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WHY THE SECOND QUARTER ECONOMIC GROWTH FIGURES PROBABLY WILL BE WRONG

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Chart 1: GDP Growth and Magnitude of Error in Advance Estimate
Chart 2: Trend and Quarterly Real GDP Growth 1976-1996

On August 1, the Department of Commerce's Bureau of Economic Analysis (BEA) is scheduled to release its preliminary or "advance" gross domestic product (GDP) growth estimate for the second quarter of 1996. This number, good or bad, inevitably will make front-page news and may have a significant impact on the presidential campaign. Just as inevitably, this preliminary number most likely will turn out to be wrong, for quarterly GDP data historically have been subject to substantial later revisions, sometimes so significant that the original estimate tells nothing about the course of the economy.

A single quarter estimate of the growth in GDP usually is a poor signal of the long-term direction of economic growth. Consider the following examples:

- The GDP growth estimate for the first quarter of 1996 has been revised downward by 21 percent (from 2.8 percent to 2.2 percent).
- During the last year of the Bush Administration, the first quarter 1992 advance estimate of GDP suggested an annualized growth rate of 2.0 percent. The subsequent revision of the GDP for that quarter showed that growth in the quarter actually was at an annualized rate of 4.7 percent. This is a 135 percent revision between the preliminary and final estimates.
- As it turns out, the BEA underestimated the growth rate during the Reagan Administration in 63 percent of its advance estimates. During the Clinton Administration, the BEA so far has overestimated the growth rate on over 69 percent of the occasions on which it published advance estimates.
- The BEA concedes that in 12 percent of the quarters between 1978 and 1991, the advance GDP growth estimate failed even to indicate correctly whether growth was positive or negative.
- The average divergence between the advance estimate of GDP growth and the final GDP growth rate between 1976 and 1996 was equivalent to 50 percent of the value of the final GDP growth rate.

WHY DOES QUARTERLY GDP FLUCTUATE SO MUCH?

Measuring GDP changes is a very complex task, made all the more difficult by the fact that quarterly GDP figures are very volatile.

Gross domestic product (GDP) represents the total value of goods and services sold for final consumption by U.S. firms and individuals. It consists of four major components: personal consumption; investment (including business inventories and both residential and nonresidential fixed investment); net exports; and government purchases of goods and services. Fluctuations in any of these individual components of GDP in a given quarter can cause large changes in the quarterly growth rate. The components which typically have the largest and most common fluctuations are changes in business inventories and in government purchases.

A glance at the quarterly GDP growth figures for the last quarter of 1995 illustrates this point. Despite an annualized growth rate in personal consumption expenditures of 1.2 percent and a respectable annualized increase in nonresidential fixed investment of 3.1 percent, overall annualized growth in this quarter was at a recession-like low of 0.5 percent. The reason: An annualized fall in government purchases of over 12 percent during the winter shutdown of 1995-1996 drove down GDP during this quarter.[2]

Similarly, a number of one-shot factors probably will drive a significant increase in GDP for the second quarter of 1996. One leading econometric consulting firm, the St. Louis-based Macroeconomic Advisers,[3] for example, cite a number of factors to support their prediction of a 3.7 percent annualized growth rate for this quarter. These factors include the complete recovery of government purchases following the winter shutdown, the end of the UAW strike at General Motors, an increase in the number of home mortgage refinancings stimulated by lower interest rates (which put extra cash into the hands of consumers), and the economy's recovery after the harsh winter weather.

The extent to which these short-term factors can influence quarterly growth figures can be gauged by looking more closely at what is happening to business inventories. Due to the GM strike and the harsh winter, business inventories fell substantially in the first quarter of 1996 as production experienced a slowdown. Macroeconomic Advisers predicts that over 38 percent of their projected growth in GDP (1.4 percent from a total annualized growth rate of 3.7 percent) in the second quarter of 1996 will come solely from firms restocking their inventories as production gets fully back on line.

WHY ADVANCE ESTIMATES OF GDP GROWTH TEND TO BE WRONG

Measuring GDP is a massive and complicated undertaking that involves attempting to record the total sales of all goods for final consumption for the entire United States. The BEA produces its estimates based on sample sales data from a number of individuals and firms, collected during every month. Prices for thousands of individual items are estimated using sample data. Taken together, these comprise virtually millions of data points.

The problem is that when the advance estimate is published only 30 days after the close of the quarter, not all of these data have been examined -- or are even available. In 1984, for example, top BEA official Robert Parker noted that for sales of all consumer goods, other than autos and trucks, only data from the first two months of the quarter were available when advance estimates of national income were being made.[4] To estimate the GDP growth in such a case, with data either missing or unexamined, BEA economists must rely on a combination of extrapolation and guesswork. But given the turbulent nature of quarterly GDP changes, this guesswork often is very inaccurate. These factors mean that large revisions need to be made as the complete dataset becomes available and is examined in full by the BEA.

The revisions also tend to be large because the GDP growth rate is a rate of change. Thus, errors of a small magnitude in total GDP can lead to large errors in the growth rate. For example, if the actual GDP growth rate is 2 percent, even a small error in total GDP could translate into a large error in the actual growth rate, perhaps even 50 percent. In this context, it is not surprising that advance GDP growth estimates often vary substantially from the real figures.

Unfortunately, despite the fact that advance GDP growth estimates are subject to frequent and large revisions, they are quickly seized upon by politicians of both parties either to support their own records or to attack those of their opponents. And unlike the publication of advance estimates, revisions of these quarterly data by the BEA hardly make the news. This process of correcting and finalizing GDP estimates can last for months -- even years -- following that initial release and can result in huge revisions which tell a completely different story about how well the economy performed.[5] Chart 1 shows the difference between the initial "advance" estimates of the real annualized growth rate of GDP and the most up-to-date revisions of these figures for the period since 1976.

Chart 1 shows the difference or "error" between the advance and the most up-to-date revised estimate of the GDP growth rate. The "magnitude of the initial error" refers to the amount by which the advance GDP growth rate was later revised. Thus, if the advance estimate was a 3 percent annualized growth rate and the revised rate was 2 percent, the absolute error was 1 percentage point, which represents a revision of 33 percent.

In most cases, the error is substantial; on a number of occasions, it exceeds the real growth rate itself. Among recent examples of large errors is the first quarter of 1992, when the BEA's advance estimate of GDP growth underestimated the real annualized growth rate by a factor of 135 percent (the advance annualized real growth estimate was 2.0 percent; real annualized growth in that quarter was actually 4.7 percent, according to the latest revision). The BEA also has revised downward its estimate of the growth rate for the first quarter of 1996 by a factor of almost one-third.

An analysis of the revisions contained in the BEA's monthly *Survey of Current Business* over the 20-year period from 1976-1996 shows that these recent examples fit a general pattern over many years. In the 80 quarters between the first quarter of 1976 and the first quarter of 1996, the average magnitude of the total revision in annualized real GDP growth amounted to 1.4 percent of GDP. The average quarterly annualized growth rate in GDP over this period was 2.8 percent. This means that the average divergence of the advance estimate of GDP growth from the actual revised figure was equivalent to 50 percent of the value of the actual revised growth rate. According to BEA economist Allan Young, "advance" GDP growth figures failed even to show correctly whether GDP growth was negative or positive in 12 percent of all quarters over the period 1978-1991.[6] Taking the Reagan years as an example, the BEA's advance figures underestimated the growth rate in roughly two-thirds (63 percent) of all quarters. Likewise, during the Clinton era, the BEA so far has overestimated the rate of growth in about 70 percent of all of its advance estimates.

WHY IT MAKES MORE SENSE TO LOOK AT TRENDS IN GDP

Because of the poor accuracy of advance estimates of GDP and the extreme volatility of quarterly GDP growth rates, a far better picture of the economy emerges from looking at the underlying trends. Chart 2 shows the trend[7] in economic growth compared with the *revised* quarterly GDP growth rates between the first quarter of 1976 and the second quarter of 1996.[8]

The data in Chart 2 show two major patterns in the rate of economic growth in recent years: an acceleration in growth rates between the first quarter of 1992 and the final quarter of 1994 and a deceleration in the growth rate beginning after the peak in 1994 and continuing through to the current period. Both the expansion and the slowdown in the economy, however, have been punctuated by misleading "spikes," or individual quarters when the GDP growth rate diverged from the trend. For

example, during the first quarter of 1993, in the middle of an expansion, the growth rate of GDP fell to zero. More recently, the economy showed strong above-trend growth in the third quarter of 1995.[9]

As can be seen from Chart 2, individual quarterly GDP numbers are a rough and often misleading signal of the long-term and medium-term strength of the economy. Quarterly GDP figures can fluctuate widely because of factors that are unique to that quarter and which pose no long-term implications for economic prosperity.

CONCLUSION

Americans should not be lulled into a false sense of either economic prosperity or impending economic decline by estimates of the economy's performance during a single quarter. The advance estimates that are scheduled to be released on August 1 are likely to be revised considerably in the weeks and months to come. And even if these quarterly snapshots actually were accurate, quarterly GDP numbers fluctuate considerably for reasons unconnected with the long-term economic growth rate. Americans should not allow themselves to be deceived by these numbers and the political posturing surrounding them; rather, they should pay attention to the longer term patterns in the economy.

Chart 1: GDP Growth and Magnitude of Error in Advance Estimate
Chart 2: Trend and Quarterly Real GDP Growth 1976-19

ENDNOTES

1. The authors would like to thank Mark Wilson, Rebecca Lukens Fellow at The Heritage Foundation, for his contributions to this study.
2. Bureau of Economic Analysis Statistical Release, June 28, 1996. This can be viewed on the World Wide Web at: *http://www.stat-usa.gov/BEN/ebb/bea/gdp.bea.*
3. Macroeconomic Advisers, *The U.S. Economic Outlook*, June 8, 1996, pp. 6-8. The forecast model used by Macroeconomic Advisers is recognized generally as the industry leader. In 1995, Macroeconomic Advisers won the Blue Chip Consensus Forecasting award. Macroeconomic Advisers also won this award in 1993 and would have won it again in 1994 except for a rule against winning two times in a row. Their forecast and analysis are confirmed by Bureau of National Affairs Special Report No. 127, *Economic Outlook*, July 2, 1996, which surveyed 22 top econometric firms and found the average forecast of GDP annualized growth for the second quarter of 1996 to be 3.8 percent.
4. Robert N. Parker, "Revisions to the Initial Estimates of Quarterly Gross National Product of the United States, 1968-83," paper presented at University of Florence, Italy, November 1984, pp. 11-12.
5. GDP data, in addition to undergoing three reviews in the months immediately following collection, undergo large-scale periodic revisions, known as "benchmarking." The most recent large-scale benchmarking of GDP figures came in January 1996, when the BEA revised and improved all GDP figures dating back to World War II. Among the revisions was the adoption of a chain-weight measure to adjust the figures for inflation, changes in the treatment of depreciation, and the use of new data from the IRS and the 1991 Census. See Bureau of Economic Analysis, "Improved Estimates of the National Income and Product Accounts for 1959-95: Results of the Comprehensive Revision," *Survey of Current Business*, January/February 1996, p. 1.
6. Bureau of Economic Analysis, *Survey of Current Business*, Vol. 73, No. 10 (October 1993), p. 29.
7. Depicted using an 8-quarter moving average. Moving averages are widely used by economists and government agencies to remove fluctuations from data. They do this by summing and then averaging the change in a variable over a set number of periods. In this case, the moving average trend estimate for a quarter is the mean of GDP growth for that quarter and the seven preceding quarters. This moving average has the effect of filtering out large fluctuations in individual quarters while capturing the long-term pattern of change. For example, a once-off upwards fluctuation in growth in one particular quarter will change this moving average by a factor of only one-eighth of the change in the point estimate, but sustained growth over a number of periods will have a larger effect on the moving average. In all cases, the latest revised GDP growth figures are used. The real growth rate is measured in Chained 1992 dollars.
8. The annualized real growth in GDP during the second quarter of 1996 is forecast at 3.7 percent by Macroeconomic Advisers.
9. It is important to emphasize that while the growth figures presented in Chart 1 represent the most up-to-date revisions, they are by no means final. All of the data, and especially the data from the most recent quarters, will continue to undergo checking

THE HERITAGE LECTURES

No. 565

Taxes, Deficits, and Economic Growth

By Daniel J. Mitchell

The Heritage Foundation was established in 1973 as a non-partisan, tax-exempt policy research institute dedicated to the principles of free competitive enterprise, limited government, individual liberty, and a strong national defense. The Foundation's research and study programs are designed to make the voices of responsible conservatism heard in Washington, D.C., throughout the United States, and in the capitals of the world.

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Taxes, Deficits, and Economic Growth

By Daniel J. Mitchell

Even assuming the Clinton Administration's forecast for this year is accurate, the United States economy's performance since 1989 will have been the worst seven-year period since the end of World War II. Adjusted for inflation, median household income has declined by 6.6 percent since Ronald Reagan left office.[1] And while the unemployment rate is reasonably low, many Americans are worried about the future and fear their children will be the first generation to have a lower standard of living than its parents.

The economy's sub-par performance has triggered a debate on how best to stimulate economic growth and boost income. The good news is that all sides of the debate agree that the key to economic growth is capital formation—increasing the levels of savings and investment (including investments in human capital). The bad news, however, is that there is a significant disagreement over the policy changes that will best meet that goal. On one side are those who argue that high tax rates dampen incentives and believe that correcting the anti-savings, anti-investment bias of the current income tax code will improve the economy's performance. The flat tax, they would argue, offers the best opportunity to generate a substantial and positive impact on job creation and income growth. The other side of the debate is dominated by those who believe the most important variable is the budget deficit. They argue that a lower budget deficit will lead to significant reductions in interest rates and that lower interest rates will spur higher levels of investment.

Finally, no discussion of economic growth would be complete without addressing the size of government. Regardless of whether it is financed through taxes or borrowing, government spending represents a transfer of resources from the private sector to the public sector. If government spends that money in a way that generates a sufficiently high rate of return, the economy will benefit. If the rate of return is below that of the private sector, however, then the rate of growth will be slower than it otherwise would have been.

Needless to say, the debate over growth has important policy implications. Should taxes be increased or decreased? Should the budget be balanced and, if so, how quickly? Is the deficit the real problem, or is it a symptom of an underlying problem of too much government? What is the impact of tax reform? What types of government spending count as investment? If certain policies increase growth, should that higher growth be included in government economic and revenue estimates?

Careful analysis of the historical and theoretical evidence yields three important conclusions that can help guide policymakers as they focus on the nation's economic problems:

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1 U.S. Bureau of the Census Current Population Reports: Series P60-189, "Income, Poverty, and Valuation of Non-Cash Benefits: 1994," (Washington, D.C.: U.S. Government Printing Office, 1996).

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1) The tax system is taking too much money out of the productive sector of the economy. Perhaps even more important, the structure of the tax system is grossly flawed and imposes a particularly steep penalty on the very behaviors—saving and investing—that are needed to promote growth.

2) Government borrowing is morally wrong because it imposes bills on future generations,[2] but the deficit should not drive economic policy. Contrary to what both political parties argue, there does not seem to be a strong relationship between the budget deficit and interest rates. Nor is there much reason to believe that lower interest rates, by themselves, will have a pronounced effect on investment. Moreover, focusing on the deficit can undermine sound economic policy by leading some to view higher taxes as an appropriate policy option.

3) Government spending is too high. Many programs fail to generate an adequate rate of return (and many, such as welfare programs, almost certainly have a negative return and have made things worse). Not all government spending, needless to say, is dependent on "rates of return," but legislators should fully understand that funding programs with money that could be more productively used by the private sector will result in less economic growth. Finally, for those who do view the deficit as the key variable, there is ample evidence that slowing the growth of spending—not higher taxes—is the only way to achieve a balanced budget.

Why Capital Matters

As stated above, there is very little controversy about what causes growth. There is near-unanimous agreement that salaries and wages are linked closely to productivity. The only way to raise the income of workers permanently—assuming no change in their skills—is through savings and investment. Simply put, workers are paid on the basis of what they produce, and giving them better tools allows them to produce more. The level of capital formation, for instance, largely explains why workers in the United States, Germany, and Japan earn more than workers in Brazil, India, and Nigeria. Similarly, workers in America today earn more than their parents because of net investment (increases in the capital stock). As a result, they are more productive, generating more output per hour of labor.

Economists of all persuasions recognize this relationship between investment and wages. Paul Samuelson, for example, a Nobel Laureate economist who endorsed Bill Clinton for President, has written:

> What happens to the wage rate now that each person works with more capital goods? Because each worker has more capital to work with, his or her marginal product rises. Therefore, the competitive real wage rises as workers become worth more to capitalists and meet with spirited bidding up of their market wage rates.[3]

Another example is taken from a 1991 report on economic growth prepared by the staff of the Joint Committee on Taxation, then controlled by the Democrats:

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2 This moral argument is less stringent if the debt was incurred to win a war or for some other purpose which presumably yields benefits to future generations.

3 Paul A. Samuelson and William D. Nordhaus, *Economics*, 12th Edition (New York: McGraw-Hill, Inc., 1985), p. 789.

> When an economy's rate of net investment (gross investment less depreciation)[4] increases, the economy's stock of capital increases. A larger capital stock permits a fixed amount of labor to produce more goods and services. The larger a country's capital stock, the more productive its workers and, generally, the higher its real wages and salaries. Thus, increases in investment tend to cause future increases in a nation's standard of living.[5]

According to a 1989 report on economic growth published by the Congressional Research Service:

> Capital deepening has been and will likely continue to be a central force for accelerating growth and potential output over the medium term. But as we have seen, a permanent increase in the long-term rate of growth will hinge on the United States' ability to increase the pace of technical advance and innovation. However, both of these routes to faster growth will be contingent upon the ability to increase the level of investment spending—more spending for capital equipment and more spending for research and development. To finance higher investment will, in turn, require that Americans raise the national rate of savings.[6]

Or consider the views of the White House. In the 1994 Economic Report of the President, the Administration noted that:

> The reasons for wanting to raise the investment share of the GDP [gross domestic product] are straightforward: Workers are more productive when they are equipped with more and better capital, more productive workers earn higher real wages, and higher real wages are the mainspring of higher living standards. Few economic propositions are better supported than these —or more important.

Competing Theories of Growth

Every economic school of thought—even Marxism—agrees that capital formation is the key to rising living standards. This happy consensus, however, does not translate into agreement about how to spur more savings and investment. In the political economic debate, at least in America, there are basically three (actually two and one-half) views on how to promote economic growth. These are:

- ✓ **Old-Fashioned Keynesianism.** This is the half-theory because it has so few adherents in America. In periods of economic sluggishness, Keynesians believe the government should increase spending, financed by borrowing, to give the economy a shot in the arm. This spending is supposed to stimulate aggregate demand, which causes private sector behavior to perk up. With a handful of exceptions, such as the failed 1993 stimulus bill, this approach does not receive much attention in Washington.

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4 Depreciation refers to the amount of capital that is used up or wears out during each period. For instance, a machine may have a life expectancy of five years. In order to measure increases in the capital stock accurately, increases in investment should be adjusted to reflect depreciation.

5 "Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution," Joint Committee on Taxation report for House Committee on Ways and Means, December 12, 1991, p. 21.

6 Craig Elwell. "The Goal of Economic Growth: Lessons from Japan, West Germany and the United States," Congressional Research Service, July 17, 1989.

- ✓ **1950s Republican/1990s Democrat Balanced Budget Orthodoxy.** The title is made up because this school of thought does not really have a name. Proponents of this approach, which is dominant in Washington, believe that the economy hinges on changes in the budget deficit. Contrary to old-fashioned Keynesianism, however, this orthodox approach argues that reducing the budget deficit is the key to economic growth. The theory works as follows: A lower budget deficit leads to lower interest rates, lower interest rates lead to more investment, more investment leads to higher productivity, and higher productivity means more growth. Although some of the proponents favor smaller government as a philosophical goal, the balanced budget crowd does not think taxes have a major effect on incentives to engage in productive behavior. As a result, they are skeptical of tax cuts and instead are willing to raise taxes.
- ✓ **The Free Market.** Another made-up title because other options—supply-side, conservative, classical liberal—do not capture the central tenet, the free-market approach believes that the keys to economic growth, at least in terms of fiscal policy, are the size of government and the structure of the tax system. In short, the free-market approach believes that total spending, regardless of whether it is financed by taxes or borrowing, hinders the economy's performance by transferring scarce resources from those in the private sector who have incentives to use them wisely to politicians and bureaucrats who oftentimes respond to political incentives. Because the size of government matters, free market advocates would prefer a government with a $1 trillion budget and a $200 billion deficit to a government with a $2 trillion budget that was balanced. On the tax side of the ledger, free market supporters believe taxes affect incentives to work, save, and invest. A major goal of these folks, therefore, is radical tax reform designed to minimize tax rates and eliminate multiple taxation of capital. These reforms, it is believed, will boost capital formation, which will increase productivity, which means faster economic growth.

