# A Strategy for Growth

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# Executive Summary

As the U.S. economy languishes at the start of an election year, leaders in both political parties are proposing tax relief as a remedy. Ill-conceived tax cuts, however, would do nothing to help the economy and would further increase the federal deficit. Fortunately, there is a better way. By selectively *reducing* taxes on capital and labor, we can stimulate the economy and reduce the deficit *at the same time*. This pro-growth strategy focuses on three types of tax measures.

**Inflation Indexing.** Although the tax code is indexed to prevent wage earners from being pushed into higher tax brackets by the effects of inflation alone, there is no similar protection for owners of capital. Currently, higher rates of inflation reduce the aftertax return on almost every type of investment. Change is needed especially with respect to capital gains and depreciation of investment in plants and equipment.

**Lowering Taxes on Capital.** Tax rate reductions in the 1980s provided an important stimulus to the economy and led to the longest peacetime economic expansion in our history. Yet recent increases in taxes on capital have had a depressing effect and are responsible for the current economic slowdown. In particular, the 1986 Tax Reform Act raised the tax rate on capital gains by 40 percent and limited the ability of people to save through IRAs and 401(k) plans. The Social Security benefit tax has eroded the value of all tax-deferred savings for a majority of American workers. These policies need to be changed.

**Lowering Taxes on Labor.** The economic expansion of the past decade was primarily due to an increased supply of labor induced by lower marginal tax rates. For millions of American workers, however, increases in the Social Security (FICA) payroll tax rate have more than offset the reductions in the income tax rate — despite the fact that higher payroll taxes are not needed to pay Social Security benefits. Moreover, a punitive retirement earnings penalty for elderly workers is encouraging unnecessary retirement at a time when American industry desperately needs their skills. These policies also need to be changed.

The pro-growth strategy in this report is based on policies that have been endorsed by Republicans and Democrats in Congress. If adopted, the proposals' economic benefits would be substantial:

- The pro-growth strategy would increase the annual U.S. economic growth rate by well over 1 percentage point over the decade of the 1990s.
- Gross domestic product (GDP) would increase by about $560 billion per year.
- By the end of the decade, there would be 3.6 million additional jobs.

The phase-in of this pro-growth package would be consistent with the budget-balancing objectives of the budget summit agreement. In Phase I, selected tax cuts would produce $129 billion in new revenue over the next five years. When combined with expected cuts in federal spending, the five-year deficit of the federal government would be reduced by almost $400 billion, producing a surplus beginning in 1996. To eliminate this surplus and provide a further stimulus, additional Phase II pro-growth measures would be adopted at mid-decade.

# Introduction

The United States experienced the longest peacetime economic expansion in its history, due to tax reductions enacted during the 1980s. The growth of output and income over the past decade cannot be explained by any other factor. Harvard economist (now Federal Reserve Board Governor) Lawrence Lindsey has called the tax cuts of the early 1980s "the growth experiment" and noted the overwhelming evidence from that experiment:[1]

> "Some of the more extreme supply-side hypotheses were proven false. But the core supply-side tenet — that tax rates powerfully affect the willingness of taxpayers to work, save, and invest and thereby also affect the health of the economy — won as stunning a vindication as has been seen in at least a half century of economics."

*"All major forecasters are predicting sluggish growth for the next five years."*

Unfortunately, we now face the prospect that the lessons of the 1980s will be forgotten or ignored. Until the first quarter of 1990, the economy had shown an extremely steady growth of about 3.3 percent over the prior five years. Since then there has been virtually no growth, however. Unless we remedy the causes of the current downturn, our economy faces a permanent reduction in its rate of growth. With the return to higher levels of regulation, government spending and taxes, combined with a looser monetary policy, the economy is now in serious danger of reverting to the slower growth "malaise" of the late 1970s.

# The Need for a Pro-Growth Strategy

The current downturn is a natural reaction of the U.S. economy to higher levels of production costs resulting from a reversal of government policies. Businesses have adjusted investment and hiring to reflect the lowered prospects for sales and profits. These responses by business have resulted in lower GNP, fewer jobs and less investment.

**Current Forecasts.** According to the forecasters, the future does not look bright:[2]

- The Office of Management and Budget is forecasting average real growth for the economy of only 2.6 percent through 1996.
- The Congressional Budget Office is forecasting an average growth rate of only 2.3 percent.

- Lawrence Kudlow (Bear, Stearns) is forecasting a growth rate for the next six quarters of 3 percent—about half of what is normal in the early stages of an economic recovery.

The forecasted sluggish growth rate will impose a heavy burden on American families relative to the past performance of the American economy:[3]

- If the economy grows at only 2.5 percent over the next five years instead of at the 3.3 percent rate posted over the five year period 1985 to 1989, the loss of output will equal $2.3 trillion. [See Figure I.]

- The slower growth rate will mean fewer jobs created, 44 million man-years of lost labor and $875 billion in lost wages.

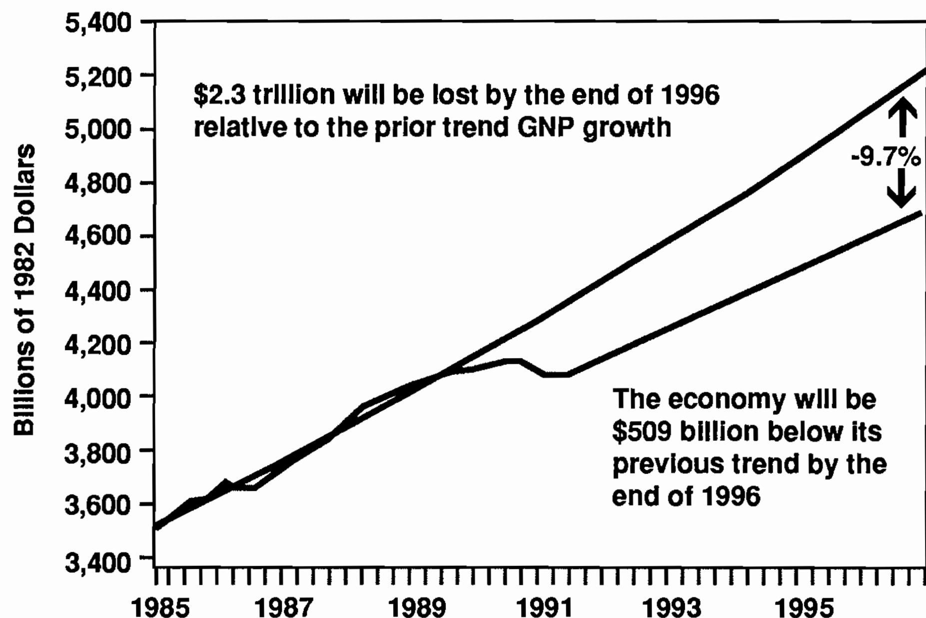
- Government will also suffer as a result of $520 billion in less revenue for the federal government and $350 billion in less revenue for state and local governments.

