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Treasury / Leslie Samuels - Repsonses to Republican Tax Package

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DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

May 21, 1996

CLOSE HOLD

INFORMATION

MEMORANDUM FOR LAURA D'ANDREA TYSON

FROM: LESLIE SAMUELS LBS
ASSISTANT SECRETARY (TAX POLICY)

THROUGH: SECRETARY RUBIN R. E. R.

SUBJECT: Responses to Republican Tax Package

The Senate will consider the small business tax relief package later this week. We are considering one or more of the following approaches to take the initiative on tax matters.

- We could work with Senate Finance Democrats to prepare a revised small business package, which they can offer as amendments either in the Committee or on the Senate floor. This might include substituting our pension reform proposals for the Republican proposals, extending the Section 127 exclusion for employer-provided educational expenses for a longer time period (while restoring the exclusion for graduate training), introducing other Administration proposals, such as the brownfields tax incentives in the President's budget and the small business tax credit for employer-provided education and training recently announced by the President, or expanding the home office deduction.

- We could use the tax legislation as an opportunity to promote the Administration's broader agenda. This would involve encouraging Senate Democrats to offer as amendments proposals in the President's Middle Class Bill of Rights, especially the deduction for education and training. (The Ways and Means Committee Democrats proposed an education and training deduction as an amendment in last week's markup of the small business tax relief legislation.)

- While Senator Dole is still considering his approach to taxation, we could continue a pro-active strategy. The President could get out in front by announcing our tax simplification package, including the cut in capital gains tax on owner-occupied homes. Note that the simplification package could appear to be a feeble response if it followed the endorsement by Republicans of a broad reform package.

Minarik
Office of Management and Budget
May 22, 1996

Republican Supply-Side Claims

1. Real Federal revenue grew more in the Reagan supply-side years than it did since.

2. The economy performed better in the Reagan supply-side years than it did since.

3. President Clinton is a big taxer.

These claims are incorrect.

Republican Supply-Side Claim #1:
Real Federal revenue grew more in the Reagan supply-side years than it did since.

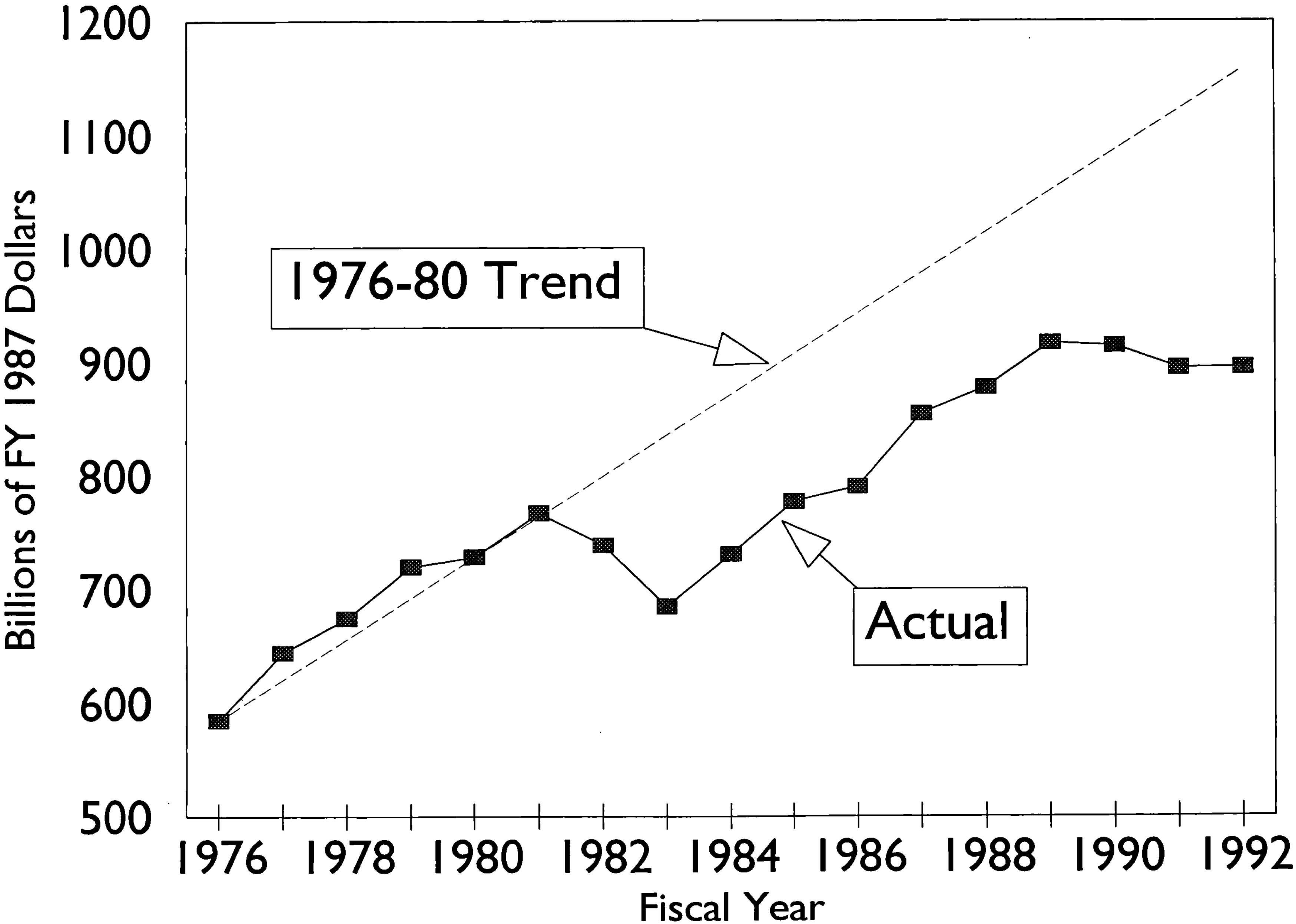
Fact: Real Tax Revenue Lagged Under Reagan-Bush

After the 1981 Reagan-Bush tax cuts, inflation-corrected Federal tax revenues fell below the trend that they had followed from 1976 through 1980.