Who Is Right?

The policy debate in Washington largely revolves between Options 2 and 3 (though there is also a fight amongst supporters of Option 2 over the size of government—Should the budget be balanced at level "X" or level "X+Y?"). Stripping away much of the rhetoric, the victor in this struggle depends on which set of relationships is more robust:

1) Are balanced budget proponents right that interest rates will fall significantly once deficit spending comes to an end? And are they correct in believing that investment is very sensitive to interest rates?

2) Are free market supporters correct in believing that there is an inverse relationship between economic growth and the size of government? Even more important, are they accurate in stating that decisions to work, save, and invest are significantly altered by the tax code?

In some sense, both sides are right. Unless economists want to repeal the laws of supply and demand, there can be no doubt that lower budget deficits will lower interest rates. And, all other things being equal, lower interest rates should mean more investment. It is also unambiguously true that lower taxes will reduce the price of providing labor and capital to the economy. And it is certainly accurate to note that a large government, by reducing the cost of not working, will adversely affect the economy's performance.

The real question is the magnitude of these effects. Would balancing the budget really reduce interest rates by two percentage points? Is the level of investment primarily driven by the interest rate? Just how sensitive are decisions to work, save, and invest to the rate of

taxation? To what extent do government spending programs actually undermine work effort?

Doubts Regarding Balanced Budget Orthodoxy

There is ample reason to question the robustness of the interest rate argument. According to the theory, lower budget deficits should result in lower interest rates. Yet there is little evidence to suggest that interest rates are significantly affected by changes in the U.S. budget deficit. This does not mean that the laws of supply and demand have been repealed. It simply means that in world capital markets, a shift of $30 billion, $40 billion, or $50 billion is unlikely to have a dramatic effect and can easily be overwhelmed by other factors such as monetary policy and demand for credit.[7]

Even if interest rates fall by a significant amount, the second link in the balanced budget chain of reasoning is very weak. Yes, interest rates must affect investment choices, but it appears that this variable is dwarfed by other influences.[8] Why invest, for instance, if there is no hope of making a profit? Real interest rates were negative during the 1930s in America, yet investment was moribund because investors did not see many opportunities to earn an adequate rate of return. Likewise, real interest rates were high in America during much of the 1980s, yet investment rose because people saw ways to make money. Moreover, since a large portion of investment is self-financed on the part of business, it is difficult to see how interest rates would have a dramatic impact.

All things being equal, it is a good idea to balance the budget. And, yes, lower interest rates will promote investment. Balancing the budget, however, is not a silver bullet for the economy. This approach is especially short-sighted if it is used as a reason to raise taxes or block pro-growth tax cuts. As the following section illustrates, changes in tax policy can have a pronounced effect on the economy's performance.

Why Free Market Supporters Are Right About Taxes and Capital Formation

The attached appendices provide a sampling of empirical work on the impact of taxes. To put that work in context, however, it is useful to walk through an example illustrating just how heavy the tax burden is on savings and investment. Between personal income taxes, corporate income taxes, capital gains taxes, and estate taxes, a single dollar of investment income can be subject to as many as four layers of tax in America. Added to that burden are provisions of the law, such as depreciation and the alternative minimum tax, which force taxpayers to overstate their income. Adding insult to injury is the heavy compliance cost of the current system.

The following example illustrates why savings and investment suffer in the current tax climate. A taxpayer has $100 of income and must decide what to do with it. He can consume the $100, spending it on food, vacations, clothing, haircuts, or some other product or service, in which case (with the exception of possible sales taxes) he will receive close to $100 in goods and services for his money. Or he can invest in the stock of a start-up company with

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7 For a complete discussion of the scholarly research on deficits and interest rates, see "Government Deficit Spending and Its Effects on Prices of Financial Assets," Department of the Treasury, May 1983.

8 Aldona Robins, Gary Robins, and Paul Craig Roberts, "The Relative Impact of Taxation and Interest Rates on the Cost of Capital," in Dale Jorgenson and Ralph Landau, eds., *Technology and Economic Policy* (Cambridge, Mass.: Bellinger Press, 1986).

the potential to provide new jobs to the community and produce goods that consumers desire. If the company succeeds, the investor most likely will profit. If it fails, he will lose his $100.

In this case, the investment bears fruit and yields a 10 percent rate of return, enabling the company to produce $10 of annual income for every $100 invested. Under the current tax code, 35 percent is skimmed off to pay the corporate income tax, leaving only $6.50 out of the original $10. This $6.50 then goes to the investor as a dividend. But there are other taxes. Depending on the investor's income, the personal income tax will take as much as 39.6 percent of his $6.50, leaving him with less than $4.00 of annual income from a "successful" $100 investment. In addition, he may face applicable state and local income taxes.

Finally, if the investor ever decides to sell the stock, he will be hit by one of the highest capital gains taxes in the industrialized world. To make a bad situation even worse, he will be taxed on the nominal gains, often meaning that taxes are paid on assets that have lost value in real terms (and do not forget that the person who sold him the stock originally may have been subject to capital gains taxes on that sale). The final insult is the estate and gift tax. Successful entrepreneurs who try to accumulate an estate to pass on to their children are penalized by inheritance taxes which can confiscate 55 percent of a deceased's assets.

Thanks to the tax code, a fortunate investor—one who actually earns money on his investments—may have to send more than 80 percent of his earnings to the government, not to mention having already paid taxes on the money used for the investment in the first place. Thus, government tax policy has created a very tilted playing field. By punishing saving and investment, the tax code encourages both individuals and businesses to consume rather than to build for America's future.

Since taxes have such a dramatic impact on incentives to work, save, and invest, it should come as no surprise that major tax changes almost always have a significant impact on the economy. Herbert Hoover's decision in 1930 to increase the top tax rate from 25 percent to 63 percent certainly contributed to the Depression. Lyndon Johnson's surtax on income tax liabilities, enacted in 1968, together with an increase in the capital gains tax helped end the 1960s expansion. Large tax increases, including inflation-induced bracket creep, contributed to the economy's dismal performance under Jimmy Carter. George Bush's record tax increase in 1990 was a principal cause of the recent recession and subsequent anemic recovery. And the sub-par performance of today's economy, particularly the decline in median household income, almost certainly is attributable in part to the record tax increase pushed through Congress in 1993 by Bill Clinton.

The Answer: The Flat Tax

Each of the tax code's many shortcomings can be addressed by targeted legislation, but a far better approach is simply to replace the existing system with a flat tax. There have been many flat tax proposals over the years, but they all share certain key features. These are:

- ✓ **One low tax rate.** All flat tax proposals have a single tax rate that applies to all income subject to tax. The actual rate imposed varies, but the upper limit would be about 20 percent. The Armey-Shelby flat tax legislation, for instance, begins with a 20 percent rate which phases down to 17 percent after a couple of years.
- ✓ **Tax income only once.** Flat tax proposals are designed to eliminate the tax code's bias against capital formation by ending the double- (and sometimes triple- and quadruple-) taxation of income generated through savings and investment. The key principle is that the

tax code not discriminate against income that is used for savings and investment as opposed to income that is consumed.

✓ **Elimination of deductions, credits, and exemptions.** All pure flat tax proposals eliminate provisions of the tax code that bestow preferential tax treatment on certain behaviors and activities. Included in this would be special tax breaks for businesses and corporations and, for individual taxpayers, the home mortgage interest deduction, the charitable contributions deduction, and the state and local mortgage interest deduction. Eliminating these "loopholes" solves the problem of complexity, allowing taxpayers to file their tax returns on a postcard-sized form.

Benefits of a Flat Tax

By addressing the many problems of the existing tax code in one fell swoop, the flat tax would have an immediate and dramatic positive impact. Included among the benefits are:

✓ **Faster economic growth.** A flat tax would spur increased work, saving, and investment. According to many economists, the rise in productive behavior would likely add one percentage point to the annual rate of economic growth. How significant is this? An increase in the growth rate of just one-half of one percentage point would boost an average family of four's yearly income by more than $5,000 after ten years.

✓ **Instant wealth creation.** Eliminating the second, third, and fourth layers of taxation on capital income would significantly boost the value of all income-producing assets. According to Professor Dale Jorgenson of Harvard University, enactment of a flat tax would immediately boost wealth by some $1 trillion.

✓ **Simplicity.** The 600-plus tax forms of the current system would be swept into the trash and replaced by two simple postcard-sized forms. Wage, salary, and pension income would be reported on the individual form and business and capital income would be reported on the business form. Neither form would require more than a few minutes to complete, substantially reducing the 5.4 billion-hour yearly burden of today's tax code.

✓ **Fairness.** All taxpayers and all income would be treated equally. A taxpayer with ten times the taxable income of his neighbor would pay ten times as much in taxes. Successful entrepreneurs no longer would be penalized by discriminatory tax rates, and no longer would the politically well-connected by able to benefit from special loopholes and preferences.

✓ **An end to micromanagement and political favoritism.** All deductions, credits, exemptions, loopholes, and preferences would be eliminated under a flat tax. Politicians would lose their ability to pick winners and losers, reward friends and punish enemies, use the tax code to impose their values on the economy. Investment decisions would be guided by economic forces rather than tax considerations.

✓ **Increased civil liberties.** The complexity of the tax code makes it nearly impossible for either taxpayers or IRS agents to follow the law. A greatly simplified tax code would eliminate virtually all of the conflicts and controversies that make the IRS one of the most feared agencies of the federal government.

The Spending Problem

While current tax policy represents a huge impediment to economic growth, policymakers also must focus on the size of government. To the extent that politicians and bureaucrats do not spend money as wisely or efficiently as it would be spent in the private sector, economic growth will lag as government increases in size. More specifically, many government programs do not generate benefits (or minimize costs) to the economy that exceed those which would have occurred had the money remained in private hands.

The appropriate approach for policymakers is to determine whether spending for a given program will yield enough benefits to offset the loss of the money to the private sector (including the incentive and compliance costs of collecting taxes). A certain level of transportation spending, for instance, will facilitate economic growth by permitting the efficient flow of goods and services. Policymakers should debate, of course, whether the spending could be privatized or conducted at the state and local level. And to the extent they believe it has to be conducted by Washington, they should do their best to ensure that funding is allocated according to sound guidelines rather than pork-barrel politics. Other types of spending, such as crime prevention, also may help the economy by reducing the cost of crime.

In too many cases, however, there is strong reason to believe that the federal government is spending money in ways that do not produce good results for the economy. Some programs, such as welfare, reduce the cost of not working and inevitably undermine productive economic behavior. Other types of spending, such as the budgets for regulatory agencies, can have significantly negative rates of return because of the heavy costs they impose on the private sector. Unfortunately, policy makers usually do not subject government programs to this type of cost/benefit analysis.

Note that one important conclusion from using this approach is that the deficit is not the critical variable. The key is the size of government, not how it is financed. Taxes and deficits are both harmful, but the real problem is that government is taking money from the private sector and spending it in ways that often are counter-productive. As a result, fiscal policy should focus on reducing the level of government spending, with particular emphasis on those programs that yield the lowest benefits and/or impose the highest costs. The importance of reducing spending, it should be noted, exists regardless of whether the budget happens to be balanced and is not contingent on changes in the tax system (just as reforming the tax system and adopting other pro-growth tax changes should not be contingent on what happens to the spending side of the ledger).

Conclusion

There is no magic formula to boost growth. The economy can only grow if people work more or work better. Unfortunately, much of the world has adopted policies that impose increasingly steep tax penalties on those who add to the economy's wealth. Compounding the damage of these policies are spending programs that shield people from taking responsibility for their own lives. The combination has been an unmitigated failure.

This raises a particularly important issue for those on the left. They must decide what is more important: keeping a tax system that may satisfy an ideological impulse to punish success, or adopting a system that helps boost the living standards of the less fortunate. It is certainly true that modest reforms like reducing the tax rate on capital gains or big reforms like the flat tax will boost after-tax income of the rich. The empirical evidence, however, shows that other income classes will benefit as well — and may benefit even more.[9]

Critics of tax reform complain that it is nothing more than "trickle-down" economics that relies on tax cuts for the "rich" to boost wages. Such rhetoric may be useful politically, but it cannot change economic reality. Economist John Shoven has explained:

> The mechanism of raising real wages by stimulating investment is sometimes derisively referred to as "trickle-down" economics. But regardless of the label used, no one doubts that the primary mechanism for raising the return to work is providing each worker with better and more numerous tools. One can wonder about the length of time it takes for such a policy of increasing saving and investments to have a pronounced effect on wages, but I know of no one who doubts the correctness of the underlying mechanism. In fact, most economists would state the *only* way to increase real wages in the long run is through extra investments per worker.[10]

For a profession usually chided for its lack of agreement, economists are nearly unanimous in their recognition that capital formation is the key to economic growth. Policymakers seeking to boost living standards and take-home pay face two competing options for how best to achieve the goal of more savings and investment: Should they focus on the deficit or should they shrink the size of government and reform the tax system? While these goals need not conflict, to the extent there is a division, there should be little doubt that a myopic fixation on the deficit will not necessarily produce the right policy results. Adopting a flat tax, by contrast, combined with long-overdue reductions in the level of government spending, will generate the desired outcome of a more prosperous economy.

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9 Barry J. Seldon and Roy G. Boyd, "The Economic Effects of a Flat Tax (Draft)," National Center for Policy Analysis, Dallas, Texas (forthcoming).

10 John B. Shoven, "Alternative Tax Policies to Lower the U.S. Cost of Capital," in *Business Taxes, Capital Costs and Competitiveness*, American Council for Capital Formation Center for Policy Research, July 1990, p. 3.

APPENDIX 1:
Taxes Affect Decisions to Work

Joint research by economists from Princeton University and Brigham Young University, based on a random survey of physicians, found that a one percentage point increase in marginal tax rates is associated with a reduction of as much as 1.11 percent in hours worked.[11]

A University of California economist found that because of the Tax Reform Act of 1986 (which lowered tax rates), the work effort of high-income married women rose by 0.8 percent for every one percent their after-tax wages increased.[12]

Another economist found that "Husbands of retirement age, 60 and over, show substantial variation in hours of work, related systematically to wages and income in the expected way." Moreover, "Wives in all age groups are quite sensitive to wages and income."[13] In other words, as after-tax income falls, so does the incentive to work.

Two other economists estimated that "wives' labor supply will increase by 3.8 percent" in response to a reduction in the marriage penalty.[14]

A comprehensive study in *The Journal of Human Resources* found that taxes reduce married males' hours of work by 2.6 percent and married females' by between 10 percent and 30 percent.[15]

According to a statistical study in *Econometrica*, yearly hours of work for white married women increase by 2.3 percent for every one percent increase in after-tax earnings.[16]

While husbands are not as sensitive to taxes as wives, the impact of taxes on their behavior is nonetheless dramatic. One study found that they work eight percent less than they would in the absence of taxes.[17] This indicates a loss in economic output of at least $1,000 per person.[18]

All studies acknowledge that higher after-tax incomes increase incentives to work by increasing the "price" of leisure, but some assume this effect is offset because lower taxes allow workers to achieve a certain level of income by working fewer hours. While this tradeoff is relevant when looking at individual choices, two economists note that "the generalization of the individual analysis to the economy as a whole is invalid" because "It will be impossible for *all* individuals to consume both more goods and more leisure as the in-

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11 Mark Showalter and Norman K. Thurston, "Taxes and Labor Supply of High-Income Physicians," unpublished manuscript, October 21, 1994.

12 Nada Eissa, "Taxation and Labor Supply of Married Women: The Tax Reform Act of 1986 as a Natural Experiment," unpublished manuscript, September 1994.

13 Robert E. Hall, "Wages, Income, and Hours of Work in the U.S. Labor Force," in G. Cain and H. Watts, eds., *Income Maintenance and Labor Supply* (Chicago: Markham, 1973).

14 Jerry Hausman and Paul Ruud, "Family Labor Supply with Taxes," *American Economic Review*, Vol. 74, No. 2 (May 1984), pp. 242-248.

15 Robert K. Triest, "The Effect of Income Taxation on Labor Supply in the United States," *The Journal of Human Resources*, Vol. XXV, No. 3, pp. 491-516.

16 Harvey S. Rosen, "Taxes in a Labor Supply Model with Joint Wage-Hours Determination," *Econometrica*, Vol. 44, No. 3 (May 1976), pp. 485-507.

17 Jerry Hausman, "Labor Supply," in Henry J. Aaron and Joseph A. Pechman, eds., *How Taxes Affect Economic Behavior* (Washington, D.C.: The Brookings Institution, 1981), pp. 27-83.

18 Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill Book Co., 1983).

dividual work-leisure analysis implies."[19] The actual economy-wide response to changes in tax rates will be higher than almost all studies indicate.[20]

One econometric model found that a one percent reduction in tax rates increased work effort for lower-income workers by 0.1 percent, for middle and upper-middle-income workers by 0.25 percent, and for upper-income workers by more than 2.0 percent.[21]

19 James Gwartney and Richard Stroup, "Labor Supply and Tax Rates: A Correction of the Record," *American Economic Review*, Vol. 73, No. 3 (June 1983), pp. 446-451.

20 This is confirmed by other economists. See, for example, Paul Craig Roberts, "The Breakdown of the Keynesian Model," *The Public Interest*, No. 52 (Summer 1978), pp. 20-33; Norman B. Ture, "The Economic Effects of Tax Changes: A Neoclassical Analysis," in Richard H. Fink, ed., *Supply-Side Economics: A Critical Appraisal* (Frederick, Md.: University Publications of America, 1982); and William G. Laffer, "Virtues and Deficiencies of Supply-Side Economics Viewed From an Austrian Perspective," unpublished manuscript, September 28, 1990.

21 Michael K. Evans, "New Developments in Econometric Modelling: Supply-Side Economics," in Fink, *Supply-Side Economics: A Critical Appraisal*.

APPENDIX 2:
Taxes Reduce Savings and Investment

In a book on taxes and capital formation, Norman B. Ture and B. Kenneth Sanden noted, "The bias against saving in the present tax system results from the fact that, with few exceptions, taxes are imposed both on the amount of current saving and on the future returns to such saving, whereas the tax falls only once on income used for consumption."[22]

Economist John Shoven estimates that a reduction of 20 percent in the top rate for capital gains would cause the stock market to rise by 3 percent.[23]

Undersecretary of the Treasury Lawrence H. Summers has written that "increases in the real after-tax rate of return received by savers would lead to substantial increases in long-run capital accumulation." Further, "bequests may account for a large fraction of national capital formation," which strengthens the argument that taxes influence savings.[24]

A study in *The American Political Science Review* noted that "Nations...where the extractive [tax] capacity of government did not significantly increase, relative to the economic product, have, in a sense, opted for...an increasing rate of private capital accumulation."[25]

Analyzing the decline in savings, a study by three experts concluded that Social Security and other transfer programs have led to a "decline in U.S. saving."[26]

Two other economists also concluded that Social Security reduces savings because workers no longer worry as much about retirement.[27]

Econometric results, according to a study published in the *Journal of Public Economics*, "suggest that dividend taxes have important effects on investment decisions" and that "an increase of 10 percent in the stock market would raise the investment rate by about 15 percent."[28]

Writing in the *National Tax Journal*, three economists found "significant effects for the after-tax return on saving, after-tax cost of borrowing, or both." The Reagan tax cuts "had a major impact on U.S. economic growth."[29]

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22 Norman B. Ture and B. Kenneth Sanden, *The Effects of Tax Policy on Capital Formation* (Washington, D.C.: Institute for Research on the Economics of Taxation, 1977).