*"The slower rate of growth will mean $2.3 trillion in lost output."*

**FIGURE I**

**Potential GNP Loss With Low Growth**

**Prior Trend Growth vs. 2.5 Percent**




Source: "Statement of Gary Robbins" in John C. Goodman, ed., "Pro Growth: The Proceedings of the Senate Republican Conference Task Force on Economic Growth and Job Creation," National Center for Policy Analysis, NCPA Policy Report No. 167, January 1992.

**Causes of the Recession**. The reasons for slower growth are the same as the reasons for the current recession: higher taxes on labor and capital and an increase in costly regulations over the past three years. The current recession is a man-made event, not a natural one, and the price the American people are paying has been high. A number of factors have combined to slow the economy:[4]

*"Causes of the recession: higher taxes and costly regulations."*

- A substantial Social Security payroll tax rate increase combined with an unexpectedly large increase in covered earnings has raised the tax on working and raised the cost of hiring labor.
- Increased regulations, most notably in the environmental area, have increased future costs of production.
- State and local governments have increased tax rates to offset a drop in the *rate of increase* in their revenues.
- Federal government spending and tax rates increased as a result of last year's budget summit.
- The attractiveness of home ownership and commercial real estate dropped dramatically as the real estate market absorbed the "hit" of a substantial, retroactive increase in capital gains tax rates.

**Prospects for Small Business.** The one sector of the economy that is most sensitive to the effects of taxes and regulations is the small business sector As Kudlow explains:[5]

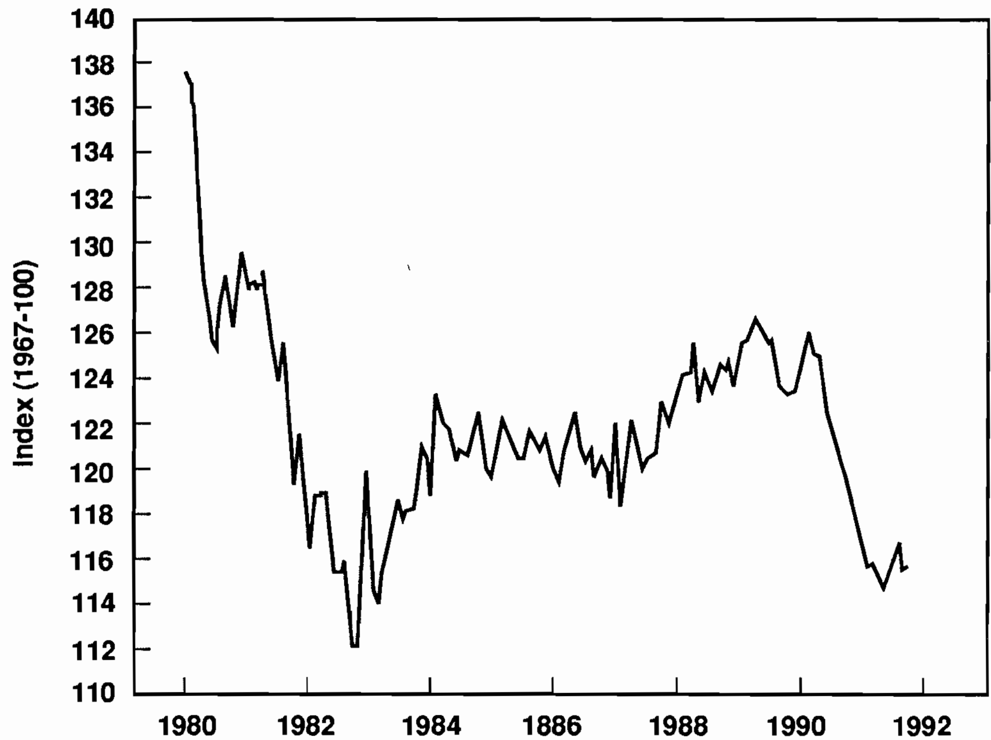
- More than 90 percent of the 18 million jobs created in the 1982-1990 expansion were created by small and new businesses.
- Yet the rate of new business formation is down 12 percent and nonfarm proprietors' income—which measures the strength of self-employed business people—has been growing at a real rate of only 1.6 percent over the past year, compared with an 11 percent growth rate in 1983. [See Figures II and IV.]

As Housing and Urban Development Secretary Jack Kemp observes, blacks, Hispanics and other minorities have the most to gain from economic expansion and have the most to lose from the depressing conditions in the small business sector:[6]

- The economic expansion of the 1980s created 4.5 million new entrepreneurs.

*"The sluggishness of the recovery is due to the failure to reignite new business formation."*

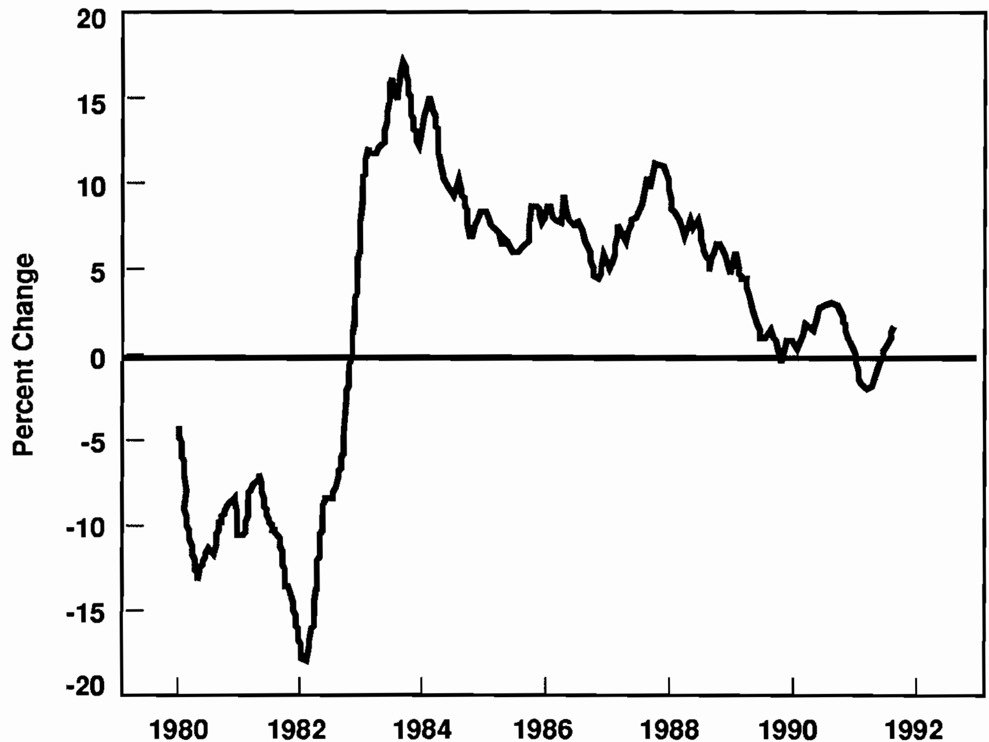
FIGURE II




Source: Lawrence Kudlow, Bear, Stearns.