They never regained that trend.

This permanent reduction in revenue was the major cause of the exploding Federal budget deficit (from $74 billion in fiscal year 1980 to $290 billion in fiscal year 1992) and the ballooning Federal debt (from $710 billion [using debt held by the public] at the end of 1980 to $2,999 billion at the end of 1992).

Real Tax Revenues Lagged Under Reagan-Bush



Republican Supply-Side Claim #1:
Real Federal revenue grew more in the Reagan supply-side years than it did since.

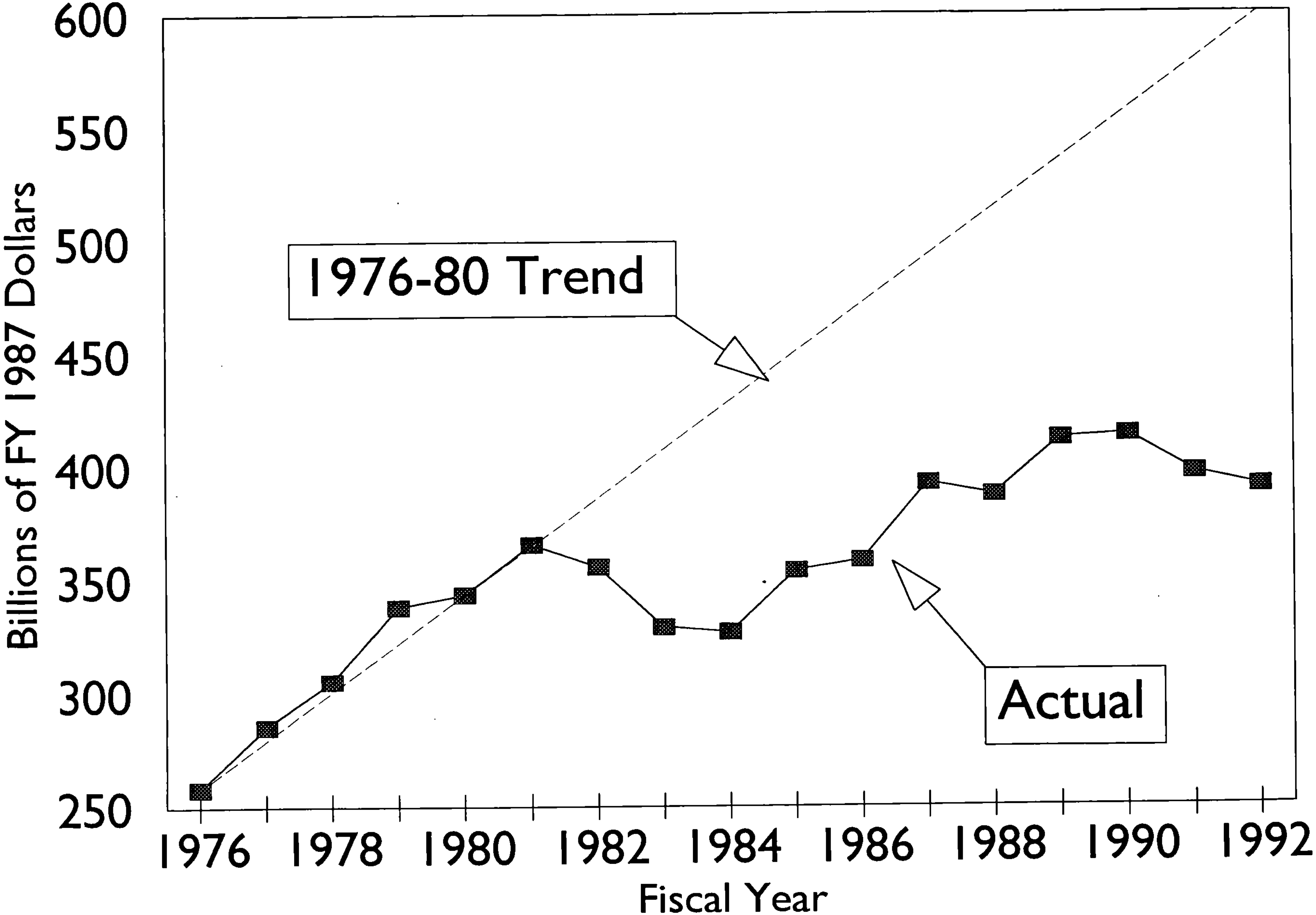
Fact: Real Personal Income Tax Revenue Fell Under Reagan-Bush

After passage of the 1981 supply-side tax cuts, inflation-corrected personal income tax revenue fell for three consecutive years.

Even when personal income tax revenue eventually began to grow again, it never regained the trend of 1976-1980.

This shortfall of individual income tax revenue was a major contributor to the growing Federal budget deficits and debt of the Reagan-Bush years.

Real Individual Income Tax Revenues Fell Under Reagan-Bush



Republican Supply-Side Claim #1:
Real Federal revenue grew more in the Reagan supply-side years than it did since.