23 Shoven, "Alternative Tax Policies to Lower the U.S. Cost of Capital."

24 Lawrence H. Summers, "The After-Tax Rate of Return Affects Private Savings," *American Economic Review*, Vol. 74, No. 2 (May 1984), pp. 249-253.

25 David Cameron, "The Expansion of the Public Economy: A Comparative Analysis," *The American Political Science Review*, Vol. 72 (1978), pp. 1243-1261.

26 Jagadeesh Gokhale, Laurence J. Kotlikoff, and John Sabelhaus, "Understanding the Postwar Decline in United States Saving: A Cohort Analysis," unpublished manuscript, November 1994.

27 Lawrence H. Summers and Chris Carroll, "Why Is United States National Saving So Low," *Brookings Papers on Economic Activity*, Vol. 2 (1987), pp. 607-635.

28 James M. Poterba and Lawrence H. Summers, "Dividend Taxes, Corporate Investment, and 'Q'," *Journal of Public Economics* 22 (1983), pp. 135-167.

29 Allen Sinai, Andrew Lin, and Russell Robins, "Taxes, Saving, and Investment: Some Empirical Evidence," *National Tax Journal*, Vol. XXXVI, No. 3 (1983), pp. 321-345.

APPENDIX 3:
Growth Is Weaker When Government Penalizes Economic Behavior

A 1983 World Bank study of 20 countries found that low-tax nations experience faster growth, generate more investment, and enjoy more rapid increases in productivity and standards of living than high-tax nations.[30]

The tax system imposes between 22 cents and 54 cents of losses for every dollar raised, according to a labor-supply economist. For working wives, the losses are even higher: more than 58 cents for very dollar of tax revenue.[31]

Another study found that each 1.0 percent increase in the federal tax burden reduces economic growth by 1.8 percent and lowers national employment by 1.14 percent.[32]

According to a statistical study published in the *American Economic Review*, for every dollar paid to the federal government in taxes, 33.2 cents is lost to the economy.[33]

The increased tax burden between 1965 and 1980 drove an estimated 1.9 million people out of the U.S. labor force.[34]

Statistical research published in *Lloyd's Bank Review* has found that in the U.K. each one percent rise in payroll taxes causes hiring to fall by approximately 1.4 percent. The same study estimated that each $1 of additional tax revenue costs $3 in lost economic output.[35]

A study printed in the *American Sociological Review* concluded that "Increases of one percent in the tax burden relative to household income are directly associated with a 2.8 percent decline in economic growth over three years, or just under one percent annually."[36]

An *American Economic Review* study found that every dollar of taxes could impose as much as $4 of lost output on the economy, with the probable harm ranging between $1.32 and $1.47.[37]

A 1981 analysis of the Swedish economy in the *Journal of Political Economy* found "The estimated long-run effects [of high marginal tax rates] are sufficient to explain up to 75 percent of the recent decline in the measured growth of the Swedish GNP."[38]

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30 Keith Marsden. "Links Between Taxes and Economic Growth: Some Empirical Evidence." World Bank Staff Working Paper No. 605, 1983.

31 Hausman, "Labor Supply."

32 William C. Dunkelberg and John Skorburg, "How Rising Tax Burdens Can Produce Recession," Cato Institute *Policy Analysis* No. 148, February 21, 1991.

33 C. L. Ballard, J. B. Shoven, and J. Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review*, Vol. 75, No. 1 (1985), pp. 128-138.

34 Otto Eckstein, "Tax Policy and Core Inflation. A Study Prepared for the Use of the Joint Economic Committee" (Washington, D.C.: U.S. Government Printing Office, 1980). See also L. Godfrey, "Theoretical and Empirical Aspects of the Effects of Taxation on the Supply of Labour" (Paris: Organization for Economic Cooperation and Development, 1975).

35 Michael Beenstock, "Taxation and Incentives in the U.K.," *Lloyd's Bank Review*, No. 134 (October 1979), pp. 1-15.

36 Roger Friedland and Jimy Sanders, "The Public Economy and Economic Growth in Western Market Economies," *American Sociological Review*, Vol. 50 (August 1985), pp. 421-437.

37 Edgar K. Browning, "On the Marginal Welfare Cost of Taxation," *American Economic Review*, Vol. 77, No. 1 (March 1987), pp. 11-23.

38 Charles E. Stuart, "Swedish Tax Rates, Labor Supply, and Tax Revenues," *Journal of Political Economy*, Vol. 89, No. 5 (1981), pp. 1020-1038.

According to a former Treasury Department official, between 75 percent and 80 percent of the additional wealth generated by increased savings and investment goes to workers.[39]

Another study in the *Journal of Political Economy* estimated that the corporate income tax costs more in lost output than it raises for the government. The "excess burden" is "123 percent of revenue."[40]

A 1984 study in the *American Economic Review* estimated "20.7 cents of welfare loss per additional dollar of tax revenue."[41]

A study of U.S. taxes at the state level found that low-tax states grew 35 percent faster than high-tax states between 1970 and 1980.[42] The relationship between growth and taxes among the states has been shown in literally dozens of studies.[43]

Another economist was able to illustrate a very strong inverse relation between average per capita growth rates and average tax rates on income and profits in developed countries.[44]

According to an article in the *Journal of Political Economy*, based on worldwide data, increasing the tax burden by ten percentage points will reduce annual growth by two percentage points.[45]

In a paper presented at the World Bank, two economists uncovered an "impressive negative relation between the rate of growth and the ratio of tax revenue to GDP" as well as a "negative association between growth and...the 'marginal' income tax rate."[46]

Of the explosive growth of Hong Kong, Taiwan, Singapore, and South Korea, Hoover economist Alvin Rabushka has written that

> The four Asian tigers adopted supply-side tax policies decades before the Reagan and Thatcher revolutions. Finance ministers oversaw systems of taxation that featured low rates and/or low levels of direct taxation of individuals and businesses, the absence of or very light charges on capital income (interest, dividends, capital gains), and a smorgasbord of inducements for domestic and foreign enterprises to invest and reinvest in each economy.[47]

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39 Norman B. Ture, "Supply Side Analysis and Public Policy," in David G. Raboy, ed., *Essays in Supply Side Economics* (Washington, D.C.: Institute for Research on the Economics of Taxation, 1982).

40 Jane G. Gravelle and Laurence J. Kotlikoff, "The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good," *Journal of Political Economy*, Vol. 97, No. 4 (1989), pp. 749-780.

41 Charles Stuart, "Welfare Costs per Dollar of Additional Tax Revenue in the United States," *American Economic Review*, Vol. 74, No. 3 (June 1984), pp. 352-362.

42 Richard K. Vedder, "Rich States, Poor States: How High Taxes Inhibit Growth," *Journal of Contemporary Studies*, Fall 1982, pp. 19-32.

43 See Bruce Bartlett, "Impact of State and Local Taxes on Growth: Bibliography," Alexis de Tocqueville Institution, 1995, and Richard K. Vedder, "Do Tax Increases Harm Economic Growth and Development?" *Arizona Issue Analysis*, Report No. 106, September 20, 1989 (Annotated Bibliography).

44 Charles Plosser, "The Search for Growth," unpublished manuscript, August 1992.

45 Robert G. King and Sergio Rebelo, "Public Policy and Economic Growth: Developing Neoclassical Implications," *Journal of Political Economy*, Vol. 98 (October 1990), pp. S126-S150.

46 William Easterly and Sergio Rebelo, "Fiscal Policy and Economic Growth: An Empirical Investigation," unpublished manuscript, March 1993.

47 Alvin Rabushka, "Tax Policy and Economic Growth in the Four Asian Tigers," *Journal of Economic Growth*, Vol. 3, No. 1.

Other studies have found that the economy is harmed when government spends tax revenue:

A National Bureau of Economic Research study, using worldwide data, found that an increase "in government spending and taxation of 10 percentage points was predicted to decrease long-term growth rates by 1.4 percentage points."[48]

According to Daniel Landau, "The results of this study [published in the *Southern Economic Journal*] suggest a negative relationship exists between the share of government consumption expenditure in GDP and the rate of growth of per capita GDP."[49]

Two economists found that increases in U.S. government outlays for social programs "are associated with reductions in the growth rate."[50]

48 Eric M. Engen and Jonathan Skinner, "Fiscal Policy and Economic Growth," National Bureau of Economic Research, *Working Paper Series*, No. 4223, December 1992.

49 Daniel Landau, "Government Expenditure and Economic Growth: A Cross-Country Survey," *Southern Economic Journal*, Vol. 49 (January 1983), pp. 783-792.

50 John McCallum and Andre Blais, "Government, Special Interest Groups, and Economic Growth," *Public Choice*, Vol. 54 (1987).

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The Thomas A. Roe Institute for Economic Policy Studies

July 19, 1996

THE HISTORICAL LESSONS OF LOWER TAX RATES

Daniel J. Mitchell
McKenna Senior Fellow in Political Economy

INTRODUCTION

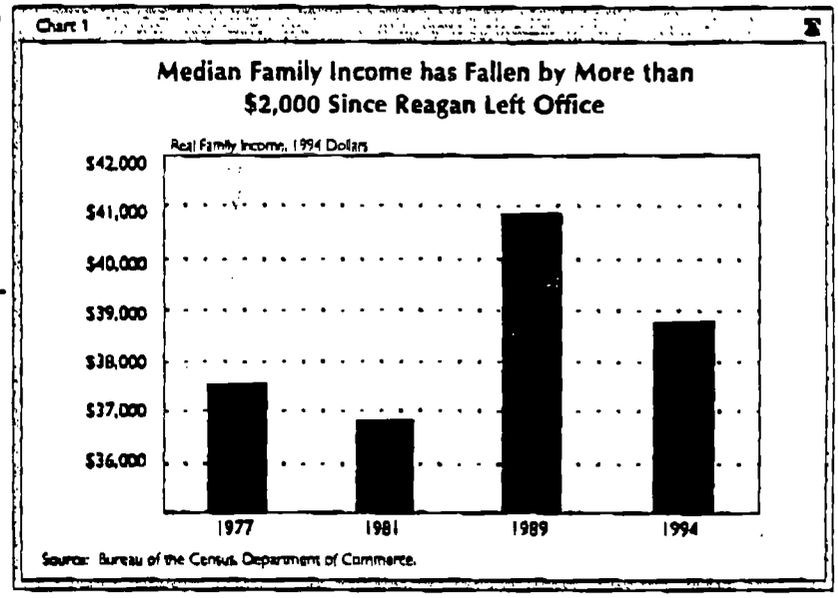
The 1996 presidential campaign has rekindled the debate over tax reductions. Among the proposals being considered are an across-the-board reduction in tax rates, the repeal of rate increases imposed in 1990 and 1993, the deductibility of payroll taxes, and a modified flat tax. But regardless of the particular features of each change under consideration, the argument is the same. Proponents argue that lower tax rates will spur economic growth by reducing the penalty on working, saving, and investing. Opponents disagree, claiming that the economy is doing fine and that tax rate reductions, if enacted, will help the rich disproportionately while widening the deficit.

Fortunately, there is a way to judge the desirability of lower tax rates. The United States has had three major episodes of tax rate reductions—the 1920s, 1960s, and 1980s. By looking at how the economy performed during these periods, and by examining what happened to the deficit and the degree to which different income classes were affected, it is possible to gain useful evidence about the desirability of tax rate reductions today.

The evidence provides strong support for those who believe the economy is weak and favor reductions in tax rates. Recent history is especially compelling. Tax rate increases in 1990 and 1993 boosted the top rate to 39.6 percent (and over 42 percent including the Medicare payroll tax). This means a 50 percent increase in the tax burden on work, saving, investment, and entrepreneurship when compared with the 28 percent rate in effect when Ronald Reagan left office. The effect has been dismal:

- ✗ During the post-Reagan era, the economy has experienced its worst seven-year performance since the end of World War II.
- ✗ Real median family income, the best measure of living standards for the average American, has fallen by more than $2,000 since Reagan left office.

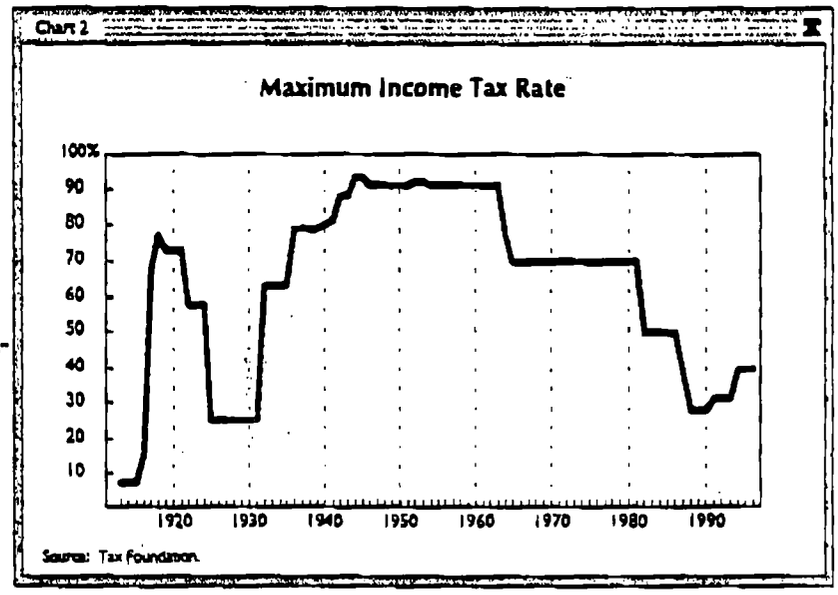
✗ Assuming there is no change in policy, the Congressional Budget Office estimates that economic growth for the next ten years will average less than 2.1 percent annually.[1] This is well below the post-World War II average of 3.2 percent.



The economy's substandard performance in recent years should come as no surprise. As seen below, major changes in tax policy inevitably affect growth.

✔ Across-the-board tax rate reductions in the 1920s reduced the top rate from 71 percent to 24 percent. The economy boomed, growing by 59 percent between 1921 and 1929.

✗ In 1930, Herbert Hoover raised tax rates from 25 percent to a maximum of 63 percent, and Franklin Roosevelt boosted them to 79 percent later in the decade. The 1930s, to put it mildly, are not remembered as one of the American economy's better decades.[2]



✔ Across-the-board tax rate reductions introduced by President John F. Kennedy reduced the top rate from 91 percent to 70 percent. These lower rates, along with substantially lower taxes on savings and investment, are associated with the longest economic expansion in American history.[3]

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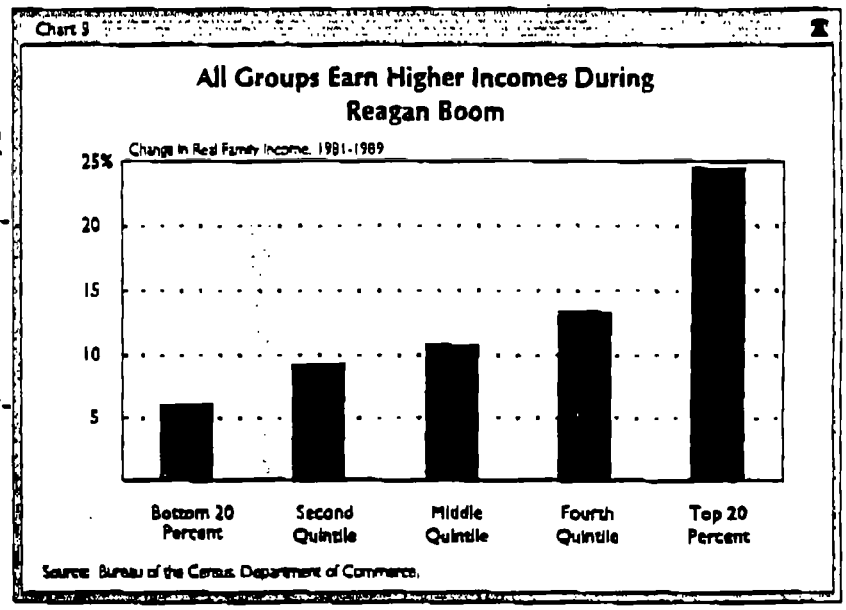
1 Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1997-2006*, May 1996.

2 It is important to note that tax policy is just one of the many ways government can influence the economy and should receive neither full credit nor full blame for how well the economy performs. In the 1930s, for instance, contractionary monetary policy and protectionist trade policy also contributed to the economy's poor performance.

3 The lower tax rates were phased in between 1964 and 1965. The lower taxes on capital went into effect in 1962.

✗ The Johnson surtax, enacted in 1968 during the administration of President Lyndon Johnson, combined with the inflation-induced bracket creep of the 1970s (subjecting taxpayers to higher rates even though their real incomes had not changed), resulted in a decade of stagflation.

✔ Reagan's across-the-board tax cuts ushered in America's longest peacetime expansion, helping to create 20 million new jobs and pushing incomes and living standards to record highs.



✗ The tax rate increases imposed under George Bush and Bill Clinton, as outlined below, are associated with the slowest growing economy in 50 years and a decline of more than $2,000 in the average family's income.

If legislators want to unleash stronger growth and more prosperity, the best tax policy would be the flat tax. Under that proposal, all three major problems of the current tax code—high rates, anti-capital bias, and complexity—would be minimized. To the extent that politicians are reluctant to adopt a flat tax, however, any change that moved in the right direction would be helpful. If history is any guide, any tax rate reduction, whether a 15 percent across-the-board cut, a repeal of the Bush and Clinton tax hikes, or some other reform, would boost the economy and raise living standards.

LOOKING AT CASE HISTORIES

The effect of tax rates on economic activity should not be overstated. The economy, after all, can be affected significantly by trade policy, regulatory policy, monetary policy, and many other government actions. Even within the context of fiscal policy, tax rates are not the only critical issue. Both the level of government spending and where that money goes are very important. And even when looking only at tax policy, tax rates are just one piece of the puzzle. If certain types of income are subject to multiple layers of tax, as occurs in the current system, that problem cannot be solved by low rates. Similarly, a tax system with needless levels of complexity will impose heavy costs on the productive sector of the economy.

Keeping all these caveats in mind, there nonetheless is a distinct pattern throughout American history: Simply stated, when tax rates are reduced, the economy prospers, tax revenues grow, and lower-income citizens bear a lower share of the tax burden. Conversely, periods of higher tax rates are associated with subpar economic performance and stagnant tax revenues.

The 1920s

- ✔ Under the leadership of Treasury Secretary Andrew Mellon during the Administrations of Presidents Warren Harding and Calvin Coolidge, tax rates were slashed from the confiscatory levels they had reached in World War I. The Revenue Acts of 1921, 1924, and 1926 reduced the top rate from 73 percent to 25 percent.

- ✔ Spurred in part by lower tax rates, the economy expanded dramatically. In real terms, the economy grew 59 percent between 1921 and 1929, and annual economic growth averaged more than 6 percent.

- ✔ Notwithstanding (or perhaps because of) the dramatic reduction in tax rates, personal income tax revenues increased substantially during the 1920s, rising from $719 million in 1921 to $1,160 million in 1928, an increase of more than 61 percent (this was a period of no inflation).[4]

- ✔ The share of the tax burden borne by the rich rose dramatically. As seen in Chart 5, taxes paid by the rich (those making $50,000 and up in those days) climbed from 44.2 percent of the total tax burden in 1921 to 78.4 percent in 1928.