*"The income of self-employed people is showing virtually no sign of recovery."*

FIGURE III




Source: Lawrence Kudlow, Bear, Stearns.

- That included an 80 percent increase in Hispanic-owned businesses, a 50 percent increase in female-owned businesses, a 40 percent increase in black-owned businesses and probably a 60 percent increase in Asian-owned businesses.

What should be done? The economy cannot achieve a higher growth rate unless we create new incentives for people to work and save and invest.

## Where Are We Now?

According to the latest government economic forecast, the federal budget will run a $348.3 billion deficit in fiscal year 1992. As Table I shows, by 1996, the deficit is expected to narrow to $55.5 billion on a unified basis.

This forecast assumes that the recession ended in the second quarter of 1991 and that a recovery is under way. Data since last July, however, indicate that the economy is much weaker, and some believe that the recovery will not begin until the second or third quarter of 1992. Poor economic performance is taking its toll on revenues. For example, at the close of fiscal year 1991, federal individual income tax receipts were $14.1 billion short of the scaled back projections made three months earlier.[7]

- Because of a continuing weak economy, we project that the fiscal year 1992 deficit will be $12 billion higher and that the deficit in 1996 will be twice the official forecast.

- The cumulative deficit over the next five years will be in excess of $1 trillion.

*"The cumulative federal deficit over the next five years will exceed $1 trillion."*

**TABLE I**

### Current Law Federal Budget Deficit

**($ billions)**

| Fiscal Year | Total Spending | Total Receipts | Official Deficit[1] | NCPA Estimated Increase | NCPA Estimated Deficit |
|---|---|---|---|---|---|
| 1992 | 1,493.8 | 1,145.5 | 348.3 | 12.2 | 360.5 |
| 1993 | 1,478.9 | 1,233.3 | 245.6 | 25.4 | 271.0 |
| 1994 | 1,466.4 | 1,334.3 | 132.1 | 39.1 | 171.2 |
| 1995 | 1,500.7 | 1,427.1 | 73.6 | 52.5 | 126.1 |
| 1996 | 1,572.5 | 1,517.0 | 55.5 | 55.8 | 111.3 |
| Five-year deficit | | | 855.1 | 185.0 | 1,040.1 |

[1]Based on Mid-Session Review.

*"Wealthy taxpayers would pay more taxes if the capital gains tax rate were cut."*

# Pro-Growth Tax Measures: Phase I

In order to avoid increasing deficits and low economic growth, the United States needs pro-growth tax cuts designed to reduce taxes on capital and labor and increase economic activity. The proposed tax measures are as follows:

**Reduction in the Maximum Capital Gains Tax Rate.** Because the tax brackets are indexed, wage earners cannot be pushed into a higher tax bracket by the effects of inflation alone. There is no similar protection for savers, however. People who sell assets are forced to pay taxes on inflation-created profits even if there has been no real profit.

Historical experience and most academic studies confirm that a reduction in capital gains tax *rates* will produce more revenue in the form of *total* capital gains taxes.[8] Lawrence Lindsey, for example, estimates that government would collect maximum revenue at a rate of about 15 percent.[9] Capital gains tax reform would also:

- Help reduce the federal government's liability in the savings and loan crisis, because it would immediately make the assets of defunct S&Ls more valuable to investors.[10]

- Make the middle-income elderly less dependent on the younger population. About one of every three elderly taxpayers has a capital gain each year, and among the middle-income elderly that figure rises to one out of two.[11]

- Increase federal revenue, in a highly *progressive* way. Taxpayers earning $75,000 or more would pay most of the increased tax payments.[12]

Senators Robert Kasten (R-WI), Connie Mack (R-FL) and Richard Shelby (D-AL) proposed the Economic Growth and Venture Capital Act of 1990. This legislation would reduce the tax rate on long-term capital gains from the sale of all capital assets. The plan couples indexing of capital gains — a major feature of the bill passed in 1989 by the House of Representatives — with a reduction in the capital gains tax rate to a maximum of 15 percent — the rate proposed by President Bush during his 1988 presidential campaign. Specifically, the proposal would:

- Lower the maximum capital gains tax rate from the current 28 percent to 15 percent on all capital assets.

- Establish a 7.5 percent rate for those taxed at the 15 percent federal personal income tax rate.

- Eliminate from taxation that part of capital gains which is due to inflation and adjust the limit on capital losses for changes in the price level (as currently is done for income tax rate brackets).

- Establish a single one-year holding period for assets to qualify for favorable tax treatment.

- Extend the favorable capital gains treatment to corporations.

*"A lower capital gains tax rate would reduce the cost of capital by 5 percent for the economy as a whole."*

We estimate that this plan would reduce the tax on capital by 8.6 percent in 1995 and by 10 percent in the year 2000. The economic effects grow over time as the indexing provision removes from taxation an increasingly larger portion of capital gains due solely to inflation. This lower tax on capital would reduce the cost of capital for the economy as a whole by about 5 percent, which would lead to more investment, more jobs and more growth.

**Indexing for Depreciation of Equipment Investments.** The tax code also fails to index the depreciation of productive assets in order to allow for their replacement. In a period of no inflation, the tax law is reasonably fair. But if inflation averages 5 percent per year, a company must spend 50 percent more to replace a machine after eight years. This means the company must earn additional income and pay additional taxes equal to about one-fourth the replacement cost.

Current tax treatment of depreciation also spreads out the recovery of the original cost of the investment. The total amount allowed to be depreciated over time equals the original purchase price only. However, because of the time value of money, amounts written off after the first year have a lower present value and, therefore, represent only partial tax offsets for depreciation.

To deal with this problem, the 1981 tax law incorporated new investment incentives, of which the Accelerated Cost Recovery System (ACRS) was the most important. The results were dramatic:[13]

- The economic recovery of the early 1980s was the most investment-oriented recovery on record, despite high real interest rates.

- Whereas in a normal recovery, investment expands 8 to 9 percent in the first two years, in the Reagan recovery, investment expanded at twice that rate.