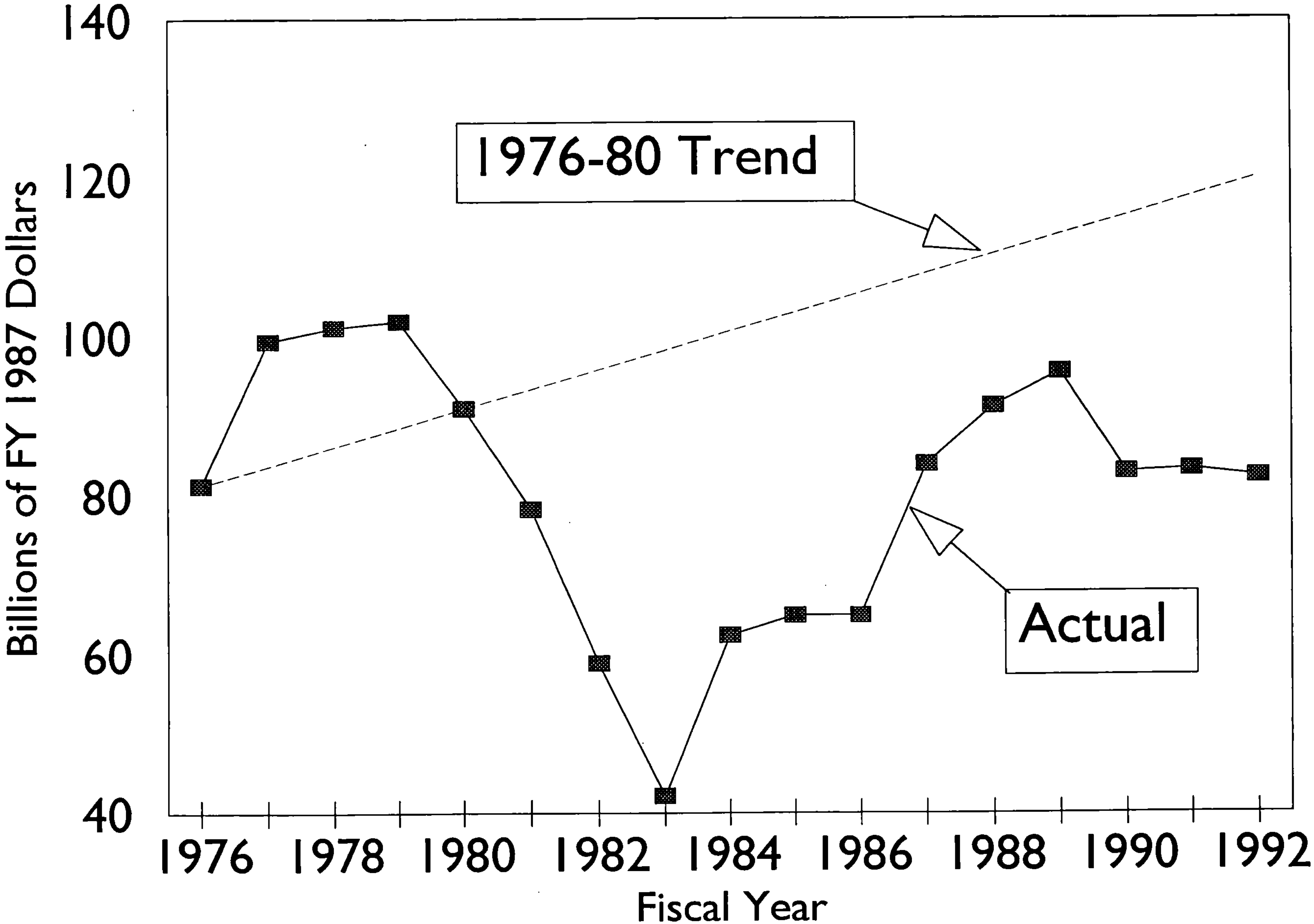
Fact: Real Corporate Income Tax Revenue Fell Under Reagan-Bush

As with personal income tax revenue, inflation-corrected corporate income tax revenue fell for three consecutive years after passage of the 1981 supply-side tax cuts.

Corporate income tax revenue began to grow more rapidly after passage of the 1986 tax reform. However, it never regained the trend of 1976-1980.

This shortfall of corporate income tax revenue added to the growth of Federal budget deficits and debt during the Reagan-Bush years.

Real Corporate Income Tax Revenues Fell Under Reagan-Bush



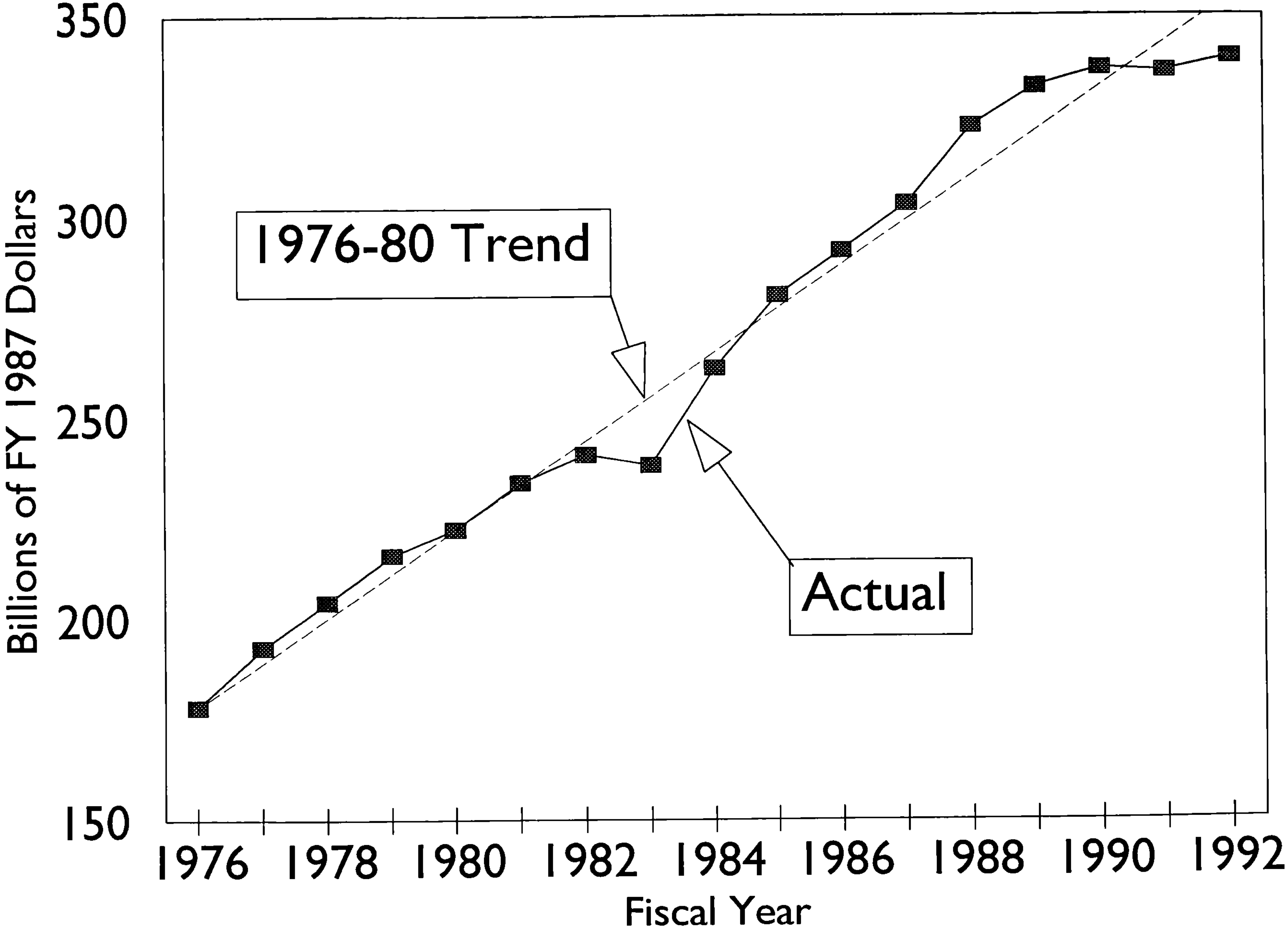
Republican Supply-Side Claim #1:
Real Federal revenue grew more in the Reagan supply-side years than it did since.