Chart 4

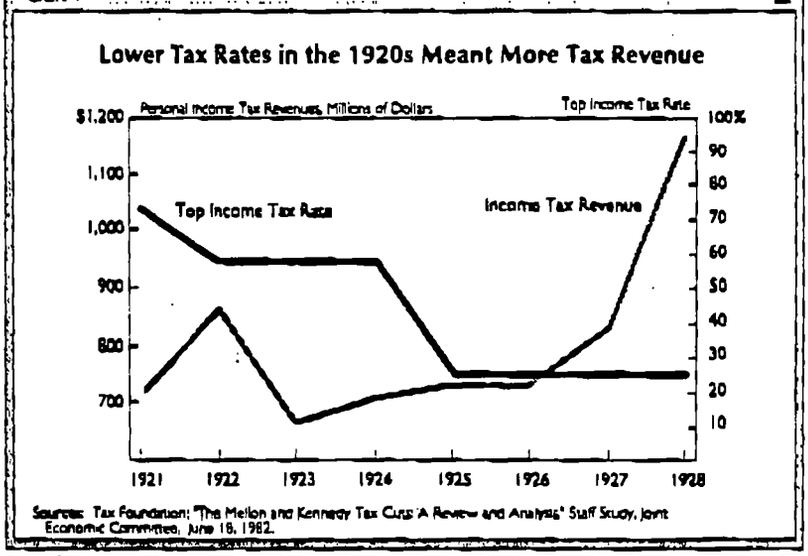
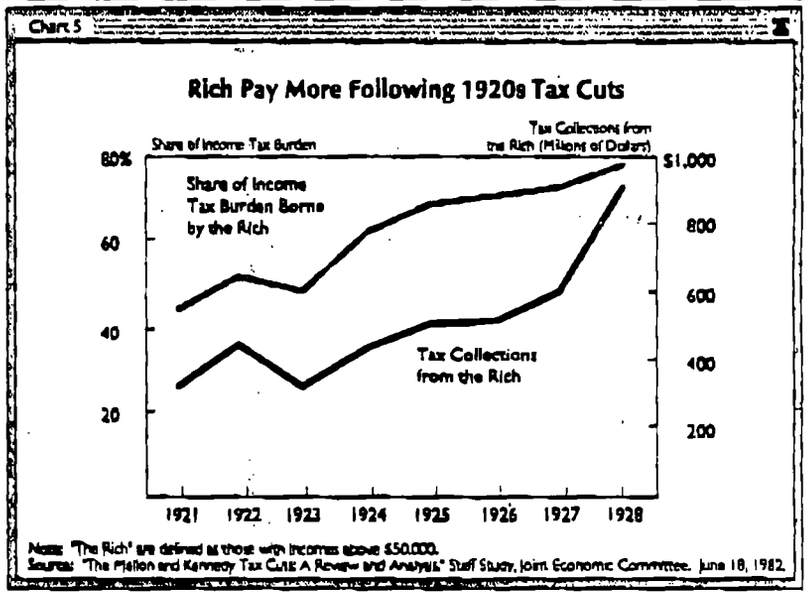


Chart 5



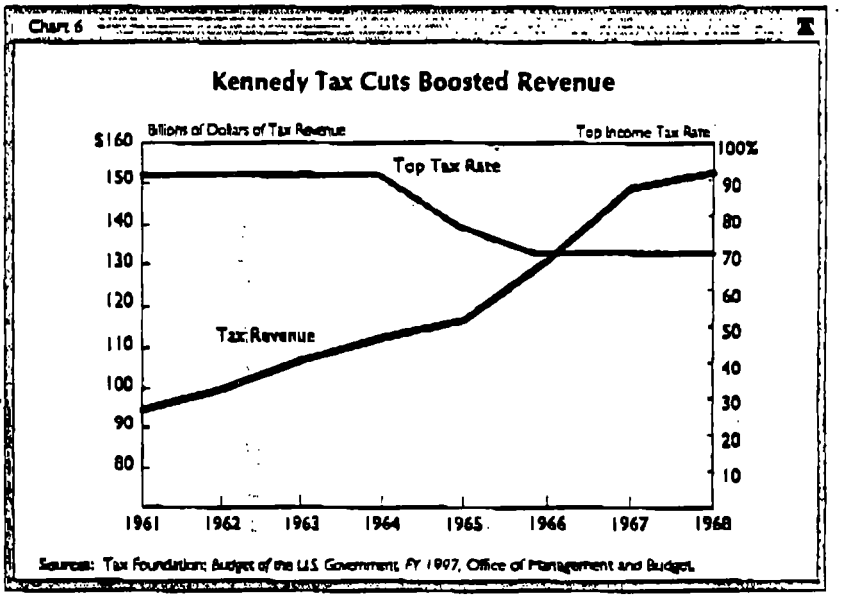
4 Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970, Part 1* (Washington, D.C.: U.S. Government Printing Office, 1976).

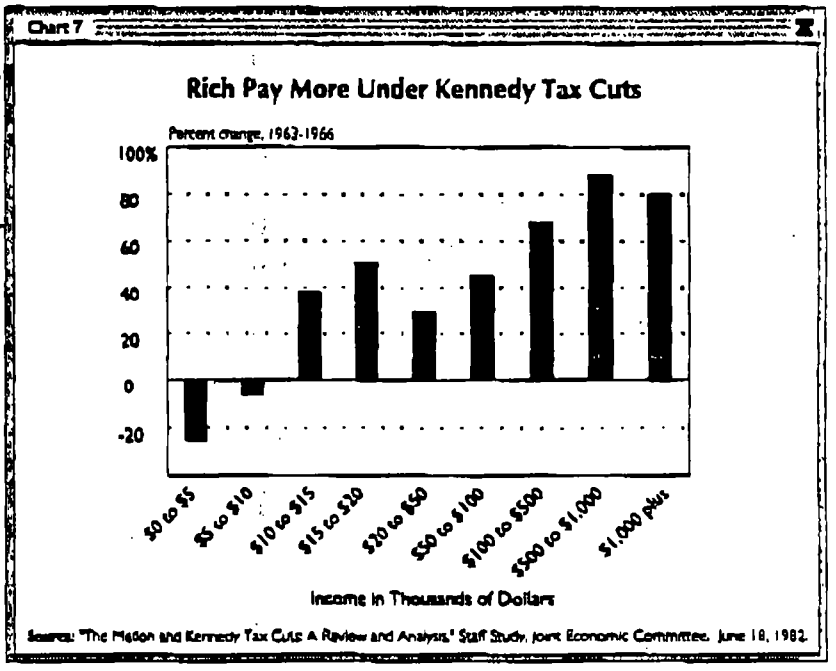
This surge in revenue was no surprise to Mellon:

> The history of taxation shows that taxes which are inherently excessive are not paid. The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find other lawful methods of avoiding the realization of taxable income. The result is that the sources of taxation are drying up; wealth is failing to carry its share of the tax burden; and capital is being diverted into channels which yield neither revenue to the Government nor profit to the people.[5]

The 1960s

- ✔ President Kennedy proposed a series of tax rate reductions in 1963 that resulted in legislation the following year dropping the top rate from 91 percent in 1963 to 70 percent by 1965.[6]
- ✔ The Kennedy tax cuts helped trigger the longest economic expansion in America's history. Between 1961 and 1968, the inflation-adjusted economy expanded by more than 42 percent. On a yearly basis, economic growth averaged more than 5 percent.
- ✔ Tax revenues grew strongly, rising by 62 percent between 1961 and 1968. Adjusted for inflation, they rose by one-third.





5 Andrew Mellon, *Taxation: The People's Business* (New York: Macmillan, 1924).

6 The Kennedy boom also was helped along by reductions, occurring in 1962, in the tax burden on investment and capital gains.

✔ Just as in the 1920s, the share of the income tax burden borne by the rich increased. Tax collections from those making over $50,000 per year climbed by 57 percent between 1963 and 1966, while tax collections from those earning below $50,000 rose 11 percent. As a result, the rich saw their portion of the income tax burden climb from 11.6 percent to 15.1 percent.[7]

According to President Kennedy:

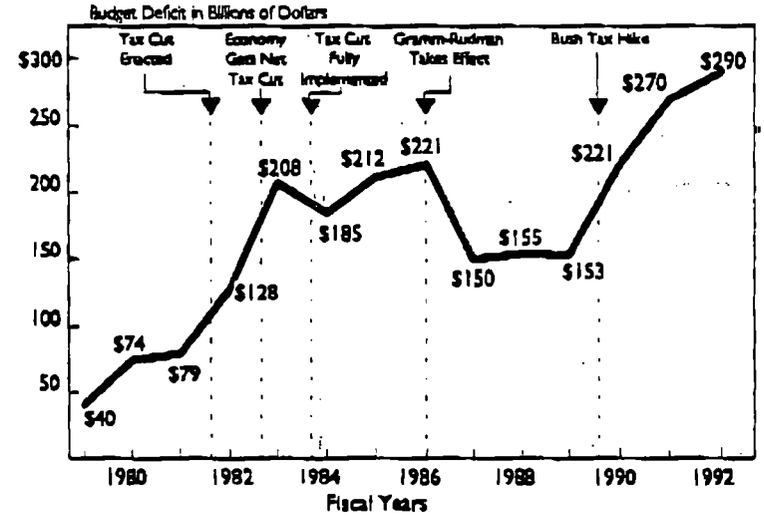
> Our true choice is not between tax reduction, on the one hand, and the avoidance of large Federal deficits on the other. It is increasingly clear that no matter what party is in power, so long as our national security needs keep rising, an economy hampered by restrictive tax rates will never produce enough revenues to balance our budget just as it will never produce enough jobs or enough profits. Surely the lesson of the last decade is that budget deficits are not caused by wild-eyed spenders but by slow economic growth and periodic recessions and any new recession would break all deficit records. In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now.[8]

The 1980s

President Reagan presided over two major pieces of tax legislation which together reduced the top tax rate from 70 percent in 1980 to 28 percent by 1988.

Chart 8

Did Tax Cuts Cause the Deficit?



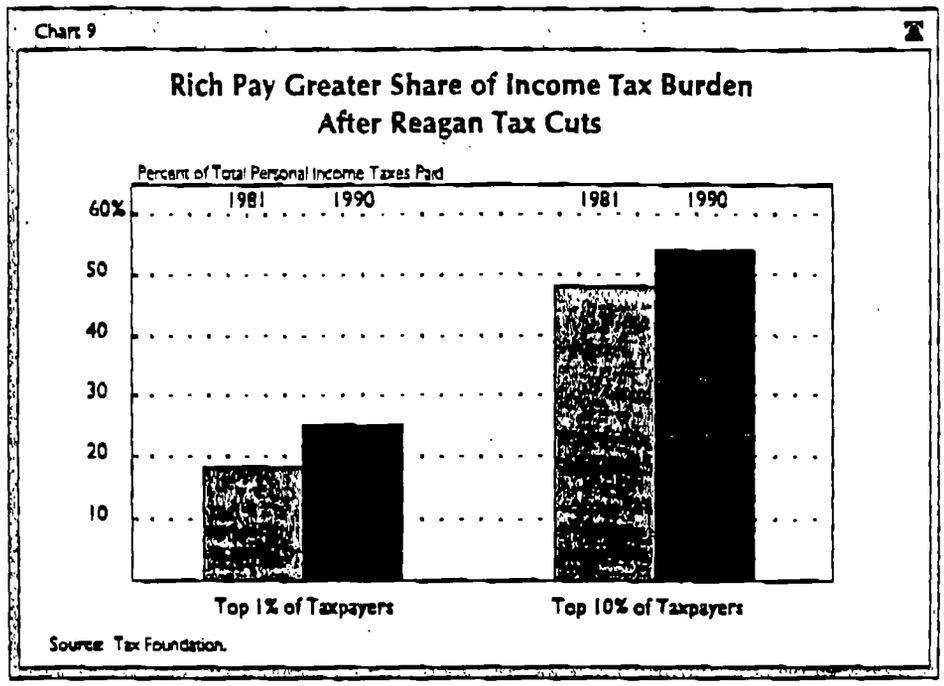
Source: *Budget of the U.S. Government, FY 1997*, Office of Management and Budget.

The economic effects of the Reagan tax cuts were dramatic. When Reagan took office in 1981, the economy was being choked by high inflation and was in the middle of a double-dip recession (1980 and 1982). The tax cuts helped pull the economy out of the doldrums and ushered in the long-

7 Joint Economic Committee, "The Mellon and Kennedy Tax Cuts: A Review and Analysis," June 18, 1962.

8 John F. Kennedy, speech to Economic Club of New York, December 14, 1962.

est period of peacetime economic growth in America's history. During the seven-year Reagan boom, economic growth averaged almost 4 percent.



Critics charge that the tax cuts caused higher deficits, but they misread the evidence. The Reagan tax cut, though approved in 1981, was phased in over several years. As a result, bracket creep (indexing was not implemented until 1985) and payroll tax increases completely swamped Reagan's 1.25 percent tax cut in 1981 and effectively canceled out the portion of the tax cut which went into effect in 1982. The economy received an unambiguous tax cut only as of January 1983. Thereafter, personal income tax revenues climbed dramatically, increasing by more than 54 percent by 1989 (28 percent after adjusting for inflation).

Contrary to conventional wisdom, it was the "rich" who paid the additional taxes. The share of income taxes paid by the top 10 percent of earners jumped significantly, climbing from 48.0 percent in 1981 to 57.2 percent in 1988. The top 1 percent saw their share of the income tax bill climb even more dramatically, from 17.6 percent in 1981 to 27.5 percent in 1988.[9]

One of the chief architects of the Reagan tax cuts was then-U.S. Representative Jack Kemp (R-NY). According to Kemp:

> At some point, additional taxes so discourage the activity being taxed, such as working or investing, that they yield less revenue rather than more. There are, after all, two rates that yield the same amount of revenue: high tax rates on low production, or low rates on high production.[10]

9 Joint Economic Committee, *Annual Report, 1992*.

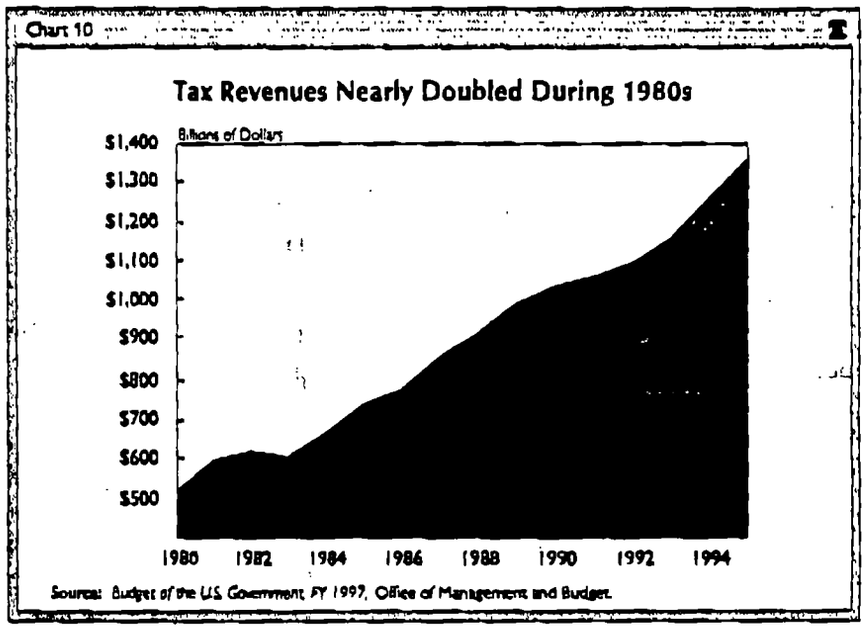
10 Jack Kemp, *An American Renaissance: A Strategy for the 1980s* (New York: Harper and Row, 1979).

THE LESSONS

1) Lower tax rates do not mean less tax revenue.

The tax cuts of the 1920s: Personal income tax revenues increased substantially during the 1920s, despite the reduction in rates. Revenues rose from $719 million in 1921 to $1164 million in 1928, an increase of more than 61 percent (this was a period of virtually no inflation).

The Kennedy tax cuts: Tax revenues climbed from $94 billion in 1961 to $153 billion in 1968, an increase of 62 percent (33 percent after adjusting for inflation).



The Reagan tax cuts: Total tax revenues climbed by 99.4 percent during the 1980s, and the results are even more impressive when looking at what happened to personal income tax revenues. Once the economy received an unambiguous tax cut in January 1983, income tax revenues climbed dramatically, increasing by more than 54 percent by 1989 (28 percent after adjusting for inflation).

2) The rich pay more when incentives to hide income are reduced.

The tax cuts of the 1920s: The share of the tax burden paid by the rich rose dramatically as tax rates were reduced. The share of the tax burden borne by the rich (those making $50,000 and up in those days) climbed from 44.2 percent in 1921 to 78.4 percent in 1928.[11]

The Kennedy tax cuts: Just as happened in the 1920s, the share of the income tax burden borne by the rich increased following the tax cuts. Tax collections from those making over $50,000 per year climbed by 57 percent between 1963 and 1966, while tax collections from those earning below $50,000 rose 11 percent. As a result, the rich saw their portion of the income tax burden climb from 11.6 percent to 15.1 percent.[12]

11 Joint Economic Committee, "The Mellon and Kennedy Tax Cuts."
12 *Ibid.*

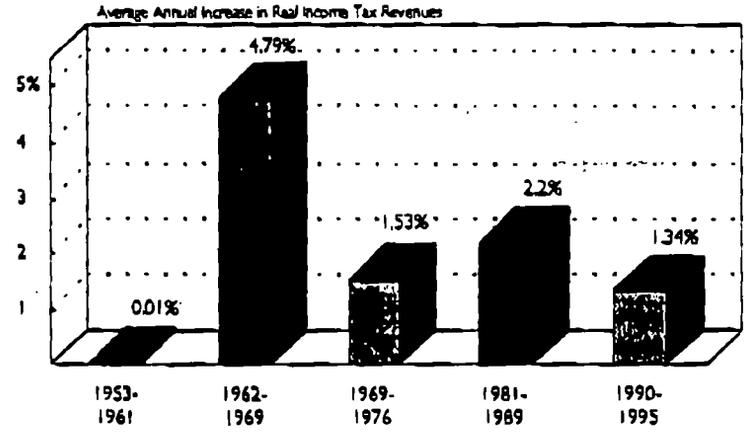
The Reagan tax cuts: The share of income taxes paid by the top 10 percent of earners jumped significantly, climbing from 48.0 percent in 1981 to 57.2 percent in 1988. The top 1 percent saw their share of the income tax bill climb even more dramatically, from 17.6 percent in 1981 to 27.5 percent in 1988.[13]

THE 1990S: IGNORING THE LESSONS OF THE PAST

Unlike reductions in tax rates, increases in tax rates have a history of failure. The Hoover and Roosevelt tax increases of the 1930s certainly contributed to the dismal economy during the Great Depression. Tax revenues fell during much of the period, and the deficit increased. And as Chart 11 shows, the high tax rates of the 1950s resulted in sluggish revenue growth. Ignoring history, both Democrats and Republicans at the time argued that tax rates reaching over 90 percent could not be cut for fear of revenue loss. Moreover, the 1970s, which began with the Johnson surtax and later were hit by bracket creep, triggered the tax revolt and the Reagan tax cuts.

Chart 11

Lower Tax Rates Work: Revenues Grew Faster Under Kennedy and Reagan



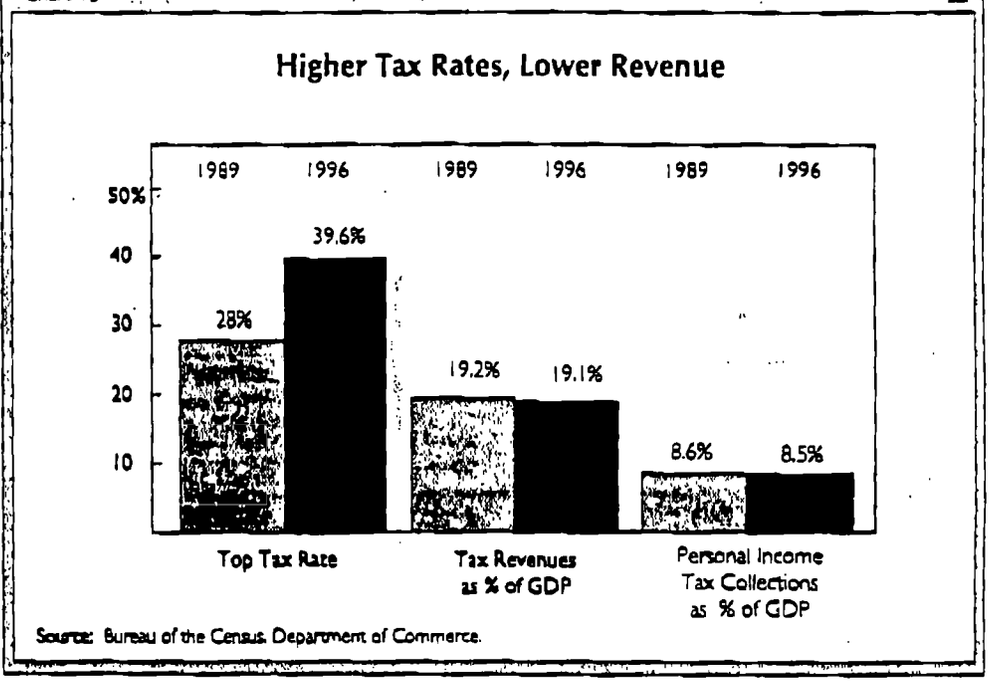
Source: Budget of the U.S. Government, FY 1997, Office of Management and Budget.

