet difficult to envision how a state or other entity could regulate within an overall sundry budget, for example.

ESTIMATED NATIONAL HEALTH EXPENDITURES -- 1992

Total: \$809.0 billion

Hospital care: \$313.9 billion

All hospitals in the U.S. and its outlying territories are included. It includes spending for services delivered to inpatients and outpatients, for physician services billed through hospitals, for drugs dispensed during hospitalization, and for services rendered through hospital-based home health agencies. Nursing home-type care provided in a hospital facility is also included in this category. All hospitals in the U.S. and its outlying territories are included.

Physician services: \$165.5 billion

Includes the offices of doctors of medicine and doctors of osteopathy plus independent laboratories and salaries for physicians in staff-model HMOs.

Dental services: \$38.6 billion

Includes dental offices, dental laboratory costs, and salaries for dentists in staff-model health maintenance organizations.

Other professional services: \$38.7 billion

Includes spending for services of all non-salaried licensed health practitioners other than physicians, dentists and in non-physician owned outpatient clinics. These include private-duty nurses, chiropractors, podiatrists, physical, speech, and occupational therapists, midwives, optometrists, among others.

Home health care: \$8.5 billion

Includes medical care services delivered in the home by non-facility-based home health agencies -- those establishments primarily engaged in providing skilled nursing or medical care in the home under supervision of a physician. Data used to prepare this estimate are from Medicare cost reports filed by Medicare-certified home health agencies. "Information covering the full scope of medical services provided by certified and noncertified home health agencies is not yet available." (From an article prepared by the folks who do the estimates.)

Home health care excludes nonmedical types of care such as Meals on Wheels, chore-worker services, friendly visits, or other social or custodial services; and nursing services provided by nurse registries.

Drugs and other nondurable products: \$55.5 billion

The category of prescription drugs includes retail sales of human-use dosage-form drugs, biologicals, and diagnostic products. These transactions can occur in community or HMO pharmacies, grocery store pharmacies, mail-order establishments, etc.

Nonprescription drugs and medical sundries comprise spending for such items as rubber medical sundries, heating pads, bandages, and nonprescription drugs (Tylenol) and analgesies.

Vision products and other medical durables: \$16.1 billion

This category includes retail purchases of eyeglasses and contact lenses and the purchase or rental of other durable medical equipment such as hearing aids, crutches, wheelchairs, and artificial limbs.

Nursing home care \$64.9 billion

Nursing and personal care facilities are establishments primarily engaged in providing inpatient nursing and health-related personal care through active treatment program for medical and health-related conditions.

Other personal health care \$14.9 billion

This category of spending covers two types of expenditure. One is industrial in-plant services, and the other is government expenditure for care not specified by kind.

Industrial in-plant services are facilities or supplies provided by employers for the health care needs of their employees. The services may be offered either onsite or offsite.

Administration and the net cost of private health insurance \$45.9 billion

This category of expenditure can be broken into three parts. The largest part comprises the difference between earned premiums and incurred benefits of private health insurers.

The next largest part comprises the administrative expenses of government programs.

The smallest part comprises the administrative expenses associated with health activities of philanthropic organizations -- the overhead expenses incurred by donor organizations.

Government public health activity: \$21.2 billion

Includes governmental activities in the prevention and control of clinical health problems in the population -- primarily FDA, CDC, and State health dept. activities. It excludes air and water pollution activities, sanitation and sewage treatment, water supplies and other environmental functions.

Research \$13.3 billion

Research is that activity carried out by nonprofit or government entities. Research and development expenditures by drug manufacturers are not included since the value of that research is assumed to be captured in the companies' sales.

Construction \$11.9 billion

The construction component is limited to the value of new construction put in place for hospitals and nursing homes. The measure includes new buildings-- additions, alterations, major replacements, and so on; nonstructural equipment such as X-ray machines and beds are excluded.

The figures reported include health care and institutional facilities except housing for nurses and doctors. Also included are sanatoria, convalescent and rest homes, nursing homes, orphanages, and similar establishments for prolonged care.