ACRS was eliminated by tax reform in 1986. In order to repeat the experience of the early 1980s, we need to remove inflation-created disincentives to invest in plants and equipment. Inflation indexing is a reasonable way, and it can also be revenue neutral. As a member of Congress, Jack

Kemp proposed the Neutral Cost Recovery System which would index depreciation and *increase* federal revenue in every future year. The proposal would adjust current tax depreciation schedules each year so that depreciation after the first year is equivalent to its first-year value. A further adjustment would reflect the increase in recovery costs due to inflation. The neutral cost recovery proposal holds the investor harmless for the time value of money and protects tax depreciation write-offs against inflation. It provides an immediate incentive, an effect similar to giving a $90 billion tax cut on new investment without any loss of federal revenue.[14]

**Creation of "IRA-Plus" Accounts.** The IRA program was one of the most successful ever adopted. By 1984, 15.4 million taxpayers were depositing $35.8 billion per year in IRA accounts. Fully 80 percent of these deposits represented new savings.[15] If we assume that the average depositor was in the 35 percent income tax bracket, for each $1 increase in the federal deficit more than $2 of new savings was added to the credit market. Thus IRAs financed an increase in private investment which led to increased tax revenues that offset government deficits.

*"A new IRA option would reduce the nation's cost of capital by 3.9 percent."*

When IRAs were introduced, most American workers could expect to be in a lower tax bracket after they retired. Hence, it made sense to avoid taxes during the working years and defer them until retirement. With the passage of the Social Security benefit tax in 1983 and the reduction in marginal tax rates passed in 1981 and 1986, the traditional assumption is not necessarily true. Many workers who today are in the 15 percent income tax bracket will be in the 28 percent bracket by the time they retire. The Social Security benefit tax can further increase their marginal tax rate to 42 percent.[16]

In recognition of these important changes in the tax law, Senators Lloyd Bentsen (D-TX) and William Roth (R-DE) introduced the "Savings and Investment Incentive Act of 1991" (S. 612) aimed at increasing U.S. savings and investment. Specifically, under the bill:

- All Americans would once again be eligible to make fully deductible IRA contributions of up to $2,000 annually. Both the contribution and accumulated earnings would be taxed at the time of withdrawal.

- Taxpayers would have another IRA option. Each individual could chose to contribute some or all of the $2,000 contribution to a backended IRA. Although these contributions would be taxed, assets in the account for at least five years could be withdrawn tax-free. Earnings withdrawn before five years would be subject to a 10-percent penalty.

- Individuals could make penalty-free withdrawals from either IRA before age 59-1/2 to purchase a home for the first time, to pay educational expenses or to defray financially devastating medical expenses. Young couples, their parents or their grandparents could use IRAs to pay for first-time home purchases without incurring the 10-percent early withdrawal penalty.

- Individuals could also make penalty-free withdrawals from 401(k) or 403(b) plans to purchase a home for the first time or pay educational expenses.

The Bentsen-Roth bill would lower the tax on capital by 7.8 percent. The lower tax on capital would reduce the cost of capital for the economy as a whole by 3.9 percent. This reduction would lead to more investment, more jobs and more growth.[17]

**Restoration of Saving Incentives for 401(k) Plans.** Employer-sponsored 401(k) plans are another important saving incentive. These plans allow workers to save for their retirement through tax-deferred contributions. They are the fastest-growing segment of the nation's private retirement system.

Prior to 1986, workers could set aside up to $7,000 in a 401(k). The Tax Reform Act of 1986 reduced that figure by the amount the taxpayer contributes to an IRA or other tax-deferred savings account. In 1991, employees could set aside a *total* of $8,475 ($7,000 adjusted for inflation) for 401(k)s and IRAs. For example, an employee with a $2,000 IRA contribution could contribute only $6,475 tax-free to a 401(k) plan.

*"The marginal tax rate on elderly workers can reach as high as 80 percent."*

To restore the pre-1986 retirement saving incentives, workers should be allowed to make aftertax contributions equal to the amount of the IRA offset. For example, an employee with a $2,000 IRA contribution could make an additional $2,000 aftertax contribution to a 401(k). Withdrawals of these funds would be tax free, and the rules for tax-paid 401(k) plans would be the same as for the IRA Plus account.

**Elimination of the Earnings Test for Social Security Recipients.** Over the decade of the 1980s, the American economy has expanded by a third in real terms. Evidence suggests that the most important reason for this growth was the expansion of the labor supply. Because people were allowed to keep a greater share of their earnings, more people went to work and they worked longer hours.[18]

Unfortunately, the supply-side revolution ignored the role of the elderly worker. Above an annual income of $10,200, elderly workers lose $1 of Social Security benefits for each $3 of wages — a 33 percent tax. When the

Social Security earnings penalty is combined with the income tax, the FICA tax and the Social Security benefit tax, the marginal tax rate on earnings can reach as high as 80 percent.[19] Raising the earnings limit (the amount that can be earned without loss of benefits) undoubtedly would expand the supply of elderly workers, help employers meet their demands for skilled labor over the next decade, and increase federal revenue. If the earnings limit were completely abolished, the federal government would still make a small profit as additional work-related taxes more than offset increased benefit payments.[20]

**Elimination of the Social Security Benefits Tax.** The elderly pay income taxes on up to one-half of their Social Security benefits if their total income (including benefits) exceeds $25,000 for individuals or $32,000 for couples. They pay taxes on 50 cents of benefits for each $1 of income above these thresholds. As a result, when the elderly receive $1 of income they pay taxes on $1.50 — causing their tax rate to be 50 percent higher than the rate paid by younger people with the same income.[21]

*"The Social Security benefits tax increases elderly tax rates by 50 percent."*

The Social Security benefit tax is *nominally* a tax on benefits. But it is *actually* a tax on income. Since about 60 percent of the income of the elderly is income from investments (including pensions), the tax is mainly a tax on income from savings. Moreover, although the tax is currently paid by the elderly, its existence automatically reduces the value of pensions, IRAs and all other tax-deferred savings of young people:[22]

- Since the average worker today is in the 15 percent income tax bracket, funds placed in tax-deferred savings avoid a 15 percent tax.

- Yet when many of these workers retire and withdraw their savings, they will face a 42 percent tax rate.

Currently, the Social Security benefit tax adds about $6 billion per year to federal revenue. Because of its devastating effect on saving incentives, however, the Social Security benefit tax, unless repealed, will continue to lower economic growth and make the federal deficit larger, not smaller.

**Excise Taxes.** In addition to the tax cuts listed above, we assume elimination of the 10 percent luxury tax enacted as part of the 1990 Budget Summit Agreement. Evidence mounts that the detrimental economic effects, of the tax has probably caused revenue losses not gains.[23]

## Economic Effects of Phase I Tax Measures

We have used a neoclassical, general equilibrium model of the U.S. economy to assess the impact of alternative tax and spending measures. This method is dynamic in that it takes into account the effect of government policy

changes on the behavior of businesses, workers and consumers. The estimates presented here compare the economic and budget effects of the proposed package against the 1992 Mid-session Review baseline of the government's economic forecast which we have updated for information available since July.