Bracket Creep — The Inflation Tax Did Raise Revenue

As Chart 11 shows, revenues do not grow quickly when tax rates are high. The one exception to this pattern occurred during the late 1970s when inflation pushed taxpayers into higher and higher tax brackets (there were more than 20 separate tax rates at the time). Ironically, the victims of bracket creep—the ones who paid the additional tax—were lower- and middle-income taxpayers. The rich already were in the high bracket and thus were not affected. Moreover, since those with lower earnings receive more than 80 percent of their income from wages and salaries, it was very difficult—at least in the short run—for them to make behavioral changes to escape the higher taxes. Rich taxpayers, on the other hand, receive the bulk of their earnings in the form of dividends, interest, capital gains, and business income. The timing and composition of these earnings can easily be altered to protect the taxpayer from confiscatory tax rates (which helps explain why higher tax rates aimed at the rich almost always fail to generate additional tax revenue). So politicians seeking higher revenues can claim some historical evidence on their side—but only if they are willing to take more money from the poor and middle class through the hidden tax of inflation.

13 Joint Economic Committee. *Annual Report, 1992.*

Chart 12



Perhaps more than any other decade, however, the 1990s make the best argument against higher tax rates. In both 1990 and 1993, the economy was subjected to record tax increases, the ostensible purpose of which was to raise revenue to reduce the budget deficit. As Chart 12 illustrates, however, these increases backfired. Total tax revenue, as a percent of economic output, is expected to be lower this year than it was when Reagan left office.[14]

Significantly, the modest decline in revenues relative to gross domestic product (GDP) is due to the slower growth in personal income tax revenues. As shown in Chart 12, individual income tax revenues totaled 8.6 percent of economic output in 1989. By 1996—two large tax increases later—individual income tax revenues had fallen to 8.5 percent of economic output. In other words, the tax that was increased the most accounts for the drop in tax revenue as a share of national output.

High tax rates are bad for the economy. High tax rates that increase the deficit by reducing the growth of tax revenue are even worse. What makes recent history especially tragic is that the economic and budgetary losses could have been avoided if Bush and Clinton had simply kept Reagan's policies in place. In 1989, the Congressional Budget Office projected that the budget deficit, which then was $152 billion, would continue to fall for the next five years assuming no change in Reagan's policies. As of 1995—again, two large tax increases later—the budget deficit had risen to $164 billion, and it is projected by the CBO to reach more than $400 billion by 2006 if Clinton's policies are left in place.

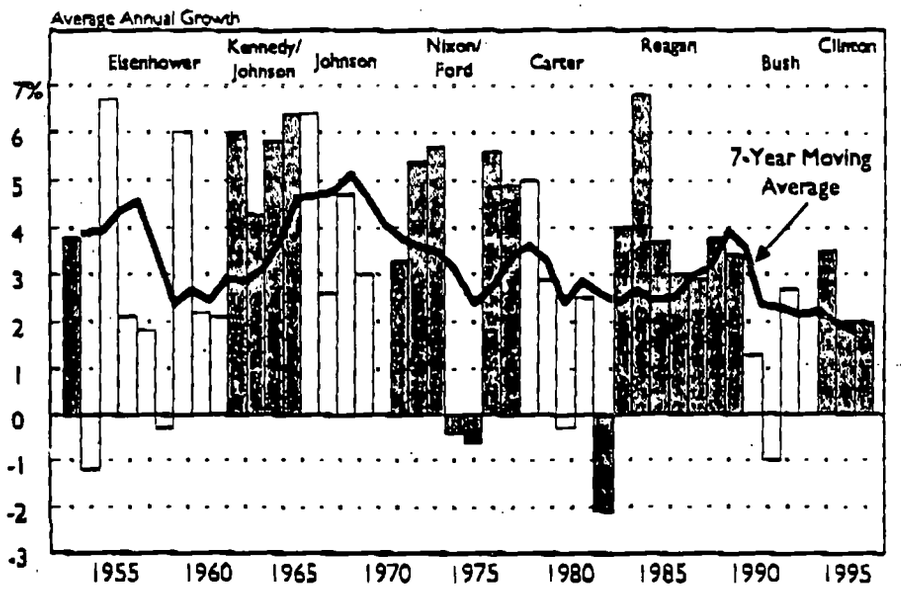
The dismal budget numbers, however, tell only part of the story. The economy has been the real victim of higher tax rates. As Chart 13 shows, the post-Reagan era has seen the slowest growth of any seven-year period since the end of World War II. As discussed earlier, this slow growth has left people with more than $2,000 less income when infla-

14 This is a particularly stunning statistic, since collections normally rise as a percentage of GDP over time in a system with graduated rates.

tion is taken into account. The biggest losers have been the poor. As Chart 14 illustrates, income for the bottom 20 percent has fallen the most during the Bush/Clinton era. The politicians who imposed the higher taxes, needless to say, argued that the rich would be the ones to suffer.

Chart 13

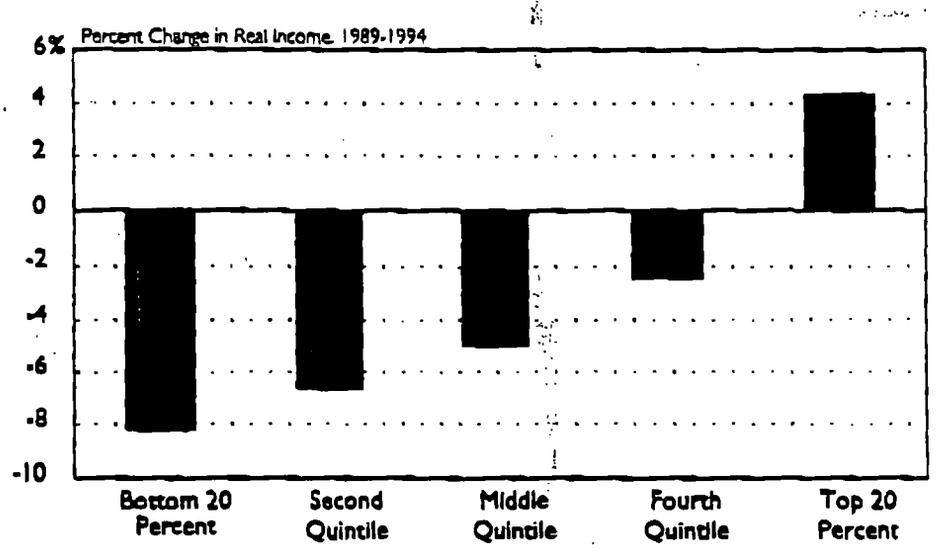
1.81 Percent Average Annual Growth Since Reagan Left Office is Worst Seven-Year Economic Performance Since End of World War II



Source: *Economic Report of the President*, Council of Economic Advisers, February 1996.

Chart 14

Lower and Middle Income Families Suffer Most During High Tax, Post-Reagan Era



Source: Bureau of the Census, Department of Commerce.

CONCLUSION

The economy is limping, incomes have been falling, tax revenues are stagnant, and it is projected that the deficit will more than double in the next ten years. This is the legacy of higher tax rates and a tax code that punishes working, saving, and investing. History shows clearly that the way to reverse this trend is to cut tax rates. Legislation to reduce rates would do this. Better still, Congress should scrap the current system as quickly as possible and replace it with a flat tax that treats all taxpayers equally and minimizes the burden on productive behavior.

The Heritage Foundation Backgrounder

IS THERE A "CLINTON CRUNCH"?: HOW THE 1993 BUDGET PLAN AFFECTED THE ECONOMY

By Scott A. Hodge, Grover M. Hermann Fellow in Federal Budgetary Affairs; William W. Beach, Visting Fellow, Tax Analysis; John S. Barry, Policy Analyst; Mark Wilson, Rebecca Lukens Fellow in Labor Policy; Joe Cobb, John M. Olin Fellow in Political Economy

The Heritage Foundation
Backgrounder No. 1078
May 1, 1996

INTRODUCTION

The American economy currently exhibits relatively low levels of inflation, interest rates, and unemployment. Yet millions of workers remain anxious about their economic security. The relatively good economic news, combined with the widespread dissatisfaction among Americans with the nation's economic performance, seems to be a paradox. But an analysis of underlying policies and economic trends suggests an answer to this puzzle.

Using the Washington University Macro Model (WUMM)[1] -- a major economic model of the U.S. economy also used by the federal government and many *Fortune* 500 companies -- economists at The Heritage Foundation investigated how the economy would likely be performing today had Congress not raised taxes in 1993 as the nation was coming out of the 1990-1991 recession.[2] The results of this analysis shed light on why Americans are so anxious about the economy's performance. According to the Heritage analysis, the 1993 tax hike, championed by the Clinton White House, did indeed produce what some critics have referred to as a "Clinton Crunch" -- a larger tax bite for families combined with a stagnation in incomes and an economy performing well below its potential.[3]

The Heritage analysis indicates that, compared with how the economy would have performed without the 1993 tax legislation, Clinton's 1993 tax and budget plan will have:

- **Cost the economy $208 billion in output** from 1993 through 1996,[4] in today's dollars.[5] This lost output is equal to nearly $2,100 for every household in America. Last year, without the 1993 economic package, gross domestic product (GDP) would have grown $66 billion more than it actually did absent the change.

- **Cut the number of private jobs created by 1.2 million** between 1993 and the end of 1996. Including the forecast for 1997, the total employment cost of the 1993 tax increase grows to nearly 1.4 million lost job opportunities.[6]

- **Delivered only 49 percent of the new revenues predicted** by the Congressional Budget Office from the increase in personal and corporate tax rates between FY 1994 and FY 1996. When compared with the 1.2 million lost jobs, the tax hike has depressed potential employment growth by 17,600 jobs for every $1 billion it achieved in deficit reduction.

- **Cut $112 billion, in today's dollars, out of potential employee wages and salaries** between 1993 and 1996.

Table 1

Opportunities Lost . . .
The 1993 Budget Plan Cost America:

- 1.2 million additional private sector jobs
- $208 billion in economic output
- 40,600 new business starts
- $112 billion in wages and salaries
- $264 billion in disposable income
- $138 billion in personal savings
- 1.3 million new car and light truck sales
- $42.5 billion in durable goods orders

- **Cut the growth in real personal disposable income** of Americans by $264 billion in today's dollars between 1993 and 1996 -- equal to over $2,600 less disposable income for every household in America.

- **Cut the potential sale of automobiles by 773,700 and light trucks by 504,000** between 1993 and 1996. Some 1.1 million of the nearly 1.3 million lost vehicle sales would have been produced domestically. In 1996, Heritage calculates that this loss in auto and truck sales will cost a projected 60,100 jobs across all industries.

- **Cut the value of business investment in durable goods by $42.5 billion** in today's dollars; $15.4 billion of this is lost investment in computers.

Some proponents may argue that even if the economy is not performing up to its potential today, this slow growth period is necessary to reduce federal deficit spending which, in turn, will promote greater future growth. Yet many respected economists maintain that this will not be the case with the 1993 tax increase and budget deal: Increased taxes (and particularly increased marginal tax rates) will permanently decrease economic activity below its potential.[7] Similarly, the Heritage analysis, using the WUMM economic model and forecasts of future economic activity, supports this theory. According to the Heritage analysis, nearly every major economic indicator is projected to be weaker under current law than would have been possible without passage of the 1993 tax increase and budget act between now and 2004. Specifically:

- **Gross domestic product is projected to be lower in each year.** In 2004 alone, GDP is projected to be $122.5 billion lower in today's dollars than would have been possible without passage of the 1993 tax increase and budget deal.

- **Real personal disposable income is projected to be lower each year.** In 2004 alone, Americans will see $142 billion less in disposable income than would be possible without the 1993 tax increase and budget deal.

In short, American workers are right to feel that they should be better off today than they are. President Clinton's 1993 economic plan turns out to have deprived Americans of a higher standard of living by cutting the economy's growth potential, leading to a slower rise in employee compensation, household income, industrial output, and most other measures of a prosperous economy.

HOW IS THE ECONOMY REALLY PERFORMING?

Despite a flow of quite good economic news in recent months, many Americans feel anxious about their economic security, complaining of stagnating family incomes, less money in their paychecks after taxes, and a belief that the economy

is performing below its full potential. They simply do not accept that the economy is, as the President claims, the "healthiest it has been in 30 years."

In the latest *Economic Report of the President*, the White House maintains that the general health of the economy is good and credits the creation of 8 million new jobs to the passage of the Omnibus Budget Reconciliation Act of 1993 (OBRA-93), which, the report says, "set the stage for this economic expansion and resurgence, by enacting historic deficit reduction while continuing to invest in technology and education."[8]

By contrast, House Majority Leader Richard Armey (R-TX) cites OBRA-93, which enacted the largest tax increase in history, as the culprit for the anxiety Americans are now feeling. Calling this condition the "Clinton Crunch,"[9] Armey claims workers are experiencing the dual effect of an actual decline in real wages and higher taxes. With fewer of their own dollars in their pockets to meet the needs of their families, he says, workers understandably have a heightened sensitivity to changing economic conditions, corporate layoffs, and downsizing.

Who is right? Is the economy performing up to its potential, as claimed by the White House? Or are Americans suffering from the "Clinton Crunch," as claimed by Armey?

Americans have good reason to be confused about the direction in which the nation's economy is headed. On the one hand, there is good news in statistics showing continued economic growth, relatively low unemployment, and record highs in the stock market. And as the Clinton Administration points out, the economy has created nearly 8 million jobs over the past three years, 93 percent of them in the private sector. Clinton also claims credit for reducing the federal budget deficit for three consecutive years: According to the *Economic Report of the President*, passage of the 1993 economic plan "put the country solidly on the road to fiscal responsibility."[10]

But other economic statistics indicate a less rosy picture for Americans in recent years. For example, existing studies and government data indicate:

- Since 1992, real median family income has stagnated even though more adult women are working than ever before.[11] Since September 1993, both real average hourly earnings and real average weekly earnings have stagnated.[12]

- Since the third quarter of 1993, the real median weekly earnings for women have decreased 3.0 percent, while men's real earnings have stagnated.[13] Over the same period, real hourly compensation (which includes benefits as well as wages) has not increased significantly.[14]

- Fifty percent of major U.S. companies eliminated jobs in the twelve months ending June 1995, up from 47 percent the year before.[15]

- More Americans are working two or more jobs to make ends meet. In March 1996, 7.9 million Americans were working two or more jobs, up 10.2 percent since March 1994.[16]

  Less than one-third of all workers displaced from full-time jobs found new jobs that pay the same as their old ones.[17] The median weekly earnings of their new jobs averaged 8.2 percent less than their old jobs, and over 14 percent less for workers 45 to 55 years old.[18]

- From March 1995 to March 1996, 325,000 high-paying manufacturing jobs disappeared.[19]

THE ECONOMY IS LAGGING BEHIND PREVIOUS EXPANSIONS

Thus, while the economy is no longer in a recession, and indeed is experiencing modest growth, many Americans are still having trouble making ends meet and corporate layoffs have many workers thinking twice about the security of their jobs. But is this just part of a typical business cycle? Experience suggests "no." Although total employment has increased in recent years, the current economic expansion -- which began in March 1991 and is now some 59 months long -- is not progressing as well as it should when compared with the three previous post-World War II expansions lasting longer than 58 months. These expansions occurred from February 1961 to December 1969, from March 1975 to January 1980, and from November 1982 to July 1990.[20] The failure of this economy to perform as well as similar expansions gives a clue as to why many Americans are concerned about their economic future.

It is interesting to compare this expansion with the average of these previous expansions. To be sure, the patterns of each expansion do differ, so data for each expansion are provided in Table 2, as well as the average.

During the current expansion:

- The gross domestic product has increased less than half as much as the average of previous post-war recoveries. Industrial production has increased just over half as much.

- Total employment has grown only half as much as the average of previous post-war recoveries.

- The number of high-paying manufacturing jobs has *declined* by 273,000, compared with an average *increase* of almost 2 million at a similar point during previous economic expansions.

- The number of unemployed Americans has declined by less than half the number during previous economic expansions.

- Real median family income has *declined* by a total of 3.2 percent during the first four years of this expansion, compared with an average *increase* of 8.8 percent during the first four years of previous expansions.[21]

- Real median weekly earnings for full-time workers have *declined* by 2.6 percent during the current expansion, compared with an *increase* of 3.1 percent during the 1982 to 1986 expansion.[22]

Thus, despite the Administration's cheerful outlook, the economy is not performing well when compared with similar points during the three previous expansions of similar lengths. The question is "why?" Would the economy have been performing less well today without OBRA-93, as the Clinton Administration claims, or did the tax increase slow down an economy in recovery and put many workers into a wage and job squeeze, as critics claim?

THE 1993 BUDGET DEAL

Virtually all economists agree that Washington can alter the course of the economy to some degree through its tax and spending decisions. This influence is particularly evident when Congress and the President enact tax and spending policies that affect income from work or investment. For example, Washington can reduce employment and workers' take-home pay by increasing tax rates on wages and salaries. Higher rates take money directly out of workers' pockets and make work less attractive. Conversely, lower tax rates increase the incentives for men and women to work, start new businesses, or invest in training and equipment for workers. In short, tax rate changes either lower or raise the cost of labor, depending on the direction of the rate movement. Commonly, lowering labor costs leads to a higher demand for labor. When combined with lower capital costs stemming from lower taxes on capital, greater levels of economic activity are attained.

When Congress and the President adopt policies that alter economic life in some significant fashion, there will be a difference between how the economy then performs and how it would have performed had policy not been changed. These differences between actual and potential performance can be estimated statistically using models of the U.S. economy that capture the economic impact of policy changes. Generally speaking, these models allow analysts to "simulate" the impact of tax and spending decisions that could have been made -- or not made -- by Congress and the President, and then compare the simulation with what actually occurred. This is what the Congressional Budget Office routinely does when Congress is considering tax and spending legislation.

There have been two major tax and spending plans enacted in recent years. These were in 1990 and 1993. American taxpayers were told that large tax increases in each of these plans would lead to a significant reduction in federal deficits and spur long-term economic growth. In this study, Heritage analysts used the WUMM model to investigate the effects of the 1993 budget deal. There were two reasons for the decision to focus on the 1993 agreement: First, by 1993, the economy was largely in recovery from the 1990-1991 recession, so the impact on the expansion of the 1993 plan could be isolated more easily. And, second, focusing on the 1993 economic plan allowed analysts to test the Clinton thesis that the plan has produced "the healthiest economy in three decades."[23]

The 1993 budget plan (OBRA-93) raised taxes $241 billion over five years and called for $77 billion in entitlement program savings and $69 billion in discretionary program savings by 1998.[24] The tax law changes included two new personal tax brackets (36 and 39.6 percent) and an extension of the Medicare payroll tax to cover all wages. The motor fuel tax was increased 4.3 cents per gallon, and the tax on Social Security recipients' income from personal savings was increased. Congress and the President agreed to raise the corporation income tax to 35 percent and to restrict business meal and entertainment deductions.

The small entitlement savings came mostly from reductions in Medicare payments to doctors and hospitals and increased charges to Medicare beneficiaries. OBRA-93 delayed cost of living adjustments for military and civil service retirees and limited Medicaid payments to the states. Small reductions also were made in veterans benefits, farm programs, and student loans.

THE FINDINGS

The comparison of the real and simulated economies suggests that OBRA-93 was not as beneficial to the economy as the White House claims. Indeed, it damaged the economy and living standards in several ways. Specifically, the Heritage analysis finds that:

1. **Economic growth has been slowed.**

   The economy would have grown significantly faster without the Clinton tax increases and spending reductions of 1993. These policy changes will have cost the economy $208 billion in today's dollars in output from 1993 through 1996, equivalent to nearly $2,100 in lost GDP for every household in America. In 1995, GDP would have grown by

nearly 0.90 percent more, or $66 billion in today's dollars, than it actually did. The model forecasts that GDP in 1997 will be 1.0 percent lower than it could be without the 1993 tax hike, or about $95.5 billion in today's dollars.