Healthcare
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TELECOPIER: (202) 637-5892**TELECOPIER COVER SHEET**Date: 10/06/92 Time: 9:05Fax No.: 456-6216 Client No.: 0011To: Richard PorterFrom: Deborah SteelmanNumber of Pages (excluding cover sheet): 2Person Sending: Brenda Ntim

Other Instructions:

Some suggested plain english on health care for debates
and other assorted purposes.IF YOU HAVE ANY PROBLEMS RECEIVING, PLEASE
CALL PERSON SENDING IMMEDIATELY

BUSH PLAN: POSITIVES

- My plan completely revamps insurance.
- My plan completely revamps medical malpractice laws.
- My plan helps people and small businesses buy insurance and makes sure the insurance is worth buying.
- My plan makes sure that insurance is affordable to all.
- My plan puts people, not government, in the driver's seat.
- Nobody expects a free lunch in health care, but everyone expects fairness and common sense. That's what my plan has.

CLINTON PLAN: ATTACKS

- Clinton's plan leads to the government making all the important decisions in health care. Americans not only have the right to health care, they have the right to make their own health care decisions.
- Under Clinton's global budget, we would have wage and price controls on a sector of our economy that is almost as big as England's entire economy. That's just plain nutty.
- Clinton's plan will be run by special interests in Washington. The members of his National Commission would decide how to spend \$800 billion or more every year. Politicians' friends would be able to call and get special favors, and people would be left with rationing and mediocre care.
- Clinton talks out of both sides of his mouth. First he was for a payroll tax. Now he finds that isn't politically popular so he calls it a "premium."
- Clinton's plan will cost small businesses at least 7% of payroll, regardless of whether he calls it a premium or a tax.

REBUTTALS TO CLINTON'S ATTACKS ON BUSH PLAN

- "All you want to do is protect private insurance. People cannot continue to be at the mercy of the insurance companies."

I care no more about insurance companies than you. In fact, our insurance reform proposals are almost identical. But you never mention this. You have to make my plan look bad to get people even consider your government take-over plan, an idea that has been rejected by the American people over and over again. You Democrats never learn.

The only alternative to private insurance is the government running our health care. Which do you want for your family, private sector health care or government health care?

- "You didn't even know health care was important to Americans until Wofford won in Pennsylvania. You only issued a plan for reelection. You won't do anything if you're elected."

I believe in that old maxim, "If you've got your health, you've got everything." Health care is too important to play your kind of cynical politics. We spent two years coming up with the right proposal, and we believe in it.

- 2 -

On the other hand, you issued one plan for the primaries, and a completely different one a month ago. I think that shows more commitment to getting elected than to reforming health care.

- **"Your tax credits aren't big enough to help people. How can a tax credit worth \$150 help someone whose insurance costs \$3,000?"**

First, don't misrepresent the tax credit proposal. My plan gives \$3,750 credit or deduction per family, on a sliding scale by income. Only a Democrat would say helping individuals instead of government is worthless. We don't have helpless consumers in this country. We have smart people. Smart people who would rather have the financial assistance to make their own decisions.

- **"You obviously don't understand my plan or you are deliberately lying about it. My plan isn't for government insurance; it is for private sector competition."**

Don't tell me I don't understand your plan; I understand it all too well. A commission in Washington will decide who gets what and when. Calling a payroll tax a premium doesn't fool anyone. Not even me.

- **"Your plan has no cost containment."**

The only kind of cost containment you recognize is the kind that has been discredited worldwide and here at home: regulation. Your kind of regulation has tied this economy in knots. Yet you want more and more.

The kind of cost containment in my plan gets at the root of the problem: medical liability, and the ability of some insurance companies, hospitals and doctors to game the system. Now you want to give them even easier pickings and let them game the government. The gaming has to stop; that means changing the underlying structure of our health care system. My plan does that.

- **"Your plan will give billions to private insurance and will increase costs. Mine saves money."**

It is easy to say that wage and price controls will save \$100 billion, \$200 billion or \$500 billion. You simply make up a figure. But that's always been the liberal's dream world. Wage and price controls have never worked, not here, not anywhere. It's political make-believe. What works is some common sense - changing the bad practices of some doctors and hospitals, making sure insurance companies operate the way they should, and reforming medical malpractice laws.

- **"You don't say how you're going to pay for your plan."**

I think we spend enough already. But we can spend it better. The state and Federal governments already spend billions on uncompensated care. My plan will virtually eliminate uncompensated care and we will spend that money on tax credits to help people.

- **"You haven't even sent your legislation to the Congress. You are not serious about enactment."**

Baloney. My bills are up there. You may want to talk about procedural junk, but I don't think the American people do. Let's not steer the conversation away from the merits. Your plan is a loser.