Table II summarizes the economic and budget effects of these tax measures taken as a whole. Overall the tax measures are very stimulative. Collectively, they would:

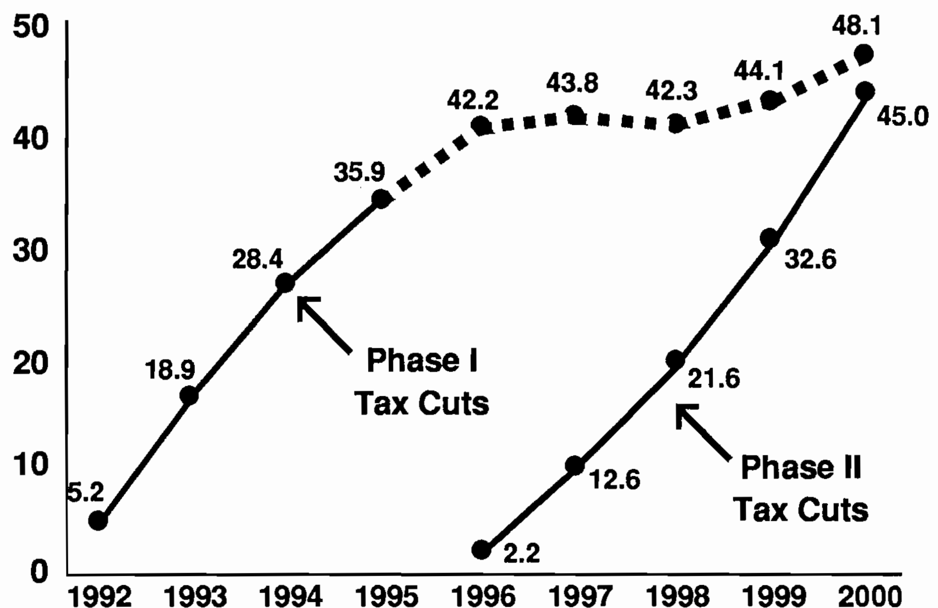
- Increase GDP by $1.1 trillion over the next five years and raise the economic growth rate by more than one full percentage point.
- Create 1.2 million jobs by 1996 and 2.2 million jobs by the year 2000.
- Spur investment that would increase the stock of U.S. capital by $3.9 trillion by 1996.
- Increase federal revenues by $129.5 billion over the next five years. [See Figure IV]

*"Pro-growth tax cuts result in more revenue for government."*

FIGURE IV

## Additional Revenue From Tax Rate Reductions

**($ billions)**



"*Phase I tax cuts would create 2 million new jobs and produce $307 billion additional government revenue.*"

**TABLE II**

## Effects of Phase I Tax Measures[1]

| Calendar Year | Jobs (mil.)[2] | Capital Stock ($ bil.)[3] | GDP Growth Rate (%) | Gross Domestic Product ($ bil.) | Static Federal Revenue ($ bil.)[4] | Net Dynamic Federal Revenue ($ bil.)[5] |
|---|---|---|---|---|---|---|
| 1992 | 0.036 | 454 | 0.44 | 45.1 | -7.0 | 5.2 |
| 1993 | 0.190 | 1,280 | 0.78 | 129.7 | -5.9 | 18.9 |
| 1994 | 0.501 | 2,201 | 0.96 | 231.7 | -12.3 | 28.4 |
| 1995 | 0.836 | 3,059 | 1.02 | 331.9 | -21.6 | 35.9 |
| 1996 | 1.224 | 3,910 | 1.03 | 434.7 | -31.8 | 42.2 |
| 1997 | 1.554 | 4,556 | 0.98 | 519.2 | -44.7 | 43.8 |
| 1998 | 1.809 | 5,201 | 0.93 | 603.2 | -60.2 | 42.3 |
| 1999 | 2.016 | 5,845 | 0.88 | 687.8 | -72.0 | 44.1 |
| 2000 | 2.191 | 6,501 | 0.84 | 774.6 | -81.6 | 48.3 |
| 1992-1996 | | | | 1,173.0 | -78.6 | 129.5 |
| 1992-2000 | | | | 3,757.8 | -337.2 | 307.9 |

[1]Changes from baseline, amounts in nominal dollars.

[2]Cumulative. Includes the effects of spending reductions.

3Cumulative.

[4]Revenue loss assuming no increase in labor or capital in response to the tax cuts.

[5]Total effect, including the revenue gain due to an increase in labor and capital in response to the tax cuts.

## Spending Measures

Reductions in domestic and defense spending from the current baseline would also be necessary to eliminate the federal deficit by 1996. Our proposed reductions in spending from current law are as follows:

- An additional five percent in defense spending reductions over those already called for in the 1990 budget agreement would yield $58.4 billion in savings over the next five years.

- Because of program forecasting errors, domestic spending ceilings are $170 billion higher than those in the January 1991 budget.[24] These spending increases, which received no legislative approval, should be rolled back to their 1992 paths.

*"Domestic spending ceilings should be returned to their budget summit level."*

**TABLE III**

## Proposed Spending Reductions[1]

**($ billions)**

| Fiscal Year | Fed Emp Benefits | Health Reform | Other Transfers | Other Domestic Programs | Defense | Total |
|---|---|---|---|---|---|---|
| 1992 | 2.1 | 1.6 | 4.5 | 6.0 | 1.9 | 16.1 |
| 1993 | 5.6 | 4.8 | 12.9 | 15.7 | 13.0 | 52.0 |
| 1994 | 4.9 | 4.5 | 12.2 | 13.8 | 14.5 | 49.9 |
| 1995 | 5.2 | 5.1 | 13.7 | 14.6 | 14.5 | 53.1 |
| 1996 | 5.5 | 5.7 | 15.3 | 15.5 | 14.7 | 56.7 |
| 1997 | 5.9 | 6.4 | 17.1 | 16.4 | 14.9 | 60.7 |
| 1998 | 6.2 | 7.2 | 19.2 | 17.4 | 15.5 | 65.5 |
| 1999 | 6.6 | 8.0 | 21.5 | 18.4 | 16.4 | 70.9 |
| 2000 | 7.0 | 9.0 | 24.1 | 19.5 | 17.3 | 76.9 |

[1]From current law baseline.

Table III suggests one way to accomplish the $170 billion in non-defense reductions. Total federal compensation, including pension and health benefits, could be reduced by 0.7 percent over the entire five-year budget baseline. Reform of Medicare and Medicaid could make the programs more sensitive to the true price of health care, thereby reducing costs.

## Effects on the Deficit: Phase I

Table IV summarizes the impact of the previous proposals on the federal budget deficit. It recaps the spending cuts, the dynamic revenue estimates which take into account the impact of the tax package on growth and the interest savings from lower federal borrowing. Over the next five years, this pro-growth package would reduce the unified deficit by $396 billion. Table V shows the deficit with and without Social Security from 1992 to 2000.