Fact: Only Real Payroll Tax Revenue Rose Under Reagan-Bush

Unlike the income taxes, the social insurance taxes -- primarily the Social Security payroll tax -- did grow at their past trend in the 1980s.

Ironically, the payroll tax rate was raised steadily over the period. Thus, contrary to supply-side doctrine, tax cuts drove personal and corporate income tax revenues down, and payroll tax rate increases to guarantee the solvency of the Social Security and Medicare trust funds did not keep payroll tax revenue down. Instead, payroll tax revenue rose.

Only Real Payroll Tax Revenues Rose Under Reagan-Bush



Republican Supply-Side Claim #2:
The economy performed better in the Reagan supply-side years than it did since.

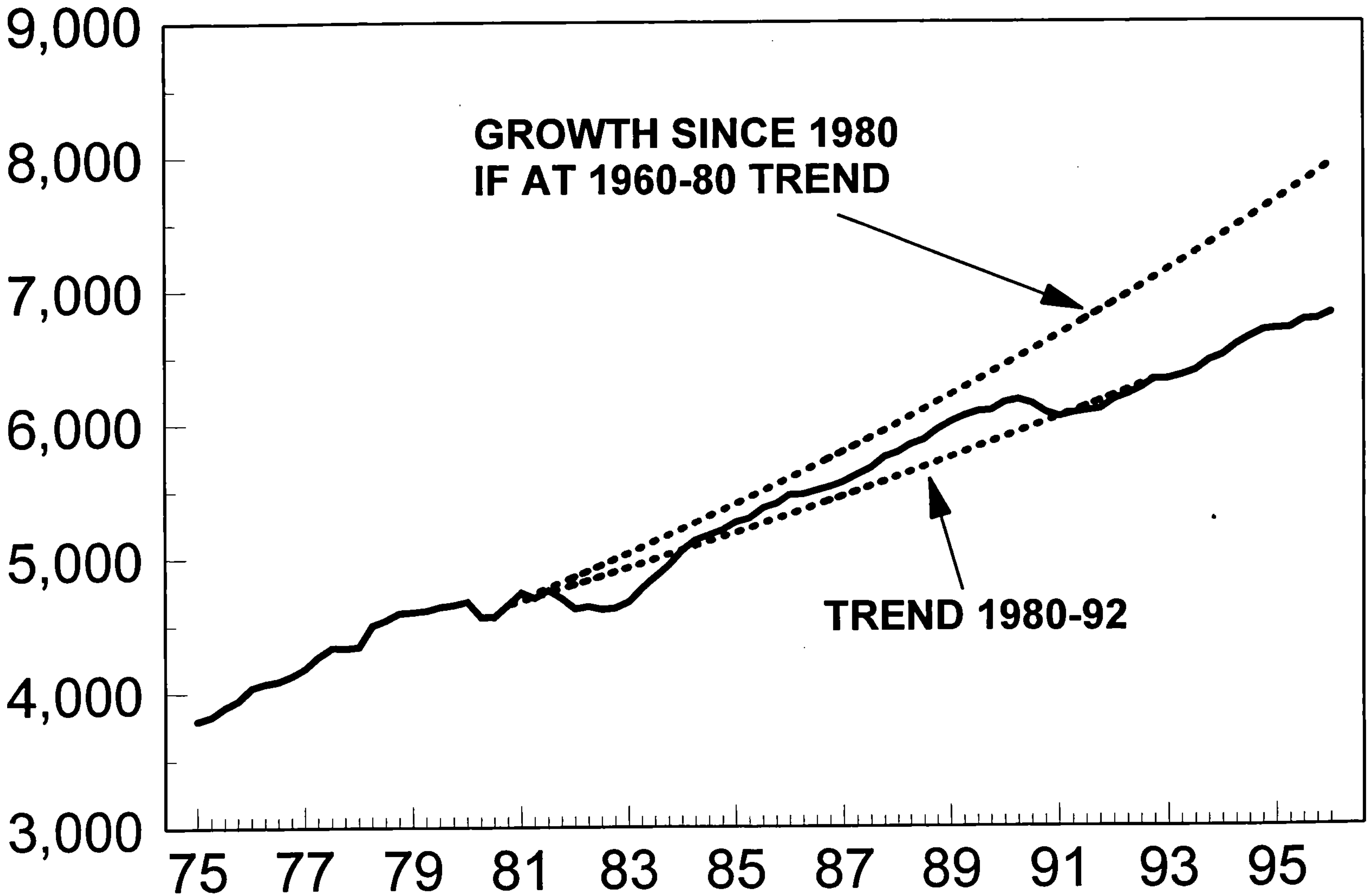
Fact: Real GDP Growth Slowed in the 1980s.

Like Federal tax revenue, real GDP fell off the 1960-80 trend in the supply-side years, and never recovered.

The years in the middle 1980s were better than those in the early and later parts of the decade, but that was mostly because the economy had fallen so far in the "Great Recession" of 1981-82 that it simply had so much room to recover. These years also do not indicate a fundamentally strong economy -- as the charts that follow will show...