2. The pace of business formation has been slowed.

Heritage analysis shows more new businesses would have been incorporated without Clinton's 1993 package. This is due to the relationship between gross domestic product and new business incorporation. In general, for every $1 billion in GDP, about 195 new businesses are incorporated. Thus, the $208 billion fall in GDP due to the 1993 legislation will have prevented the formation of 40,600 new businesses between 1993 and the end of 1996.[25]

What This Means: The loss of new businesses means not only a loss of valuable entrepreneurs, but also the loss of many new jobs. The Small Business Administration (SBA) estimates that five new jobs are created with each new business establishment. Using the SBA estimate, the loss of 40,600 new businesses between 1993 and 1996 will have meant the loss of 203,000 new jobs.

3. Job growth has been slowed.

The economy produced 1.2 million fewer private sector jobs between 1993 and 1996 than it would have without the tax increase and budget changes of 1993. President Clinton claims credit for more than eight million new jobs during his Administration, so far, with roughly seven million of these in the private sector. But the Heritage analysis indicates that 1.2 million *additional* Americans could have been working without his policy changes. If the forecast for 1997 is added to these figures, the total private employment cost of the tax increase grows to nearly 1.4 million.[26]

It must be noted that the loss of potential civilian employment is one of the more remarkable findings of the analysis, based on the model's design. It is also one of the more controversial. While it is the Heritage Foundation's policy to accept the model's macroeconomic results and assumptions (other than the action of the Fed -- see box, page 8) and not make adjustments in these results through statistical work performed outside the model, this particular effect of OBRA-93 deserves a brief explanation. The model's measurement of how much employment will change when taxes change (the so-called tax elasticity of employment) sits roughly in the middle of the professionally accepted range for such measurements: The model contains a factor of .29 percent change for every one percent change in labor income, and the standard range among economists goes from .12 to .37 percent. These elasticities mean that a 10 percent increase in take-home pay leads to an increase in the labor supply of between 1.2 and 3.7 percent.

The designers of the WUMM model caution users regarding the output of the model's employment equations. However, Heritage economists decided to accept the model's results because further investigations and calculations using other data bases gave general support to the conclusions in this Heritage study. If the rate changes associated with OBRA-93's increases in payroll and income taxes are applied only to the incomes of those with more than $70,000 in income, we calculate that potential employment was at least 350,000. Of course, the increase in tax rates also negatively affected investment decisions, which resulted in slower growth of job-creating new businesses and business expansion. For example, Heritage calculates that the loss in potential capital stock may account for an additional decrease of 470,000 jobs. When these and other capital effects are combined with the direct and minimal employment effects, the calculation derived from the model of 1.2 million in 1996 between actual and potential employment appears reasonable.[27] Even using lower elasticities favored by some economists would mean an employment effect of at least 400,000 lost jobs.

What This Means: Heritage calculates approximately 203,000 of the potential lost jobs between 1993 and the end of 1996 were a result of new businesses that were not formed. The remainder of lost potential jobs, some 1 million, most probably results from existing businesses that hired fewer employees than they otherwise would have or expanded less.

4. The growth in household income and savings has been cut.

When the job losses are combined with higher taxes on working families, a disturbing picture of lost household income growth emerges.

- **The growth in wages and salaries has been cut.** The 1993 legislation will have cut $112 billion, in today's dollars, out of employee wages and salaries between 1993 and 1996, when compared with the pattern that otherwise would have occurred. Extending the analysis to 1997 would mean $162 billion in total lost wages and salaries, again in today's dollars.

What This Means: In 1996 alone, the Heritage analysis shows that the Clinton program depressed the growth in wages and salaries by $46.5 billion in today's dollars, roughly $465 for every household in America. The loss of potential income means that families spent less than they could have spent on food, clothing, transportation, medical care, and other necessities for their families. Indeed, in a typical month, the average household spends $251 on groceries, $160 on medical costs, and $40 on education.[28] The addition of $465 in purchasing power for the typical household means an average of 1.8 months of groceries, or 2.9 months of medical bills, or 12 months of educational

expenses in a typical year.

- **The growth in personal disposable income has been cut.** The 1993 budget deal raised taxes on millions of American households and will have cut overall real personal disposable income by $264 billion in today's dollars from 1993 through 1996 -- equal to over $2,600 less disposable income for every household in America. In 1996, households will have nearly 2 percent, or $101 billion, less money to spend on education, food, medical care, and other items than they would have had without the 1993 legislation.

What This Means: Total personal disposable income measures both wage income and non-wage income from such things as investments. Besides lost future wages, the Heritage analysis shows that the Clinton tax increase and budget plan will have cost households $152 billion in non-wage income, in today's dollars, between 1993 and the end of 1996. This is equal to $1,500 for every American household. In 1996 alone, the average household will realize $550 less in non-wage disposable income, nearly double the amount the Bureau of Labor Statistics estimates the average household spends on appliances each year.[29] Many households use income from non-wage sources to make large purchases such as the down payment on a new car, a washing machine, and other appliances. Alternatively, families may use this income to finance extraordinary events such as weddings, college education, or vacations.

- **The growth in personal savings has been cut.** Between 1993 and the end of 1996, the 1993 budget plan will have reduced personal savings by roughly $138 billion in today's dollars. This cut in family savings means that future consumption of the things for which families save, principally housing and education, will be lower than it would have been. If 1997 is included, savings will have been cut by a total of $192 billion, in today's dollars.

What This Means: The three things households save for most are education, housing, and retirement. To illustrate the impact of these lost savings, Heritage analysts distributed the $138 billion in lost savings to families with children, young families saving to purchase a home, and those saving for retirement, based upon age and population. We then assumed that this amount would grow at an everyday interest rate of 5 percent, to see what important purchases these three groups could make in the future with their respective accumulated savings. Each of the following amounts is what could be purchased with the future value of each group's portion of the $138 billion in lost savings:[30]

- $432 billion for higher education expenses; and
- $335 billion for buying homes; and
- $3.6 trillion for retirement.

Had the portion of this $138 billion we allocated to families with children been allowed to earn interest for the average number of years available for savings in the under-18 age group, then the cumulative amount could have purchased a four-year college education for 7 million students at $14,000. Had the foregone savings we allocated to young families saving to purchase a home (the age group 18 to 35), been allowed to grow for 18 years, the total sum could have resulted in 17 million future home sales where a $20,000 down payment is required. And had the portion of this $138 billion allocated to people above the age of 35 -- those saving for retirement -- been allowed to grow for the average number of years before this cohort retires, the future value could have resulted in 6.4 million 15-year retirement annuities paying $37,500 per year.

- **The growth of household wealth has been cut.** The 1993 legislation will have reduced the growth of household net wealth by $111 billion from between 1993 and 1996. The WUMM model defines net household wealth as a sum of personal savings, the purchase of automobiles and other durables, the existing household stock of durable goods and personal capital gains.

5. The reduction in the deficit attributable to the 1993 plan has been small.

The President maintains that taxes had to be raised in 1993 to reduce mounting federal debt.[31] He now points to a fall in the deficit as justification for the 1993 legislation. But the Heritage analysis indicates that the weak economy produced by the tax hike will have generated far less new revenue, and thus less deficit reduction, than the Congressional Budget Office (CBO) had predicted for FY 1994 through the end of FY 1996. On the other hand, the analysis indicates that the modest amount of savings predicted from the spending cuts will materialize. These findings suggest that if OBRA-93 had enacted few or no tax increases to slow the economy, but more spending cuts, the deficit would be far less today than it is.

In 1993, CBO predicted that OBRA-93 would lower the cumulative deficits between FY 1994 and FY 1996 by $171 billion. Some $50 billion of these savings -- 29 percent of the total -- was to come from spending cuts, including $17 billion in net interest savings and asset sale proceeds. The remaining $121 billion in deficit reduction -- 70 percent of the total -- was to come from the new revenues generated by the increase in tax rates.

The Heritage analysis indicates that OBRA-93 will have produced just 74 percent of the deficit reduction CBO had estimated, or a total of $127 billion.[32] This, however, does not tell the whole story. While the spending cuts will

have produced slightly more savings than CBO predicted, $52 billion (excluding asset sale proceeds), accounting for 41 percent of the overall deficit reduction achieved,[33] the tax increase accounts for roughly 54 percent of the total, having delivered far less new revenue than was promised.

- The Heritage analysis shows that the tax increase will have produced just $68 billion in actual deficit reduction between FY 1994 and the end of FY 1996, just 56 cents of actual deficit reduction for every new dollar CBO predicted would be generated.

- However, excluding the roughly $16 billion in new revenues generated by the increase in the motor fuels tax, the analysis shows that the increase in personal and corporate tax rates produced only 49 percent of the new revenues CBO predicted would be generated.

- Thus, comparing the actual amount of deficit reduction produced by the 1993 tax hike between 1994 and 1996, with the 1.2 million potential new jobs lost, it can be said that the 1993 tax increase will have meant the loss of over 17,600 new jobs for every $1 billion it achieved in deficit reduction.

The Heritage analysis of the near-term consequences of the 1993 tax increase largely confirms the results of a recent study by noted Harvard University economist Martin Feldstein and Daniel Feenberg, an economist at the National Bureau of Economic Research. Their analysis of the impact of the 1993 tax increase on individual behavior shows that the higher tax rates placed on upper-income taxpayers encouraged these individuals to change their economic behavior and, thus, report lower taxable income. As a result, in the first year it took effect, the 1993 tax rate increase raised just 45 percent of the "revenue that would have been collected if taxpayers had not changed their behavior."[34]

Moreover, Feldstein and Feenberg discovered that the 1993 tax hike caused considerable inefficiencies in the economy, what economists call "deadweight losses." "This means that for every dollar of additional revenue collected by the government as a result of the higher tax rates, taxpayers experience a decline in their well-being equivalent to three dollars as a result of the induced changes in work, in the form of compensation, and in tax deductible expenditures."[35] In other words, conclude Feldstein and Feenberg, "the structure of the 1993 tax increase thus made it a very inefficient way of increasing revenue."[36]

This analysis so far has examined what might be called the short-term effects of the 1993 package. The current debate is about these short term effects, with the White House claiming benefits to today's economy. But for there to be a complete verdict on the 1993 tax and budget plan, one needs to project into the future, to explore whether the short-term effects analyzed above are merely a prelude to future growth.

THE LONG-TERM PICTURE

To estimate the longer-run future effects of the 1993 plan, Heritage analysts used the WUMM model to extend the simulation of potential economic performance without passage of the 1993 tax increase and budget deal through 2004. The results of this simulation were then compared with the baseline economic projections -- under current law and including the 1993 tax increase and budget deal -- produced by the owners of the WUMM model in December 1995. The comparison shows that nearly every major economic indicator is projected to be weaker under current law than would have been possible without passage of the 1993 tax increase and budget act between now and 2004. Specifically, the Heritage analysis concludes:

- Gross domestic product is projected to be lower in each year. In 2004 alone, GDP is projected to be $122.5 billion lower in today's dollars than would have been possible without passage of the 1993 tax increase and budget deal.

- Real personal disposable income is projected to be lower each year. In 2004 alone, Americans will see $142 billion less in disposable income than would be possible without the 1993 tax increase and budget deal.

- Employment is projected to be less in every year. By 2004, 1.5 million fewer jobs will be created because of the 1993 tax increase and budget deal.

CONCLUSION

While there is good news in the economy, such as low interest rates, low inflation, 8 million new jobs, and lower federal deficits, many workers and their families feel that the recovery is anemic as far as they are concerned. The Clinton Administration is taking credit for good economic news and asserts that the news is a justification of its economic policies; specifically, the 1993 budget deal, which included the largest tax increase in history.

The evidence does not support the Administration's claim that the 1993 budget plan triggered stronger economic growth. On the contrary, the critics of the 1993 legislation appear to be correct that because of it Americans are caught in what some refer to as the "Clinton Crunch," the dual effect of declining real wages combined with higher taxes. The analysis by Heritage Foundation economists, using the WUMM model, indicates that OBRA-93 has had a damaging impact on the nation's economy. Removing the effects of OBRA-93 in an econometric simulation shows that the economy would have been performing better today had Congress not enacted the legislation.

Thus, President Clinton is right to point to the 1993 budget deal as creating today's economic climate. But rather than create a better climate, the legislation has cast a dark shadow over the economy.

APPENDIX: TECHNICAL NOTES

Appendix: Economic Impact of the Omnibus Budget Reconiliation Act of 1993 (OBRA-93)

Notes on the Simulation

The simulation of the Omnibus Budget Reconciliation Act of 1993 (OBRA-93) was developed using the Washington University Macroeconomic Model of the United States economy. The baseline is that produced by the model in December 1995. Only those variables in the model that reflect federal tax and spending policies were modified to create the simulation. Both the baseline case and the simulation incorporated the model's Federal Reserve reaction function. Specifically, Heritage economists made the following decisions regarding tax and spending data inputted into the model for the simulation:[37]

- **Tax Changes** -- Most changes in tax policy were initiated in the first quarter of 1993 to account for the retroactive nature of the tax increases included in OBRA-93.

  1. The maximum federal corporate tax rate was restored to its "pre-OBRA-93" level to account for the one percentage point rate increase included in OBRA-93.

  2. The statutory depreciation period for nonresidential structures was restored to its "pre-OBRA-93" level of 31.5 years. The corporate capital consumption allowance, as a percentage of total capital consumption allowance, was increased to accommodate the shorter depreciation periods within the simulation.

  3. The federal statutory income-weighted marginal tax rates on wages, dividends, and interest were restored to their "pre-OBRA-93" levels.

  4. The average federal personal tax rate was adjusted to account for lower marginal tax rates within the simulation compared to actual levels.

  5. The federal statutory income-weighted marginal Social Security tax rate on wages and salaries was re-set to its "pre-OBRA-93" level.

  6. Federal collections from social insurance taxes were adjusted to account for the repeal of the cap on earnings subject to the Medicare tax.

  7. Federal collections from indirect business taxes were adjusted for the extension and increase of the motor fuels tax account.

  8. Federal collections from business taxes were adjusted to account for non-rate changes in the business income tax code.

- **Mandatory Spending Changes**

  1. The actual spending level for **Medicare** was increased for each fiscal year by the amount the Congressional Budget Office estimated in September 1993 that OBRA-93 changes would save -- a total of $55.8 billion between 1994 and 1998.

  2. The actual spending level for **Medicaid** transfers was increased for each fiscal year by the amount the Congressional Budget Office estimated in September 1993 that OBRA-93 changes would save -- a total of $7.1 billion between 1994 and 1998.

  3. The actual spending level for personal transfers was adjusted for each fiscal year by the amount the Congressional Budget Office estimated in September 1993 that OBRA-93 changes in **federal employee retirement and health benefits, veteran benefits**, and the **Earned Income Tax Credit** would create -- a net total of $6.7 billion of increased spending between 1994 and 1998. The increased spending for the Earned Income Tax Credit more than offset the savings from reforming federal employee retirement and health benefits, and veterans benefits. Therefore, the simulation actually calls for less spending on personal transfers than actually occurred during the past three years.

  4. The actual spending level for other grants-in-aid was adjusted for each fiscal year by the amount the Congressional Budget Office estimated in September 1993 that OBRA-93 changes in **federal farm programs**, the **food stamp program**, and **"other" mandatory programs** would save -- a net total of $7.2 billion between 1994 and 1998.

  5. The proceeds from FCC electromagnetic spectrum auctions and the savings from changes in federal family education loans were added to the unified deficit but not included in the NIPA-based spending accounts.

- **Discretionary Spending Changes** -- The actual spending levels for **non-defense purchases, defense purchases, and**

federal grants to state and local governments were adjusted for each fiscal year by the amount the Congressional Budget Office estimated in September 1993 that OBRA-93 changes in discretionary spending would save -- a total of $68.5 billion between 1994 and 1998. This was evenly distributed among the three separate accounts.

- **Spending Projections FY 1999 - FY 2004** -- CBO September 1993 estimates extended through FY 1998. For fiscal years 1999 through 2004, the underlying growth rates were assumed.

Other Technical Notes

- **Personal Savings** -- The Heritage analysis concludes, among other things, that the tax policy changes of 1993 undercut personal savings by $138 billion. The estimates of long-term consumption effects were calculated as follows. The foregone personal savings were distributed across an array of seven age groupings by the percentage of people that fall in each grouping. This array consists of population estimates made by the U.S. Bureau of the Census for 1995.[38]

- For those people 18 years old or less, the distributed personal savings were allowed to grow until their 18th year at a compounded rate of 5 percent. The sum of this compounding ($432 billion) was divided by $14,000 to arrive at the estimate of 7 million people who could pay for four years of state university education.

- For those people between the ages of 18 and 35, the distributed personal savings were allowed to grow at a compounded annual rate of 5 percent until their 35th birthday. The sum of this compounding ($335 billion) was divided by $20,000 to arrive at the estimate of 17 million home sales that might be effected by potential home purchasers having $20,000 for a down payment and other home-buying costs.

- For those people between the ages of 35 and 65, the distributed savings were allowed to grow at a compounded annual rate of 5 percent until their 65th birthday. The sum of this compounding was $3.6 trillion. To this sum was added the amount of distributed personal savings for people above age 65. It was assumed that this amount is consumed as it is received. Therefore, the total amount available for retirement was $3.6 trillion. This $3.6 trillion estimate was divided by $37,500 (an estimate of annual living costs at retirement for the cohort aged 35 and above) to arrive at the estimate of 6.4 million 15-year retirement annuities.

Endnotes:

1. This study was prepared by The Heritage Foundation using the Washington University Macro Model. The methodologies, assumptions, conclusions, and opinions herein are entirely those of The Heritage Foundation. They have not been endorsed by, nor do they necessarily reflect the views of, the owners of the model.
2. This model is celebrated throughout the economics profession for its excellent forecasting accuracy and rich analytical capabilities. It is widely used in the private sector to guide business plans and in the public sector to estimate the economic implications of policy change. The WUMM team won the Blue Chip Consensus Forecasting Award for 1995.
3. The tax increase was contained in the Omnibus Budget Reconciliation Act of 1993 (OBRA-93).
4. All figures in calendar years except for deficits, which are expressed in fiscal years. The 1996 component is based on the WUMM December 1995 forecast of the U.S. economy during 1996.
5. Figures throughout this study are expressed in 1995 constant dollars.
6. See the discussion of these employment results on page 11 of this study.
7. See, for example, Martin Feldstein and Daniel Feenberg, "The Effect of Increased Tax Rates on Taxable Income and Economic Efficiency: A Preliminary Analysis of the 1993 Tax Rate Increases," National Bureau of Economic Research *Working Paper* 5370, November 1995.
8. *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1996), p. 3.
9. Representative Dick Armey, "A Republican Agenda to Reverse the Clinton Crunch," *Heritage Lecture* No. 556, speech given at The Heritage Foundation on February 27, 1996.
10. *Economic Report of the President*, 1996, p. 3.
11. Bureau of Census, Internet site http://www.census.gov/ftp/pub/hhes/www/incpov.html, and published in "1994 Income and Poverty Estimates," October 1995.
12. Bureau of Labor Statistics, Internet site http://stats.bls.gov:80/cgi-bin/surveymost?ee, or as published in "Employment and Earnings," various issues.
13. Bureau of Labor Statistics, "Usual Weekly Earnings of Wage and Salary Workers," various issues.

14. *Economic Report of the President*, 1996, p. 332.

15. American Management Association, "Corporate Downsizing, Job Elimination, and Job Creation," 1995.

16. Bureau of Labor Statistics, "The Employment Situation," BLS Press Release, April 1994 and April 1996.

17. Jennifer M. Gardner, "Worker Displacement: A Decade of Change," Bureau of Labor Statistics *Monthly Labor Review*, April 1995. The BLS definition of displaced workers refers to persons with 3 or more years of job tenure that lost their jobs because their plant or company closed or moved, there was insufficient work for them to do, or their positions or shifts were abolished.