## Pro-Growth Package: Phase II

If the pro-growth proposals made above are adopted, the federal government will have an annual surplus of $8.2 billion in 1996, growing to $157.3 billion by the year 2000. Although the general fund will have a deficit, the Social Security trust funds will take in more than they will pay out to beneficiaries.

TABLE IV

## Phase I Federal Deficit Reduction

($ billions)

| Fiscal Year | Spending Cuts | Additional Revenue | Interest Savings | Deficit Reduction | Cumulative Deficit Reduction |
|---|---|---|---|---|---|
| 1992 | 16.1 | 2.5 | 0.6 | 19.2 | 19.2 |
| 1993 | 51.9 | 16.0 | 3.7 | 71.6 | 90.8 |
| 1994 | 49.9 | 25.3 | 9.0 | 84.2 | 174.9 |
| 1995 | 53.0 | 33.3 | 15.3 | 101.6 | 276.5 |
| 1996 | 56.6 | 40.1 | 22.7 | 119.5 | 396.0 |
| 1997 | 60.6 | 42.9 | 31.3 | 134.9 | 530.9 |
| 1998 | 65.5 | 42.2 | 40.9 | 148.6 | 679.5 |
| 1999 | 70.9 | 43.1 | 51.6 | 165.6 | 845.1 |
| 2000 | 76.8 | 46.7 | 63.5 | 187.0 | 1,032.0 |

TABLE V

## Federal Budget Deficit Under Phase I

**With and Without Social Security**

($ billions)

| Fiscal Year | Deficit w/SS[1] | Deficit wo/SS[2] |
|---|---|---|
| 1992 | 341.3 | 405.1 |
| 1993 | 199.4 | 272.3 |
| 1994 | 87.0 | 175.3 |
| 1995 | 24.5 | 126.3 |
| 1996 | -8.2 | 111.7 |
| 1997 | -40.5 | 94.4 |
| 1998 | -73.3 | 78.5 |
| 1999 | -111.8 | 59.0 |
| 2000 | -157.3 | 34.9 |

[1]With Social Security.

[2]Without Social Security.

*"Phase I pro-growth measures would eliminate the federal deficit by 1996 and create surpluses thereafter."*

This Social Security surplus is supposed to be used to reduce federal debt in the hands of the public. Experience teaches, however, that the surplus probably will be spent. Future tax increases can be enacted into law this year to take effect at a later date. Spending reductions cannot. There is no guarantee, therefore, that these surpluses will be used to retire the national debt.

**Middle Class Tax Relief: A Reduction in the Social Security Payroll Tax.** An alternative is to use the surplus to reduce Social Security taxes and provide an added mid-decade boost to the economy. Senators Daniel Patrick Moynihan (D-NY) and Robert Kasten (R-WI) introduced a bill to roll back the payroll tax increases that took effect in 1988 and 1990. The major objection to their proposals is that they would increase the federal deficit. However, the surplus after 1996 is about 40 percent more than what is needed to cover a 2.2 percentage point reduction in the Social Security payroll tax.

*"To increase the supply of labor, we need a payroll tax reduction."*

Today, many workers pay more in payroll taxes than in income taxes. Giving the budget surplus back to workers and their families in the form of a payroll tax reduction would reduce the tax burden on lower and middle income workers. Furthermore, the reduction in payroll taxes also would lower labor costs and increase employment.

**New Depreciation Rules for Structures.** Another pro-growth measure would be to extend neutral cost recovery to structures, beginning in 1996. As in the case of equipment, this proposal would lose almost no revenue and provide a large investment stimulus. Furthermore, neutral cost recovery of both equipment and structures would greatly reduce the double taxation of investment and savings that exists in the current U.S. tax system.

**Flexible Freeze.** Adjusting government spending for price increases only beginning in 1996 would save an additional $25 billion per year. These savings could be used to balance the budget.

**Economic Effects.** Table VI summarizes the economic and budget effects of these tax and spending measures in addition to those in Pro-Growth Package: Phase I. Lowering the Social Security payroll tax rate by 2.2 percentage points, extending neutral cost recovery to structures and instituting a flexible freeze beginning in 1996 would:

- Increase GDP by $5 trillion over the decade of the 1990s and raise the economic growth rate by more than one-and-one-quarter percentage points.

- Create 3.7 million jobs by the year 2000, about 1.5 million jobs in addition to Phase I proposals.
- Spur investment that would increase the stock of U.S. capital by $10.4 trillion by the year 2000.
- Increase federal revenues by $202.6 billion over the next nine years.

**Effect on Federal Budget.** Table VII summarizes the impact of Pro-Growth Package: Phase II on the unified federal budget deficit. Over the next five years, it would reduce the deficit by $395.6 billion. Table VIII summarizes the impact of Phase II on the federal deficit with and without Social Security. The unified budget would run a surplus of $6.5 billion in 1996. The budget without Social Security would run a surplus of $17.8 billion in the year 2000.

*"The entire pro-growth package would create 3.7 million new jobs and increase the growth rate by more than 1 percentage point."*

**TABLE VI**

## Pro-Growth Package: Phase II[1]

| Calendar Year | Jobs (mil.)[2] | Capital Stock ($ bil.)[3] | GDP Growth Rate (%) | Gross Domestic Product ($ bil.) | Static Federal Revenue ($ bil.)[4] | Net Dynamic Federal Revenue ($ bil.)[5] |
|---|---|---|---|---|---|---|
| 1992 | 0.036 | 454 | 0.44 | 45.1 | -7.0 | 5.2 |
| 1993 | 0.190 | 1,280 | 0.78 | 129.7 | -5.9 | 18.4 |
| 1994 | 0.501 | 2,201 | 0.96 | 231.7 | -12.3 | 28.1 |
| 1995 | 0.836 | 3,059 | 1.02 | 331.9 | -21.6 | 35.6 |
| 1996 | 1.339 | 4,408 | 1.16 | 492.0 | -81.3 | 2.2 |
| 1997 | 1.994 | 5,937 | 1.26 | 673.2 | -97.6 | 12.6 |
| 1998 | 2.621 | 7,529 | 1.32 | 863.9 | -116.9 | 21.6 |
| 1999 | 3.174 | 9,003 | 1.32 | 1,045.7 | -132.8 | 32.6 |
| 2000 | 3.652 | 10,435 | 1.29 | 1,225.6 | -146.9 | 45.0 |
| 1992-1996 | | | | 1,230.4 | -128.1 | 90.7 |
| 1992-2000 | | | | 5,038.7 | -622.4 | 202.6 |

[1]Changes from baseline, amounts in nominal dollars.
[2]Cumulative. Includes the effects of spending cuts.
[3]Cumulative.
[4]Revenue loss assuming no increase in labor or capital in response to the tax cuts.
[5]Total effect, including the revenue gain due to an increase in labor and capital in response to the tax cuts.