REAL GDP GROWTH SLOWED IN THE 1980s

($ billions, chain-weight basis)



Republican Supply-Side Claim #2:
The economy performed better in the Reagan supply-side years than it did since.

Fact: Business Fixed Investment Growth Slowed in the 1980s

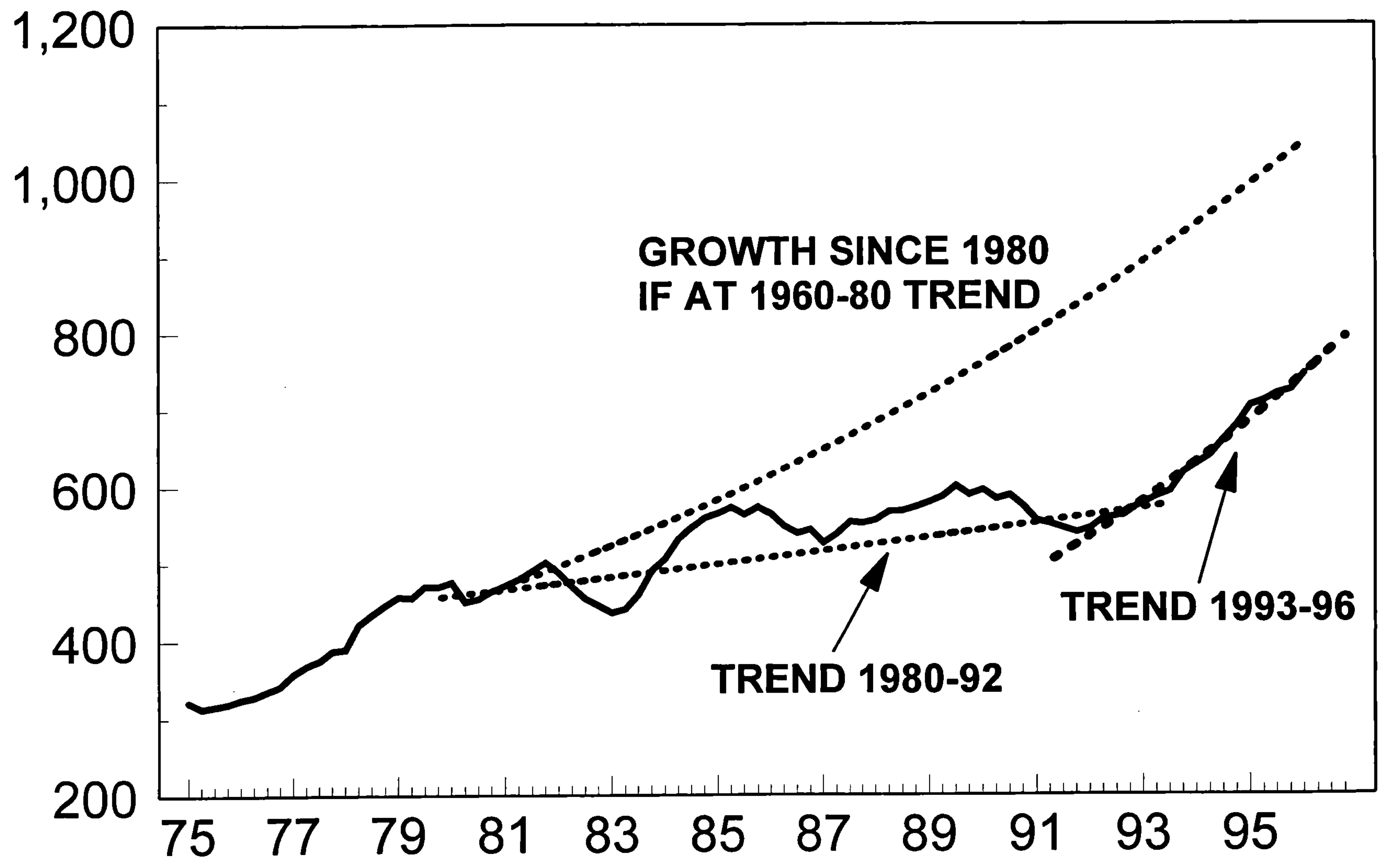
When investment grows, the economy becomes more productive and increases its capacity to produce in the future. Economic growth based on business investment is therefore more lasting and sustainable.

Investment in the 1980s was weaker, not stronger, than the surrounding years. Supply-side economics did not result in an increase in investment.

Since President Clinton took office, however, business investment has accelerated to a rate even faster than before the supply-side experiment.

BUSINESS FIXED INVESTMENT GROWTH SLOWED IN THE 1980s

(Fixed Private Nonresidential, $ billions, chain-weight basis)



Republican Supply-Side Claim #2:
The economy performed better in the Reagan supply-side years than it did since.