18. Most of the change in earnings can be accounted for by the loss in firm-size wage premiums as workers have moved from larger to smaller firms. All else being equal, larger firms pay 12 to 23 percent more than smaller firms. See Wesley Mellow, "Employer Size and Wages," *Review of Economics and Statistics*, August 1982, and Charles Brown and James L. Medoff, "The employer size-wage effect," Harvard Institute of Economics Research *Discussion Paper* No. 1202, 1986.

19. Bureau of Labor Statistics, Internet site http://stats.bls.gov:80/cgi-bin/surveymost?ee, or as published in "Employment and Earnings," various issues.

20. The data comparisons made in this section refer to similar points in time during these four expansions. For example, average employment growth from March 1991 to the present (59 months) is compared with the average employment growth from February 1961 to December 1965 (59 months), from March 1975 to January 1980, and from November 1982 to October 1987.

21. U.S. Bureau of the Census, "Income and Poverty 1995," http:/www.census.gov/ftp/pub/hhes/www/incpov94.html. These are the most recent data available.

22. Data on median weekly earnings are not available on a consistent basis prior to 1979.

23. There are limits to the historical changes economists can make in structural macroeconomic models. Clearly the major limitation is the time period. While economies rarely experience major changes in the span of a few years, structural stability is far less likely over longer time periods. The six years of changes in variables in the WUMM model needed to measure the 1990 tax increase would have stretched prudent econometric practice to its limits. A number of prominent macroeconomists have written on the deleterious effects of the 1990 budget deal. For a summary of these viewpoints, see Daniel J. Mitchell, "The Impact of Higher Taxes: More Spending, Economic Stagnation, Fewer Jobs, and Higher Deficits," Heritage Foundation *Backgrounder* No. 925, February 10, 1993, and Daniel J. Mitchell, "Why Higher Tax Rates on Income Will Slow Growth, Cost Jobs," Heritage Foundation *Backgrounder* No. 942, May 25, 1993.

24. Congressional Budget Office, *The Economic and Budget Outlook: An Update* (Washington, D.C.: U.S. Government Printing Office, 1993), Table 2-2, p. 29.

25. This estimate is derived from a statistical analysis of the relationship between the number of new business incorporations and real GDP over the period 1959-1994. Overall a decrease in GDP of $1 billion was found to be associated with a decrease in the number of new business incorporations by an average of 194.957 over this period. (The estimate had an R-squared of .92748, a standard error of 9.35, and a t-statistic of 20.852.) Multiplying this figure by the $208 billion lost from GDP over 1993-96 (as a result of the Clinton tax increase) gave an estimate of 40,600 fewer new businesses. Figures for GDP and business formation came from the 1995 and the 1996 *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1996), Tables B-2 and B-92, respectively, pp. 282, 385.

26. The estimate of lost potential employment results from increases in taxes on the wages and salaries of upper income Americans, on the income of corporations, and on capital, an effect that stems from lengthening the period of depreciation on capital goods as well as taxing interest, dividends, and capital gains at higher rates. Such tax increases reduce capital formation and promote consumption. By increasing both the cost of capital and the cost of additional labor, the rate of business expansion and formation falls below potential which, in turn, reduces the potential growth of employment.

27. Most labor economists view tax increases as being equivalent to wage decreases, but they hold sharply divergent views about the degree of change in employment that results from a change in the tax rate on labor income. See Mark Killingsworth, *Labor Supply* (New York: Cambridge University Press, 1983), Chapter 6, esp. pp. 356-360. This variation in the amount of labor that is supplied as the wage level changes is called the "wage or income supply elasticity of labor." More specifically, the supply elasticity of labor is a measurement of the percentage change in the amount of labor that is supplied from a one percent change in the compensation of labor. The professional literature contains estimates of the labor supply elasticity that range from. 12 to. 37 percent for every one percent change in total labor income (which become negatively signed when analyzing the effect of taxes on labor supply). See Killingsworth, *Labor Supply*, pp. 119-125, Table 3.2 to 3.5. Also see comparable variation in the demand elasticities

for labor in Daniel S. Hamermesh, *Labor Demand* (Princeton, N. J.: Princeton University Press, 1993), Tab elasticity of labor supply used in the Washington University Macro Model is 0.29 percent and lies within th midrange of the estimates contained in this literature.

28. U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Expenditures in 1993*, Report 885, Decem Table 4. The figures are an average of all consumer units and have been adjusted to 1995 dollars.

29. Bureau of Labor Statistics, *Consumer Expenditure Survey, 1992-93*, September 1995, p 27. Figures have be adjusted for inflation.

30. See Technical Notes for a full description of how these figures were calculated. It should be noted here, hov the foregone savings is distributed to three different age groupings that each save for only one of the three p Allowing only one purchase for each group significantly simplified an otherwise complicated problem. The that is saving for education (those people under age 18) is not saving for a home purchase. The group that i for a home purchase (aged 18 through 35) is not saving for retirement. And the group saving for retirement and above) is saving only for retirement.

31. "... because the deficit has increased so much beyond my earlier estimates and beyond even the worst offici government estimates from last year. We just have to face the fact that to make the changes our country nee Americans must contribute today.... " President Clinton, "Address to the Nation," February 15, 1993.

32. The FY 1996 forecast does include some spending cuts enacted by the 104th Congress and signed by the Pr Heritage analysts, however, are unable to estimate these effects at this time.

33. A disproportionate share of the savings from spending cuts, $33 billion or 63 percent, are achieved in FY 1

34. Feldstein and Feenberg, "The Effect of Increased Tax Rates on Taxable Income and Economic Efficiency: Preliminary Analysis of the 1993 Tax Rate Increases."

35. *Ibid.* p. 3.

36. *Ibid.* p. 21.

37. For further information or clarification, please contact the authors.

38. See U.S. Government Printing Office, *Economic Report of the President Together with the Annual Report Council of Economic Advisers* (Washington, 1996), Table B-30, p. 315.

WIN IN '96 DEMOCRATIC NATIONAL COMMITTEE
Donald L. Fowler, *National Chair* • Christopher J. Dodd, *General Chair*

THE DNC RESEARCH DEPARTMENT

TO: Jason -
Gene asked about this.
Heritage still hasn't released
the study Dole referred to.
However, I found a recent
study on the FY 97 budget.

FAX:

FROM: **RESEARCH**
Nat

PHONE: **202-479-5130**

RE:

DATE:

PAGES, INCLUDING COVER: 13

MESSAGE:

GROUP FILE

Dole Lays Out Conservative Vision, Criticizes 'Touchy-Feely' Liberals

By Dan Balz
Washington Post Staff Writer

HERSHEY, Pa., April 10—Senate Majority Leader Robert J. Dole (R-Kan.) outlined a conservative governing agenda here tonight and assailed critics who claim he has no vision as "touchy-feely" liberals and members of the news media who only want to spend money on more government programs.

"You asked a lot about what's Bob Dole's vision for America," the presumptive Republican presidential nominee said.

"Well it's not that hard for me, but it is for some of these liberals and the media. They want some touchy-feely thing. They want to spend more money, that's vision. If you want to spend another billion, boy, that's vision."

Dole said his views were old-fashioned and straightforward.

"I want to make America better," he said. "I want people to find jobs. I want poor people to find good-paying jobs to get off welfare. . . . What could be better than to have more jobs created in this state where the unemployment rolls shrink and shrink and shrink? What would be better than to have the American Legion and VFW out of business because we didn't have conflicts because we had peace around the world because we had strong leadership?"

Speaking to a pro-business audience in a state he said would be crucial in his hopes of unseating President Clinton in the fall, Dole promised to fight for tax cuts for families with children while balancing the budget and pledged to appoint conservative judges to the federal court.

Dole's speech, although short on specifics, offered a preview of what are likely to be the main themes of his campaign against Clinton. Dole told his audience that, unlike some politicians, he intends to govern on the same issues on which he campaigns—a veiled criticism of the president, whom he said had promised tax cuts and delivered a tax increase.

Dole said Clinton's 1993 tax increase had damaged the American economy and, citing an unnamed study, claimed that the higher taxes had resulted in the loss of 1 million jobs, had reduced economic output by $200 billion and lowered wages by $111 billion.

Nelson Warfield, Dole's campaign spokesman, said Dole was previewing the results of a Heritage Foundation study that has not yet been released.

Dole also accused Clinton of settling for slow growth in the economy, despite criticizing then-President George Bush for a weak economy in the 1992 campaign.

America "can do better" than to have two-parent families working "from dawn to dusk" to make ends meet and to have single-parent families struggling to pay the bills, Dole said.

"We've got to listen," he said. "We've got to act."

Dole said the best way to help struggling families would be to enact the $500 per child family tax credit that Republicans have advocated throughout the 104th Congress.

Dole's quick trip to Pennsylvania marked the beginning of four days of campaigning that will take him to Texas and Iowa for fund-raising events.

He will return to Pennsylvania early next week for another day of campaigning in advance of the state's Republican primary on Tuesday.

CAMPAIGN '96

Quillen Closing Out 34 Years in House

Republican Rep. Zeliff Also Retiring; Rep. Laughlin Loses Primary

By John E. Yang
Washington Post Staff Writer

Rep. James H. "Jimmy" Quillen (R-Tenn.) said yesterday he would not run for reelection this fall, ending a 34-year House career.

"I'll be 81 at the end of this term and my wife needs me," said Quillen, who is tied with Rep. Joseph M. McDade (R-Pa.) as the most senior House Republican. Quillen's wife, Cecile, has been ill for several years.

In addition, Rep. Bill Zeliff (R-N.H.) said earlier this week he would not seek a fourth House term in order to run for governor this fall. Last week, two-term New Hampshire Gov. Steve Merrill (R) unexpectedly announced that he was leaving politics to spend more time with his family.

The two retirements bring to 65 the number of lawmakers who are not trying to return to the House this year, as 27 Democrats and 18 Republicans have said they will not seek reelection. Ten of those lawmakers are running for the Senate, while two Texas Democratic Reps. John Bryant and Jim Chapman were defeated in their bids for their party's Senate nomination.

In addition, Rep. Greg Laughlin (R-Tex.), a former Democrat, lost a primary race Tuesday, becoming the first incumbent to be defeated for reelection this year.

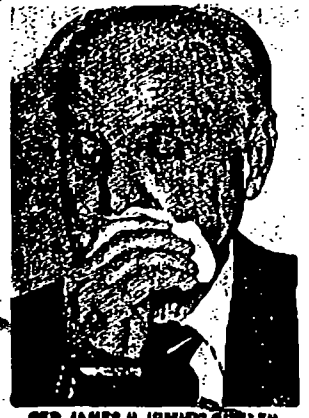
Quillen had often been considered a likely candidate for retirement. He had quintuple bypass surgery in March 1993 and began donating campaign funds to Tennessee hospitals and colleges because he did not expect to run for reelection in 1994. He changed his mind and, despite giving away about $600,000, still had $475,000 on hand for the race. He won with 73 percent of the vote.

A self-made man whose education ended with high school, Quillen's House career has been spent tending to his constituents in northeastern Tennessee. For many years he was the top Republican on the important House Rules Committee, where he showed a willingness to work with Democrats. In 1990, he gave up his ranking minority spot to the more confrontational Rep. Gerald B.H. Solomon (R-N.Y.). When Republicans took control of the House last year, Solomon became chairman and Quillen was given the title chairman emeritus.

Republicans should have little problem keeping Quillen's district, which is solidly Republican. President George Bush won 58 percent of the vote in 1992 despite the presence of then-Tennessee Sen. Albert Gore Jr. on the Democratic ticket, which carried the state.

Zeliff, 59, said he was leaving the House to try to become part of the "important transfer of power from the federal government to the states. . . . It will be our nation's governors who will be on the front lines of policy decisions that will greatly affect our quality of life," he said.

Voters in Zeliff's southeastern New Hampshire district have been reliably Republican, giving Bush a narrow victory there in 1992 even though President Clinton carried the state.



REP. JAMES H. "JIMMY" QUILLEN
. . . "my wife needs me"

The Backgrounder
The Heritage Foundation

CLINTON'S FY 1997 BUDGET: THE ERA OF BIG GOVERNMENT LIVES ON

Scott A. Hodge
Grover M. Hermann Fellow in Federal Budgetary Affairs

The Heritage Foundation
Backgrounder No. 1071
March 11, 1996

INTRODUCTION

Just weeks after telling the nation, in this year's State of the Union address, that the "era of big government is over," Bill Clinton indicated that the obituary notice was somewhat premature when he delivered his a 20-page FY 1997 budget to Congress. In contrast to the Balanced Budget Act of 1995 (BBA), which he vetoed last fall, the latest Clinton budget would mean $1,927 in higher taxes and $3,155 in higher spending for every household in America over the next seven years. This is the eighth budget plan Clinton has delivered to Congress in a year; and, except for the FY 1996 budget submitted last February (which called for $200 billion deficits through the end of the decade), each has been short on specifics and long on promises.

While Clinton claims his FY 1997 budget will eliminate the federal deficit by FY 2002 using Congressional Budget Office (CBO) estimates, it does so only by using the same assortment of smoke, mirrors, and other gimmicks that has made taxpayers increasingly cynical about Washington's commitment to budget-making. Even worse, although the Clinton budget balances on paper, it flinches from making the tough decisions needed to eliminate wasteful and outmoded programs, end welfare as we know it, save Medicare from bankruptcy, or transfer failing federal programs to the states.

The FY 1997 Clinton budget is not the end of big government, it is the embodiment of it. Clinton's plan, for example:

- Increases federal spending by $361 billion over the next seven years and hikes tax revenues by $526 billion;
- Spends a total of $12.16 trillion over the next seven years, or $306 billion more than the vetoed Balanced Budget Act of 1995. That means $3,155 more for every household in America;
- Raises a total of $11.4 trillion in tax revenues over seven years, $187 billion more than the BBA, and $1,927 more in taxes for every household in America;
- Allows $119 billion more deficit spending through 2002 than the BBA, which is equivalent to passing along $1,227 per household in debt to the next generation of American workers;

- Fails to eliminate a single program of any significance;
- Fails to eliminate even one Cabinet-level agency;
- Increases entitlement spending by $365 billion over the next seven years while failing to save Medicare from bankruptcy, end welfare as we know it, or protect states from the exploding costs of Medicaid; and
- Spends $111 billion more on discretionary programs than the BBA while calling for billions more in spending on programs that have failed or become obsolete, that duplicate others, or that should be transferred to state and local government control.

The FY 1997 Clinton budget signals not the end of big government, but the continuation of status-quo government.

CLINTON 8, TAXPAYERS 0[1]

Despite a campaign promise to balance the budget in five years while providing tax cuts for working families, President Clinton has consistently resisted congressional efforts to enact a balanced budget plan with tax cuts. In addition to vetoing the Balanced Budget Act of 1995, Clinton presented four budget plans to Congress during 1995 -- each time falling far short of balancing the budget, according to the Congressional Budget Office. After a year of prodding, Clinton presented a fifth budget plan on January 5, 1996. CBO certified -- at least on paper -- that this new proposal would balance the budget by 2002. Closer review of each of the budget plans proposed by Clinton during the past year, however, including the FY 1997 budget, shows that the White House has never been serious about either balancing the budget or providing meaningful tax relief. It seems interested only in finding ways to spend more taxpayer dollars while appearing to agree that the budget should be balanced.

Clinton Budget #1

In February 1995, the Clinton Administration responded to the 1994 election results by presenting a status-quo FY 1996 budget to the new Congress. This budget deviated little from "baseline" forecasts which projected $200 billion deficits through the end of the decade. According to CBO, the President's February budget would increase the deficit from an estimated $177 billion in 1995 to $276 billion in 2000. Spending would grow an average of 5 percent per year, some $422 billion in all in just five years.

The February Clinton budget did propose a few modest privatization initiatives, such as selling the Power Marketing Administrations, portions of the Strategic Petroleum Reserves, the Naval Petroleum Reserves, and portions of the National Weather Service. It also proposed terminating a few small programs and consolidating some 270 programs into 27 new programs. In addition, the budget proposed a "Middle Class Bill of Rights" which included a modest $300-per-child tax credit for families that have children below age 13 and who earn less than $60,000 per year. But the Administration did little to fight for any of these proposals. On May 19, the Senate defeated Clinton's budget plan by a vote of 99 to 0.

Clinton Budget #2

On June 13, 1995, after months of criticizing congressional efforts while offering no plan of his own, Clinton presented a second budget plan which he claimed balanced the budget in ten years, by FY 2005. This Clinton plan, barely 30 pages in length, fared no better than his first effort under CBO scrutiny. According to CBO, in addition to not balancing the budget, this plan would produce $200

scrutiny. According to CBO, in addition to not balancing the budget, this plan would produce $200 billion deficits for at least the next ten years.

The second budget plan also included the modest tax cut for families with children in addition to tax deductions for higher education and expanded Individual Retirement Accounts (IRAs).

Due to revised economic forecasts, the Administration later said that this plan would balance the budget in nine years. However, the CBO maintained that it would never balance the budget. Indeed, CBO found less than $400 billion in legitimate deficit reduction in this Clinton offer -- $350 billion short of the total seven-year deficit reduction in the Balanced Budget Act.

Clinton Budget #3

On December 7, the day Clinton vetoed the Balanced Budget Act of 1995, he presented yet a third budget plan. The Administration claimed that this plan also would balance the budget in seven years but was more in line with the President's priorities than the one he had vetoed.

Once again, CBO found that the Administration's numbers failed to reach a balanced budget by 2002. While this plan proposed larger savings from discretionary spending programs and welfare reform than the June budget, it also proposed smaller savings in Medicare and Medicaid. In total, Clinton's third budget produced only $385 billion in credible deficit reduction over seven years -- $365 billion short of the savings achieved by the BBA he had vetoed. Moreover, according to the CBO, instead of balancing the budget in FY 2002 as advertised, it would leave a deficit of $115 billion in that year.

Clinton Budget #4

On December 15, after two weeks of negotiations with congressional leaders, Clinton presented a fourth budget plan. But this plan was mostly an iteration of Budget Plan #3 and contained no new policy recommendations.

The CBO scored this plan as $69 billion out of balance in FY 2002. The Administration tried to make up for its shortcomings in reducing the deficit by challenging CBO technical and economic estimates. The Administration had been arguing for weeks that CBO's economic assumptions were too conservative and thus required excessively deep spending cuts to balance the budget. In other words, the Administration wanted to have it both ways: Claiming that it wanted to balance the budget, it actually wanted to spend more money as the budget was moving toward balance.

On December 18, the House defeated this plan by a vote of 412 to 0.

Clinton Budget #5

On January 6, 1996, Clinton presented a fifth budget plan to Congress. This plan, largely adapted from a proposal by Senate Democrats, was certified by CBO to balance the budget in seven years, at least on paper.

It is likely that Clinton never would have submitted this plan had it not been for the conditions Congress included in the continuing resolution passed on January 5, 1996. These conditions stipulated, in effect, that a bill to provide operating funds for unappropriated federal programs through January 26 would not be sent to the President until he submitted a seven-year balanced budget plan scored by the CBO.

Though it mathematically balances the budget in seven years, the fifth Clinton budget falls far short of being credible. The reasons:

In the fifth Clinton budget, most of the heavy lifting of deficit reduction was required in the two years following the end of Clinton's possible second term as President. Indeed, 62 percent of the plan's $583 billion in deficit reduction fell in FY 2001 and FY 2002. For example, the plan called for $102 billion in Medicare savings over seven years, but 63 percent of these savings was to come in the last two years. Similarly, the plan called for $37 billion in discretionary spending cuts beyond the savings needed to achieve a "hard freeze" in these programs, yet 95 percent of these additional savings fell in the last two years.

While the fifth Clinton budget plan called for $87 billion in gross tax cuts ($17 billion in net tax cuts) over seven years, these cuts were "sunsetted" in FY 2001 -- one year before the budget would be balanced. This means taxes would have to be raised. Mathematically, such a ploy "boosts" tax revenues by at least $15 billion in FY 2002 and thus requires fewer spending cuts to achieve a balanced budget. The overall size of the tax cut proposal is reduced by the plan's call for $60 billion in new revenue from closing "corporate loopholes."

Some 43 percent of the revenues generated from these tax hikes would be received in FY 2002.