*"The complete growth package would leave the federal government with a large surplus."*

TABLE VII

## Phase II Deficit Reduction

**($ billions)**

| Fiscal Year | Spending Cuts | Additional Revenue | Interest Savings | Deficit Reduction | Spending Deficit Reduction |
|---|---|---|---|---|---|
| 1992 | 16.1 | 2.5 | 0.6 | 19.2 | 19.2 |
| 1993 | 51.9 | 16.4 | 3.7 | 72.0 | 91.1 |
| 1994 | 49.9 | 25.7 | 9.0 | 84.6 | 175.8 |
| 1995 | 53.0 | 33.7 | 15.3 | 102.0 | 277.8 |
| 1996 | 84.8 | 10.2 | 22.8 | 117.8 | 395.6 |
| 1997 | 100.7 | 9.6 | 31.5 | 141.8 | 537.4 |
| 1998 | 109.1 | 18.9 | 42.1 | 170.1 | 707.5 |
| 1999 | 118.4 | 29.3 | 54.7 | 202.5 | 909.9 |
| 2000 | 128.7 | 41.4 | 69.6 | 239.7 | 1,149.6 |

*"If Social Security is excluded, the budget would be virtually balanced."*

TABLE VIII

## Federal Budget Deficit Under Phase II

**With and Without Social Security**

**($ billions)**

| Fiscal Year | Deficit w/SS[1] | Deficit wo/SS[2] |
|---|---|---|
| 1992 | 341.3 | 405.1 |
| 1993 | 199.0 | 271.9 |
| 1994 | 86.6 | 174.9 |
| 1995 | 24.1 | 125.9 |
| 1996 | -6.5 | 113.4 |
| 1997 | -47.4 | 87.5 |
| 1998 | -94.8 | 57.0 |
| 1999 | -148.7 | 22.1 |
| 2000 | -210.0 | -17.8 |

[1]With Social Security.
[2]Without Social Security.

## Growth and Fairness

The pro-growth package proposed here would eliminate the federal deficit by 1996. In order to prevent a growing surplus in the Social Security trust funds beyond that point, a reduction in payroll taxes is proposed. As a result, the federal budget excluding Social Security would be roughly in balance at the end of the decade. This package, then, both reduces the deficit and promotes economic growth at the same time. Would it also be fair?

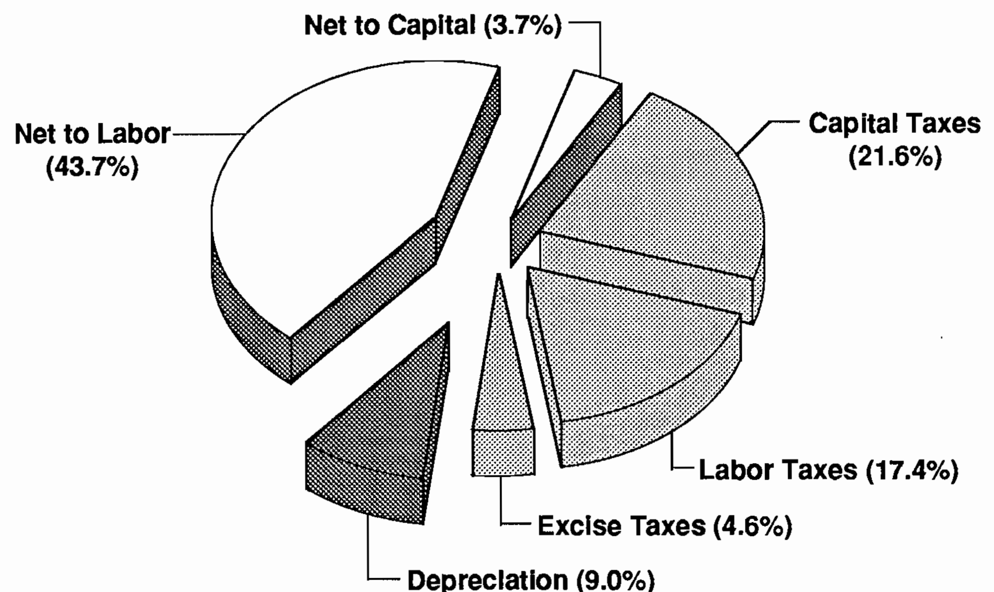
Since this pro-growth package results in a net increase in federal revenue in each and every year, who will pay the higher taxes? Primarily they will be paid by higher-income taxpayers. For example, about one-half the increase in personal income taxes as a result of the capital gains tax cut will be paid by families earning more than $75,000.

Moreover, the vast bulk of new income created by lowering taxes on capital flows to wage earners and to government, rather than to owners of capital. [See Figure V]. Under the current tax system:[25]

*"For every additional $1 of aftertax income received by owners of capital, workers will get $12, and the government will get $12."*

**FIGURE V**

### Proceeds of Additional GNP Under the Current Tax Structure




Source: Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

- For every $1 billion cut in taxes on investment income, we can expect about $25 billion in increased production.
- Government will get about $12 billion in increased revenue—making an $11 billion "profit."
- Wage earners will receive about $12 billion in additional aftertax wages, whereas investors will receive only $1 billion in additional aftertax income.

Because the tax reductions considered here are so large, these relationships will change somewhat over time. When tax cuts on investment income are combined with reductions in labor taxes, the U.S. economy will have about $10 trillion in additional capital and 3.6 million new workers by the end of the decade. This additional labor and capital will produce more than $1.2 trillion in additional output in the year 2000. Because of the large capital stock, about $389 billion will be consumed by depreciation — leaving a net increase in private output of about $845 billion.

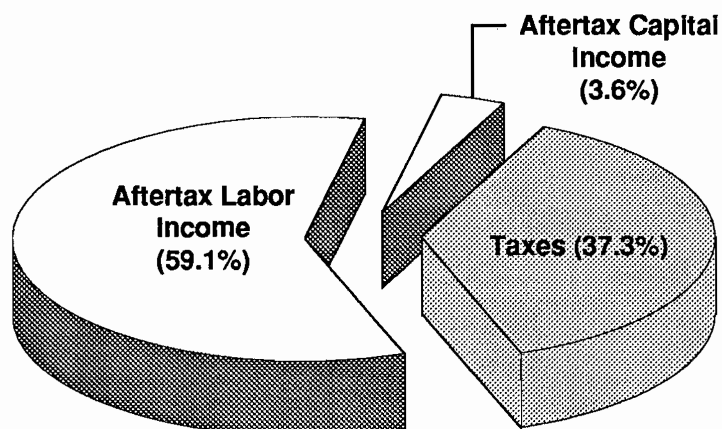
Relative to the position of investors, this increase in national income will be a good deal for workers and for government. [See Figure VI.]

- Of the $845 billion increase in national income in the year 2000, $500 billion will go to labor, $315 billion will go to government and only $30 billion will go to owners of capital.
- For every $1 of additional aftertax income created for investors that year, wage earners will receive $16 and government will receive $10.