Fact: Business Equipment Investment Growth Slowed in the 1980s

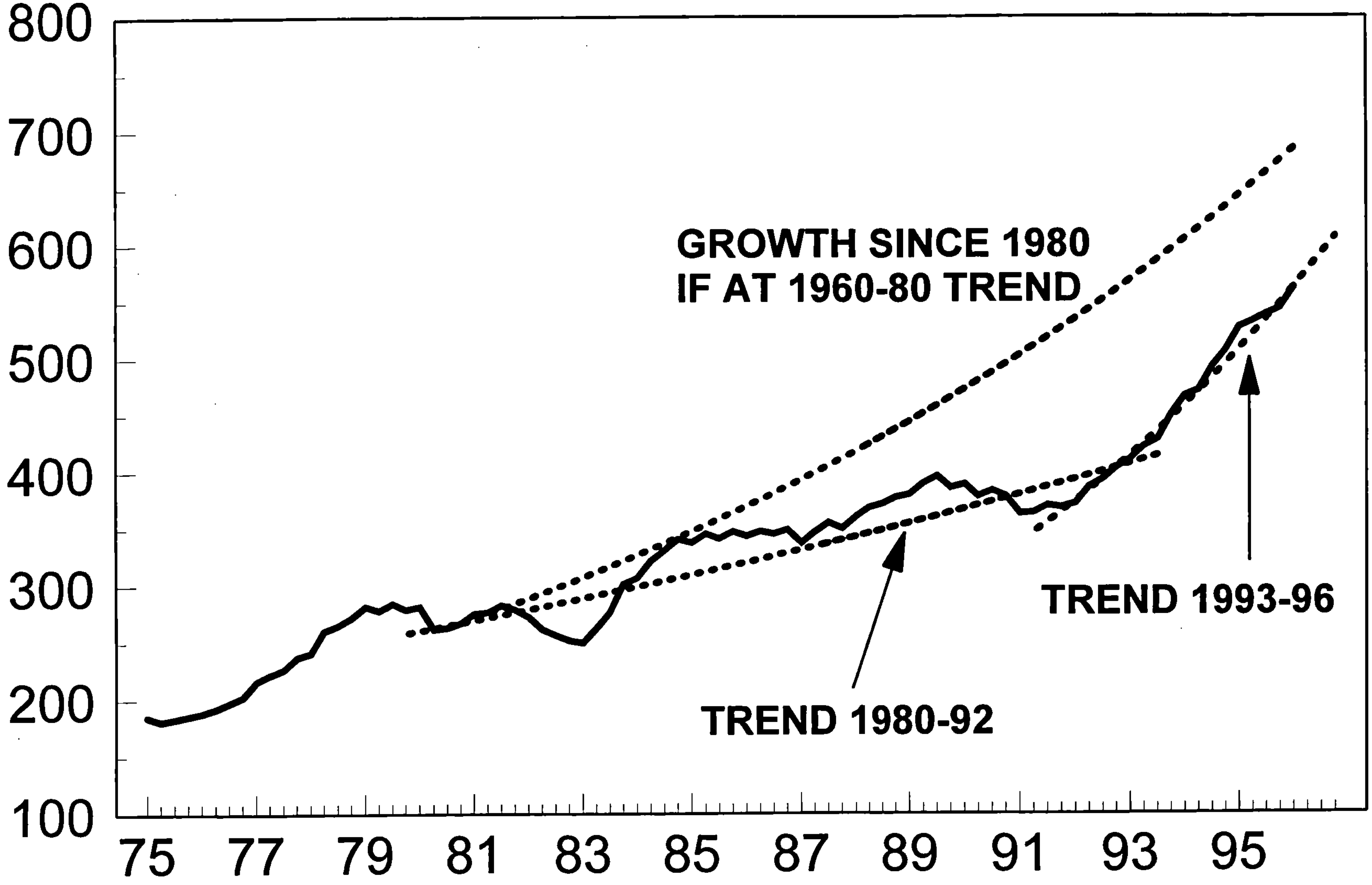
Business investment in equipment is thought by some economists to be the most important category of investment -- because equipment may be most likely to embody the new technology that increases productivity.

Like business investment broadly, business investment in equipment slowed in the 1980s. Thus, the supply-side tax cuts clearly did not increase the economy's capacity to grow.

Since President Clinton took office, business investment in equipment has been the fastest-growing part of the economy -- significantly faster than the 1980s, or even the period before the Reagan-Bush tax cuts.

BUSINESS EQUIPMENT INVESTMENT SLOWED IN THE 1980s

(Nonresidential Producers' Durable Equipment, $ billions, chain-weight basis)



Republican Supply-Side Claim #2:
The economy performed better in the Reagan supply-side years than it did since.

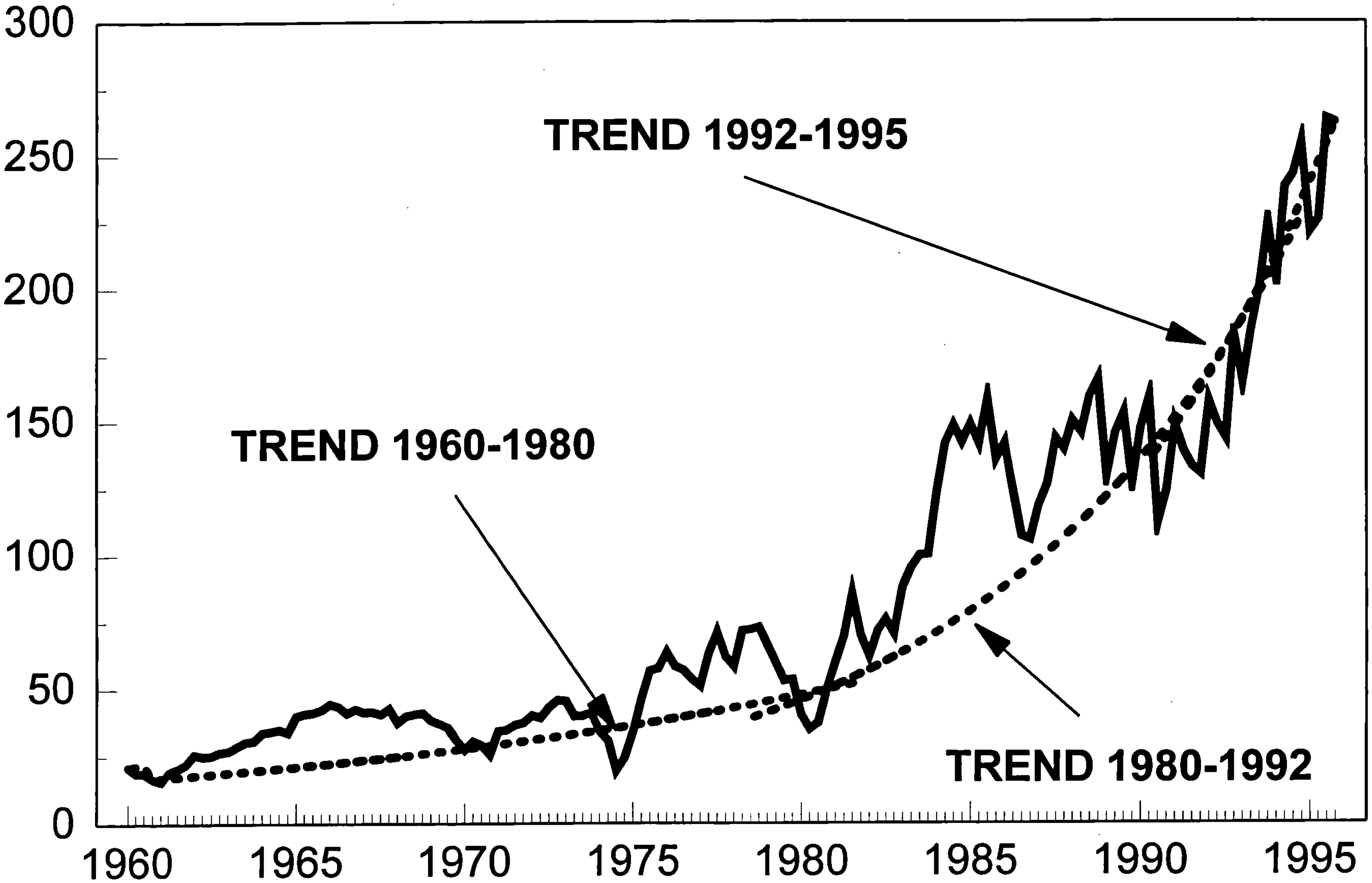
Fact: Real After-Tax Profits Have Grown Since the 1980s