Clinton Budget #6

The sixth Clinton plan was submitted to Congress on January 9. It moved only slightly beyond the previous plans, modestly increasing the proposed savings from Medicare, Medicaid, and welfare reform while boosting the net size of the tax cuts to $85 billion. Overall, this Clinton plan would produce nearly $160 billion less in budget savings than the last congressional offer and nearly $70 billion less in deficit reduction. Moreover, the White House still avoided the fundamental reforms in Medicare, Medicaid, and welfare needed to achieve budget savings and restructure the programs.

Clinton Budget #7

The seventh Clinton plan was submitted to Congress on January 18. This budget plan was essentially identical to the January 9 plan except that it substantially increased the amount of new revenues it would generate from closing "corporate tax loopholes" and other such devices. Because of these new revenues, the net size of the tax cut would be reduced to a mere $36 billion over seven years.

Clinton Budget #8: The FY 1997 Budget

Like the seven budget plans that preceded it during the past year, the FY 1997 Clinton budget, presented to Congress February 5, would force hard-working Americans to pay higher taxes in exchange for more spending on programs which have become old and obsolete, or which are ripe for termination, privatization, or transfer to state control. Moreover, each plan ignores the fundamental problems facing the government's major entitlement and welfare programs. Clinton has shirked his responsibility to address, for instance, a Medicare program facing insolvency, a Medicaid program that is bankrupting state budgets, and a welfare system that perpetuates a culture of poverty.

WHAT CLINTON'S FY 1997 BUDGET WOULD MEAN

The eight Clinton budgets clearly demonstrate that this President envisions a government that has a balanced budget but somehow remains largely unchanged from government with perpetual $200 billion deficits. In other words, Clinton wants it both ways. He says he wants a balanced federal budget, but he is

deficits. In other words, Clinton wants it both ways. He says he wants a balanced federal budget, but he is not willing to challenge the size and scope of government as a credible balanced budget plan requires.

The boldest proposal the Administration can muster is to "reinvent government," which, in practice, amounts to putting a new paint job on a house whose foundation is collapsing under its own weight. American taxpayers sent government a very clear message in the 1994 election: They do not want useless and obsolete programs merely to waste their money more efficiently. They want the budget to be balanced in a timely fashion, and they want the result of this effort to be a smaller, less costly government.

The Clinton FY 1997 budget would leave less money in the pockets of working families and more money in the hands Washington's big spenders.

It spends money taxpayers cannot afford. The 20-page FY 1997 Clinton budget proposes to "balance the budget" in FY 2002 while boosting spending $361 billion over the next seven years. It would spend a total of $12.16 trillion over the next seven years, $306 billion more than would be spent under the Balanced Budget Act the President vetoed last December. This amounts to $3,155 more government spending for every household in America.

It takes more of their money in tax revenues. The Clinton budget assumes federal tax collections will grow an astonishing $526 billion by FY 2002, a jump of nearly 39 percent. Also, the Administration expects the government to collect a total of $11.4 trillion in tax revenues over the next seven years, $187 billion more than under the BBA. This amounts to $1,927 more in taxes for every household in America.

It adds to tomorrow's debt burden. Because the Clinton budget fails to control federal spending, it would add $755 billion in accumulated deficits to the national debt, even while promising to balance the budget over seven years. Compared to the BBA, this is $119 billion more deficit spending over seven years, equivalent to transferring $1,227 per household in added debt to the next generation of American workers.

Balancing the Budget Without Lifting a Finger

As was the case with Clinton's previous "balanced budget" plans, the only way the FY 1997 budget can be made to balance -- at least on paper -- is by leaving the real work of deficit reduction to a future President and Congress. How does it do this?

First, the Clinton plan purports to save nearly $596 billion over the next seven years, but less than 40 percent of these savings is achieved during the first five years. The painful task of accomplishing 61 percent of the plan's deficit reduction falls to the first Congress and President elected in the next century. Indeed, some 54 percent of the plan's Medicare savings and 60 percent of its Medicaid savings will fall beyond a possible second Clinton term in office.

Second, while Clinton claims his budget balances according to Congressional Budget Office assumptions, it does not. Clinton makes his job of balancing the budget in FY 2002 easier by challenging or ignoring CBO assumptions.[2] For instance, CBO currently projects a $228 billion deficit in FY 2002. Clinton, however, reduces that projection to $221 billion by challenging one of CBO's technical assumptions, thereby avoiding the need to cut $7 billion in spending. Also, Clinton's budget uses Office of Management and Budget (OMB) estimates of proposed spectrum auction proceeds, rather than CBO estimates, to produce an additional $11 billion in deficit reduction in FY 2002 -- again, to avoid having to produce real spending cuts. The Senate Budget Committee reports that if honest accounting methods were used, Clinton's budget would produce a $9 billion deficit in FY 2002, not the balance the Administration claims.

Administration claims.

Modest Tax Cuts, More Tax Increases

The Clinton budget also manipulates its proposed tax cuts in order to avoid having to make tough choices on curbing spending. The budget proposes a meager $98.5 billion in gross tax cuts over seven years, equivalent to returning just 8 cents of every $1,000 in taxes the government expects to collect. The centerpiece of the plan is a tax credit for dependent children that begins at $300 per child and increases to $500 per child in 1999.[3] However, Clinton "sunsets" the child credit after FY 2001, increasing taxes on these families by over $17 billion in 2002 -- the year Clinton promises to balance the budget.

The Clinton budget proposes to generate $59.4 billion in new tax revenues by "cutting corporate tax subsidies, closing loopholes, and improving tax compliance."[4] This amount exceeds the Administration's proposed seven-year savings in Medicaid ($59 billion) and is nearly 50 percent greater than its proposed welfare cuts ($40 billion). These new revenues effectively reduce the net size of the tax cut package to $39 billion, equal to a cut of just 3 cents for every $1,000 taxpayers will send Washington over the next seven years.

One of the major contributing factors in the Clinton budget's ability to "balance" the budget in FY 2002 is the temporary nature of the tax cuts combined with the permanent nature of the new tax revenues. The new tax measures purportedly generate $11.9 billion in FY 2002. When this amount is added to the $17 billion tax hike on families resulting from the unseating of the child tax credit, the result is $29 billion in deficit reduction, roughly 15 percent of Clinton's total deficit savings in FY 2002. Again, there is no need to make tough choices on real spending cuts.

The Failure to Address Exploding Entitlement Growth

Regrettably, Clinton proposes no credible solutions to the serious problems facing the nation's major entitlement programs, such as Medicare, Medicaid, and welfare. The meager savings the Administration proposes to achieve from these programs fall far short of stemming the tide of red ink in the near term -- and far short of the fundamental changes needed to keep these programs from collapsing. The White House has been warned repeatedly of the need to curb runaway entitlements:

CBO projects that, if nothing is done to slow the overall growth of entitlement programs, they will grow by $465 billion over the next seven years, a 63 percent increase. Worse yet, CBO expects entitlements to consume 57 cents of every dollar spent by the federal government in 2002 -- over 8 cents more than is spent today.

The long-term forecasts reported by the Bipartisan Commission on Entitlement and Tax Reform, headed by Senators Robert Kerry (D-NE) and John Danforth (R-MO, now retired), are even more troubling. These projections suggest that entitlements will become a liability that cannot be sustained by the federal government, by the economy, or by the taxpayers.

Some examples of the Commission's findings:

> **Example:** "The gap between Federal spending and revenues is growing rapidly. Absent policy changes, entitlement spending and interest on the national debt will consume almost all Federal revenues in 2010. In 2030, Federal revenues will not even cover entitlement spending."[5]

> **Example:** "By 2030, unless appropriate policy changes are made in the interim, projected spending for Medicare, Medicaid, Social Security, and Federal employee retirement programs alone will consume all tax revenues.... If all other Federal programs (except interest on the national debt) grow no faster than the economy, total Federal outlays would exceed 37 percent of the economy. Today, outlays are 22 percent of the economy.... "[6]

> **Example:** "The share of Medicare Part B cost paid by enrollees as monthly premiums has been shrinking since the program began. When the program started, the enrollee and the Federal government had a 50-50 partnership -- each paid 50 percent of the cost. Today, the Federal government pays 70 percent of Part B costs; by 2030 the government's share is projected to increase to 92 percent."[7]

Entitlements grow as a share of budget. Under the proposed FY 1997 Clinton budget, overall entitlement spending would increase by $365 billion (nearly 50 percent) over the next seven years. While the Clinton plan would slow the aggregate growth rate of these programs to an average of roughly 6 percent per year from a CBO-projected average of 7.2 percent per year, entitlement programs will increase substantially as a share of the overall federal budget. Currently, mandatory programs consume 48.7 cents of every dollar spent by the federal government. The Clinton budget plan would increase the share of federal spending dedicated to these programs to 58.8 cents of every federal dollar by FY 2002.

One reason is Clinton's failure to address significantly the systemic problems within these programs. The other reason is that Clinton's budget plan achieves more than 55 percent of its overall deficit savings from discretionary programs -- which comprise just 36 percent of federal spending. As these annually appropriated programs shrink as a share of total spending, a greater share of the federal budget is consumed by "uncontrolled" entitlement spending.

Medicare is left at risk. In April 1995, the Medicare Trustees issued a warning that the Medicare Hospital Insurance (HI) Trust Fund was in severe financial imbalance and that Congress should take "timely action to establish long term financial stability for the program."[8] Indeed, recent figures from the Health Care Financing Administration (HCFA) show that in 1995, the HI program paid out $35.7 million more in benefits than it took in through the HI payroll tax, thus forcing HCFA to reduce the trust fund's accrued balance to pay its bills. This is a sign that the HI trust fund, which is expected to go bankrupt by the year 2002, could face a financial crisis even earlier than has been feared.

Despite these warning signs, the Clinton Administration's Medicare reform proposal falls short of restoring the long-term solvency of the program. Even though the President's budget promises to reduce the growth of Medicare spending by $124 billion over the next seven years compared to CBO projections, it provides too few details to justify such claims. The plan purports to allow beneficiaries more choices from the private sector, but it does not replace today's defined benefit program with a defined contribution program that truly gives America's seniors an unprecedented opportunity to choose their own health plan and range of benefits.

Furthermore, the President's budget proposal maintains a heavy taxpayer subsidy of Medicare's Part B premiums by requiring beneficiaries to pay only 25 percent of Part B program costs. The original Part B program required beneficiaries to pay premiums which reflected one-half of program costs. Maintaining the taxpayer subsidy at 75 percent means there are not enough incentives to encourage enrollees to compare the costs and benefits of more efficient private alternatives with the costs and benefits of the Part B program. The more the subsidy is reduced, the more level the playing field between private-sector plans and government. The elderly would have incentives to choose more efficient plans in the private sector. The likely result: not just a reduction in the subsidy, but a significant reduction in gross budget outlays for

The likely result: not just a reduction in the subsidy, but a **significant reduction in gross budget outlays** for Medicare.

More Medicaid costs are shifted to the states. The Clinton Medicaid reform proposal would exacerbate the crisis facing most state governments: growing Medicaid costs that are siphoning off precious resources from such other priorities such as education, prisons, and infrastructure. Heritage Foundation analysts have calculated that "if no changes are made to current law, the states and the District of Columbia probably will need to raise taxes or cut other spending by $146 billion over seven years in order to meet their mandated obligations."[9]

Clinton's proposal would control federal Medicaid costs by some $59 billion over seven years by implementing a "per capita cap" on the amount Washington sends to states to provide health care for the poor and elderly. But this purported reform retains Medicaid's existing entitlement structure by maintaining most of the current eligibility requirements in Title XIX of the Social Security Act. Maintaining these federal strings could impose an additional $47.4 billion in Medicaid costs on already financially strapped states.[10]

Limiting federal Medicaid expenditures while increasing the financial exposure of the states is irresponsible. The President's proposal does not allow states the flexibility they need to design benefit packages or other major program parameters. If the federal government is going to cap its Medicaid expenditures, the states must be allowed to establish new benefit packages, provider reimbursement systems, and -- most important -- eligibility criteria. While the Administration's proposal allows for some limited changes in managed care enrollment, it represents a large unfunded mandate to the states because they will not have the freedom to control costs as dictated by the federal per capita caps. The magnitude of an such an unfunded mandate will vary from state to state because of differences in population. However, a large state, such as California, could face additional costs of $4.4 billion from the per capita cap.

Welfare reform ignores the root causes of poverty. The Clinton welfare reform proposal will hardly make a dent in the massive federal welfare system that has cost taxpayers $5.5 trillion since 1965. The federal welfare system is a vast network of 78 interrelated, overlapping, means-tested programs designed to assist poor or low-income Americans. The cost to all levels of government was $350 billion in 1994, with Washington contributing 72 percent. This amounts to $3,400 for every taxpaying household in America.

Clinton proposes to trim the welfare state by an unnoticeable $40 billion over the next seven years. Real reform would send programs back to the states with only a few necessary strings attached, but the Clinton plan keeps the existing structure of federal anti-poverty programs and talks vaguely about giving flexibility to the states. Clinton also talks in tough terms about imposing real work requirements on welfare recipients but the reforms drafted by the Administration contain only sham work requirements.

The most serious flaw in the Clinton welfare plan is its failure to address one of the major root causes of poverty: illegitimacy. Since 1965, the percentage of children born out of wedlock has grown from 7 percent of all children to 32 percent -- an almost five-fold increase. Rather than deal substantively with this problem, the Clinton plan simply tries to address the symptoms by spending more on job training and child care programs.

Spending Initiatives That Outweigh Spending Cuts

While stating that "government should not do for individuals what they can do for themselves," the Clinton budget outlines a sweeping agenda of spending initiatives in areas such as education, high

Clinton budget outlines a sweeping agenda of spending initiatives in areas such as education, high technology, crime fighting, and the environment. Remarkably, the discussion of this new spending falls under the heading "Spurring Economic Growth," thus confirming the Administration's strange and obsolete notion that directed government spending, not private spending, is the key to creating jobs and economic growth. Nowhere, however, does Clinton's budget provide even a hint of how it intends to achieve the $297 billion in discretionary spending cuts that comprise 55 percent of its deficit reduction plan. These details, presumably, will be outlined in the Administration's full FY 1997 budget, due to be published this month.

Clinton's spending initiatives would add yet another layer of bureaucracy to the hundreds of failed programs currently funded in the federal budget in areas the President claims are priorities. Clinton has an obligation to explain to taxpayers why these hundreds of existing programs have failed, and why they have not been eliminated, before trying to justify pumping even more money into these areas.

Some of these new spending priorities include:

Job training. The budget proudly states that the Administration has shifted more money into job training programs and would increase funding for Skill Grants for dislocated workers. Yet:

- The General Accounting Office (GAO) reports that 14 separate federal departments and agencies currently fund some 164 job training programs at a cost to taxpayers of roughly $25 billion per year. Moreover, the few controlled studies that have been conducted show that these programs have little or no success either in putting people to work or in raising their wages.

Education. The Administration claims it has shifted more money to education programs such as Goals 2000 and the Safe and Drug-Free Schools and Communities program. Now Clinton wants new programs to "connect every classroom to the information super-highway," in addition to expanded work-study for college students, merit scholarships for high school students, and charter schools. Yet:

- The Department of Education already manages roughly 240 programs, dozens of them targeted to the same students for whom Clinton would create new programs. Indeed, Goals 2000 does little to benefit students; it primarily funds state bureaucracies and duplicates many programs currently operated by the states. Also, many states already are experimenting with reform initiatives such as charter schools and do not need Washington's help. Moreover, there are some 240 programs targeted to "at-risk youth" scattered throughout such agencies as the Departments of Education, Health and Human Services, Justice, and Labor. Creating more programs targeted to these young people only adds to the bureaucracy.

Science and technology "investments." The Clinton budget places great emphasis on maintaining Administration's investments in high-technology spending. Yet:

- These myriad "investment" programs have turned out to be little more than expensive corporate welfare. There is evidence to suggest that these programs not only do not create jobs, but actually may induce the recipient corporations to downsize their research and development departments.[11] Many corporations figure there is no reason to fund their own R&D if Washington will pick up the tab for them.

Crime. The Clinton budget "fully funds the President's Community Oriented Policing Services (COPS) initiative," which the Administration claims will put 100,000 new police officers on the street. Clinton claims this program is responsible for the hiring of 23,000 new policemen to date. Yet:

- The problem with Clinton's promise to put 100,000 new police officers on the street by 2000 is that the math does not work. The 1994 crime bill, which authorized the COPS initiative, provided $8.4 billion in federal funds over six years, enough money either to put only 20,000 permanent new policemen on the street or to pay 100,000 officers less than $15,000 per year. Since police officers make more than the minimum wage, state and local governments that accept these federal funds will have to finance the remaining cost themselves -- a cost that could total $28 billion over six years.[12] Congress would change this program from a matching grant to a simple block grant, allowing local governments to use the funds for other law enforcement-related purposes such as purchasing equipment, paying overtime, and establishing neighborhood programs. Clinton has rejected these reforms, and the reason is obvious: Block granting the funds will not force local governments to pay for Clinton's campaign promises.

Discretionary Spending "Cuts"

The Clinton FY 1997 budget proposes to spend $111 billion more on discretionary programs than the Balanced Budget Act the President vetoed, while claiming to save $297 billion over seven years from these programs. How can this be true? The truth is these savings are calculated from the CBO "baseline," which projects higher spending on discretionary programs in future years. Thus, simply freezing aggregate spending on these programs at FY 1995 levels "saves" $258 billion over seven years. The roughly $40 billion in additional "savings" (bringing the total to $297 billion) is due to Clinton's proposal to spend less in future years, below what was spent in 1995. However, the Clinton budget would implement 95 percent of these cuts in FY 2001 and FY 2002, thus leaving the tough decisions to a future President and Congress.

CONCLUSION

The era of big government is far from over. The Administration's repeated use of gimmicks and accounting ploys to "balance the budget" casts doubt on its sincerity in negotiating a balanced budget plan with Congress. At every turn, Clinton fought attempts to cut spending, or even to reduce the growth in spending. Clinton challenged CBO's conservative economic assumptions because they required greater savings to balance the budget. In other words, he wanted more money for favored programs while claiming to support a balanced budget. Clinton repeatedly called on Congress to reduce the size of the BBA's tax cut package, not because eliminating the tax cuts would balance the budget any faster (say in five years rather than seven), but because smaller tax cuts would allow more money for government spending. The record is clear: Bill Clinton prefers keeping money in the hands of Washington bureaucrats to keeping it in the pockets of American taxpayers.

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Endnotes:

1. This section is derived largely from the forthcoming Heritage Foundation publication *Issues '96: The Candidate's Briefing Book*. Sources for figures: Congressional Budget Office and House Budget Committee, Majority Staff.

2. For a detailed analysis of these gimmicks, see Senate Budget Committee, Majority Staff, *Budget Bulletin* No. 5, February 12, 1996.

3. The Administration's child credit begins phasing out for families with incomes above $60,000 and reaches zero at $75,000 in family income. Only families with children under age 13 (ages 12 and below) are eligible for the credit. For a detailed analysis, see Scott A. Hodge, "Balanced Budget Talking Points #5: Clinton's $300-Per-Child Tax Cut Plan Denies Tax Relief to 23 Million Children," Heritage Foundation *F.Y.I.* No. 78, December 11, 1995.

4. Clinton FY 1997 Budget, p. 14.

5. Bipartisan Commission on Entitlement and Tax Reform: Final Report, January 1995, p. 4.

6. *Ibid.*, p. 8.

7. *Ibid.*, p. 18.

8. *1995 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund*, April 3, 1995, p. 4.

9. William W. Beach, "Updated Estimates of the Costs to the States of Not Reforming Medicaid and the Additional Costs of Adopting Per Capita Caps," Heritage Foundation *F.Y.I.* No. 81, December 18, 1995. p. 1.

10. *Ibid.*

11. Gilbert M. Gaul and Susan Q. Stranahan, "High-Tech Handouts," a seven-part series published in *The Philadelphia Inquirer*, June 3 to June 10, 1995.

12. Scott A. Hodge, "The Crime Bill's Faulty Math Means a $28 Billion Unfunded Liability to the States," Heritage Foundation *F.Y.I.* No. 29, August 16, 1994.