*"In the year 2000, for every additional $1 of income to investors, $16 will go to wage earners and $10 will go to government."*

**FIGURE VI**

## Division of Additional National Income In the Year 2000



# Conclusion

*"A carefully designed growth package can generate income for government and increase growth at the same time."*

As the economy languishes during an election year, pressure is building for the Congress and Administration to cut taxes. The last thing the U.S. economy needs is an ill-conceived tax cut that would do nothing for growth and only increase the deficit. Fortunately, there is a better way. By selectively reducing tax rates on capital and labor we can create an economic stimulus that will sustain economic growth and meet the revenue needs of the federal government at the same time.

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or the U.S. Chamber of Commerce or as an attempt to aid or hinder the passage of any bill before Congress.

# Footnotes

[1] Lawrence B. Lindsey, *The Growth Experiment* (New York: Basic Books, 1990), p. 10.

[2] See "Statement of Lawrence Kudlow" in John C. Goodman, ed., "Pro Growth: The Proceedings of the Senate Republican Conference Task Force on Economic Growth and Job Creation," National Center for Policy Analysis, NCPA Policy Report No. 167, January 1992. The Blue Chip forecasters are predicting 1.6 percent growth for 1992 and 3.1 percent for 1993. See "Blue Chip Economists Say Growth in 4th QTR Virtually Nonexistent," *Investor's Business Daily,* January 10, 1992.

[3] See "Statement of Gary Robbins" in Goodman, "Pro-Growth."

[4] For an analysis of the effects of payroll tax increases, see Gary Robbins and Aldona Robbins, "Reducing Social Security Taxes: Sound Policy for Today and Tomorrow?", Institute for Policy Innovation, IPI Report No. 110, March 1991; for increased regulations see Ron Utt, "The Growing Regulatory Burden: At What Cost to America," Institute for Policy Innovation, IPI Report No. 114, November 1991; for state and local tax increases on capital, see Robbins and Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992. For the effects of the 1990 budget summit agreement, see Gary Robbins and Aldona Robbins, "Taxes, Deficits and the Current Recession," National Center for Policy Analysis, NCPA Policy Report No. 156, January 1991, and Robbins and Robbins, "If the Budget Summit Was a Success, Why is the Five-Year Deficit Heading Toward $1 Trillion?," National Center for Policy Analysis, NCPA Backgrounder No. 109, March 11, 1991; for the effects of increased taxes on real estate, see Robbins and Robbins, "Adding to the S&L Solution: The Case for a Lower Capital Gains Tax," U.S. Chamber of Commerce, August 1990.

[5] "Statement of Lawrence Kudlow" in Goodman, "Pro-Growth."

[6] "Remarks by Jack Kemp" in Goodman, "Pro-Growth."

[7] David Wessel, "Budget Deficit Sets a Record of $268.7 Billion," *Wall Street Journal*, October 30, 1991, p. A10.

[8] For a summary of the historical experience, see Ronald Utt, "Capital Gains Taxation: The Evidence Calls for a Reduction in Rates," *Heritage Foundation Backgrounder,* No. 704, May 2, 1989; for a survey of the academic studies, see Lawrence Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," *National Tax Journal,* Vol. 40, No. 3, September 1987.

[9] Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986."

[10] See Aldona Robbins and Gary Robbins, "Adding to the S&L Solution," U.S. Chamber of Commerce.

[11] John Goodman, Aldona Robbins and Gary Robbins, "Elderly Taxpayers and the Capital Gains Debate," National Center for Policy Analysis, NCPA Policy Report No. 153, July 1990.

[12] Aldona Robbins and Gary Robbins, "The Bush Savings Plan," National Center for Policy Analysis, NCPA Policy Report No. 152, June 1990.

[13] Lindsey, *The Growth Experiment,* pp. 117-118.

[14] We would propose that the Neutral Cost Recovery schedules follow the current Modified Accelerated Cost Recovery System (MACRS). Slowing cost recovery for five- and seven-year assets would eliminate static revenue losses for the first five budget years. By contrast, a 10 percent investment tax credit would have one-third as much stimulus and would lose $30 billion in revenue the first year.

[15] Steven F. Venti and David A. Wise, "The Determinants of IRA Contributions and the Effects of Limit Changes," in Zvi Bodie, John Shoven and David Wise, eds., *Pensions and the U.S. Economy* (Chicago: University of Chicago Press, 1988).

[16] Aldona Robbins and Gary Robbins, "Taxing the Savings of Elderly Americans," National Center for Policy Analysis, NCPA Policy Report No. 141, September 1989.

[17] For an analysis of how the Bentsen-Roth bill would effect IRA contributions and the economy see Aldona Robbins and Gary Robbins, "The Case for IRAs" NCPA Policy Report No. 112, April 1991.

[18] John P. Judd and Bharat Trehan, "Working Harder," *Federal Reserve Bank of San Francisco Weekly Letter*, June 22, 1990.

[19] John Goodman, "Should 85 Percent of Social Security Benefits Be Taxed?", National Center for Policy Analysis, NCPA Policy Backgrounder No. 101, July 20, 1990.

[20] Aldona Robbins and Gary Robbins, "Paying People Not to Work: The Economic Cost of the Social Security Earnings Limit," National Center for Policy Analysis, NCPA Policy Report No. 142, September 1989.

[21] These rates apply to people who are below the maximum tax, where one-half of benefits are fully taxed.

[22] Robbins and Robbins, "Taxing the Savings of Elderly Americans."

[23] "The Cost of Tax-Related Job Loss Versus Projected Revenue Gain from Luxury Taxes in Fiscal 1991," Report of the Joint Economic Committee, Minority Staff, July 1991.

[24] Budget documents list these forecasting errors as "technical revisions."

[25] Aldona Robbins and Gary Robbins, "The Bush Savings Plan."

[26] Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth."

# About the Authors

**Aldona Robbins,** Vice President of Fiscal Associates and Senior Fellow of the NCPA, has extensive experience with public and private retirement programs. She served as senior economist in the Office of Economic Policy, U.S. Department of the Treasury from 1979 to 1985 and has developed a model to project Social Security benefits and tax revenues. Recent publications include NCPA Reports entitled "What A Canadian-Style Health Care System Would Cost U.S. Employers and Employees" and "Taxing the Savings of Elderly Americans," an NCPA and Institute for Policy Innovation Report entitled "Paying People Not To Work: The Economic Cost of the Social Security Retirement Earnings Limit," a book entitled *The ABCs of Social Security* published by the Institute for Research on the Economics of Taxation Economic Report, and an article entitled "Encouraging Private Provision for Long-Term Care" in Compensation and Benefits Management. Articles on Individual Retirement Accounts and Medicare have appeared in The *Wall Street Journal.* She received a master's and doctorate in Economics from the University of Pittsburgh.

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