Although business investment lagged in the 1980s, corporate profits did not. Corporate taxes grew slowly, and so after-tax profits increased rapidly.

In the Clinton Administration, corporate profits taxes have grown sharply. But the economy has performed so well that after-tax corporate profits have still increased healthily. This profit growth has helped to finance the investment boom which promises to increase productivity and incomes in the years to come.

REAL AFTER-TAX PROFITS OF NONFINANCIAL CORPORATIONS

(billions of chained 1992 dollars)



Republican Supply-Side Claim #2:
The economy performed better in the Reagan supply-side years than it did since.

Fact: Real Government Spending Fueled the Growth of the 1980s

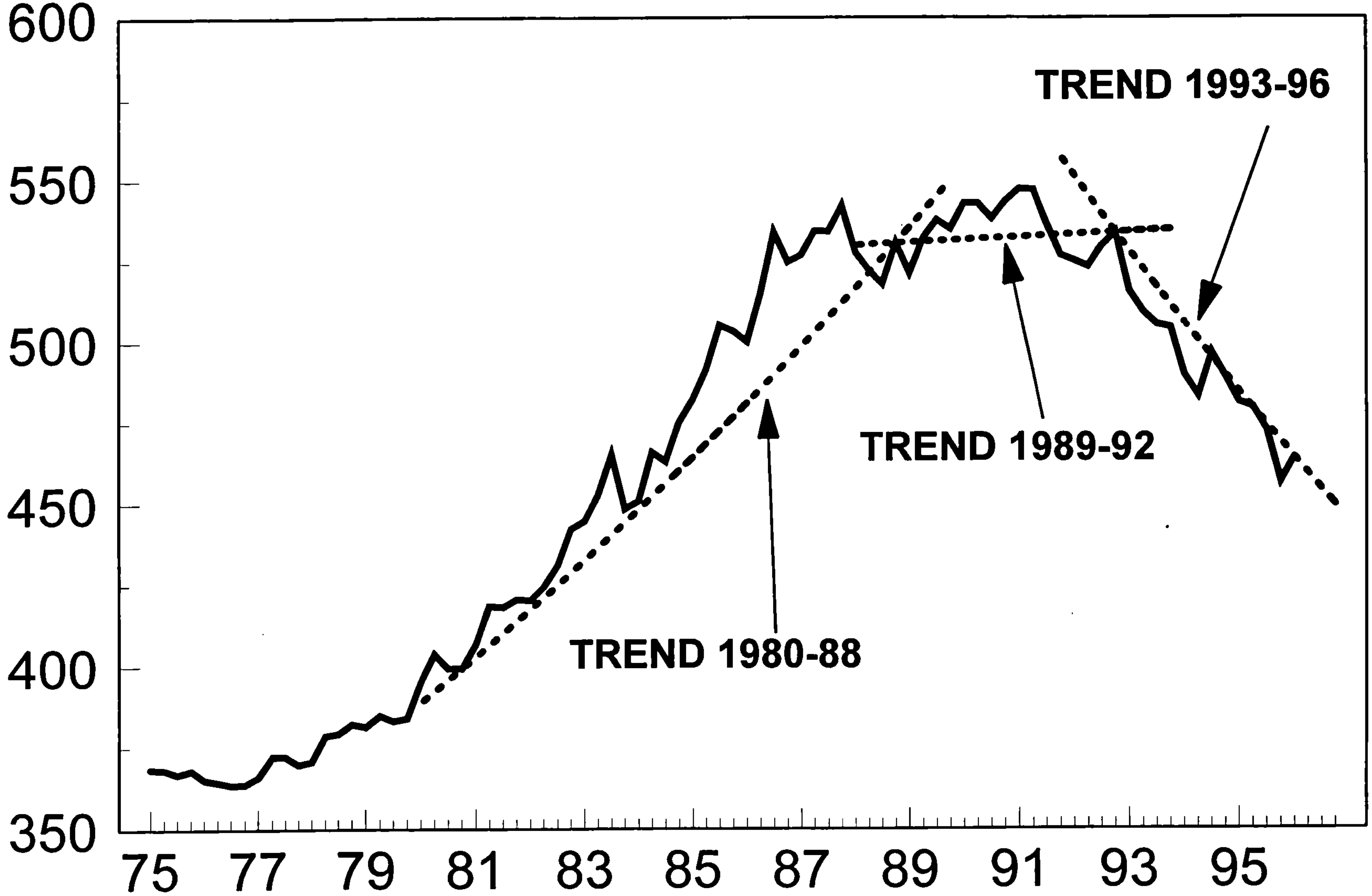
Economic growth in the 1980s was mediocre; but investment performance was even weaker. So what supported growth during the supply-side tax cuts?

Ironically, the sector of the economy that grew faster than its preceding trend was Federal government spending. Driven by the defense buildup, the public sector contributed heavily to the economic growth that some ascribe to tax cuts.

Since the beginning of the Clinton Administration, real Federal spending in GDP has actually declined. The economy has grown at a pace that is equal to the Reagan years, but driven by private-sector investment -- not public-sector spending. Thus, the economic growth of the Clinton years is more durable and sustainable than that of the 1980s -- which witnessed the financial-market crash of 1987, and ended with the recession of 1990-91.

REAL GOVERNMENT SPENDING DROVE GROWTH IN THE 1980s

(Government Consumption and Gross Investment, $ billions, chain-weight basis)



Republican Supply-Side Claim #3:
President Clinton is a big taxer.

Specifically, under President Carter, Federal receipts equaled 19.725 percent of GDP; under President Reagan, only 19.65 percent; under President Bush, only 19.525 percent; but under President Clinton ("first three years"), back up to 19.933 percent. (Bruce Bartlett, *Washington Times*, May 20, 1996; "Source: Author's calculations.")

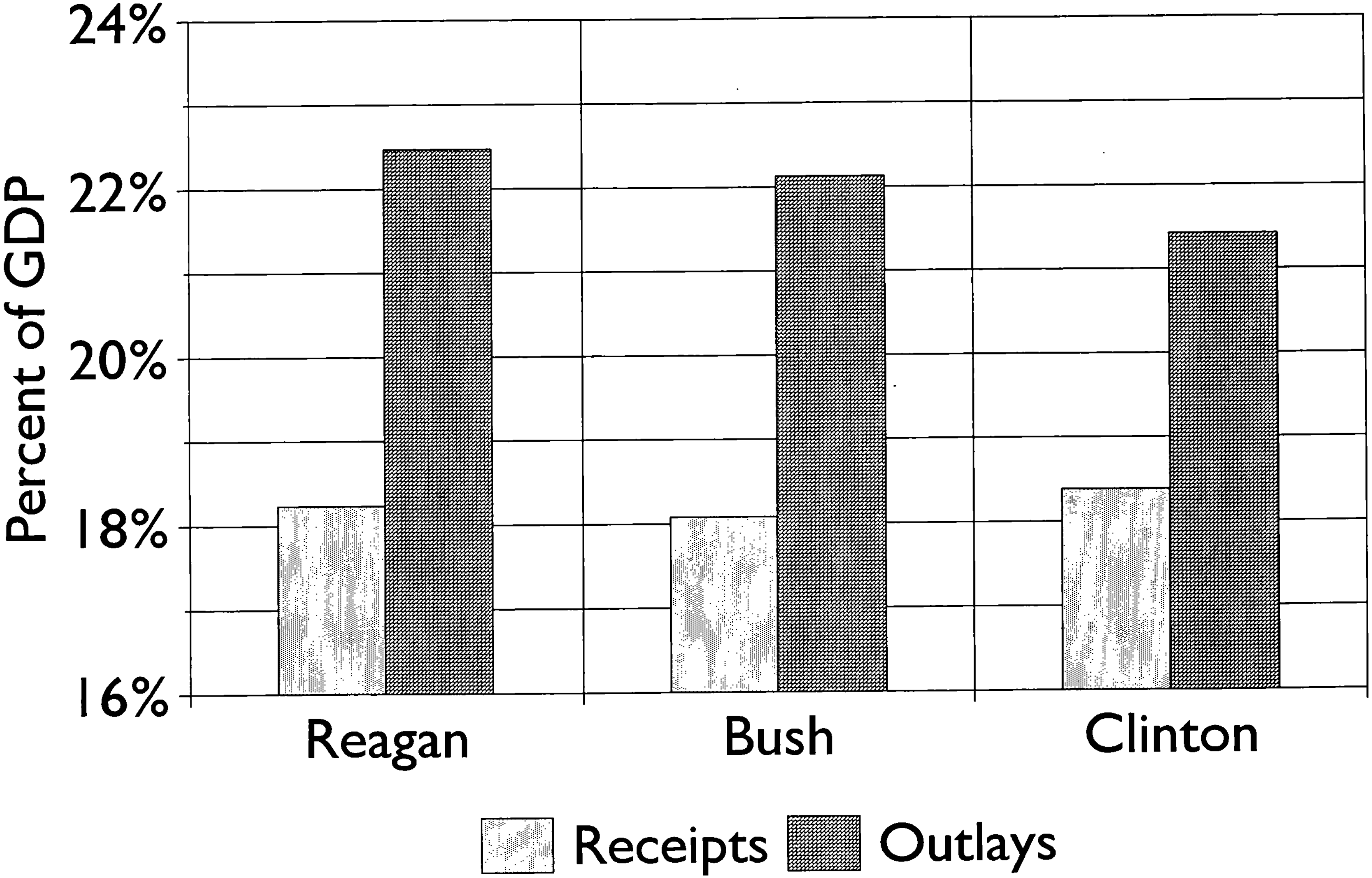
Here are the flaws in this analysis:

1. The numbers are wrong. The correct figures for the four Administrations are virtually identical: President Carter, 18.5 percent; President Reagan, 18.2 percent; President Bush, 18.1 percent; and President Clinton, 18.4 percent. (*The Budget of the United State's Government, Fiscal Year 1997: Historical Tables*, table 1.2, using latest GDP data; see attached chart.)

2. What are very different, however, are the levels of Federal spending under the four Administrations. Under President Carter, outlays were 20.9 percent of GDP; under President Reagan, 22.5 percent; under President Bush, 22.1 percent; and under President Clinton, 21.4 percent. Thus, President Clinton reduced the deficit in small part by revenue increases targeted closely to those most able to pay, but in greater part by far by holding spending down.

3. Finally, there is an element of schizophrenia in the criticism of President Clinton. On the one hand, adversaries complain that revenues have grown too slowly; on the other, that revenues have grown too fast. And always, data are presented using selective and misleading time periods and concepts. The bottom line is that, under President Clinton, the economy has been strong and the deficit has been cut by more than half.

Clinton Taxes Little Different Than Reagan-Bush, But Spending Is Lower



Deficit History