National Center for Policy Analysis

BRIEF ANALYSIS
No. 134
For immediate release:
Monday, October 3, 1994

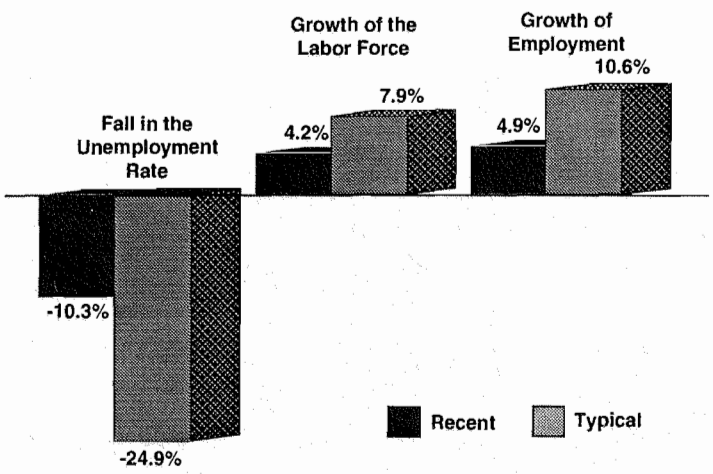
Evaluating the Clinton Economic Plan

The Congressional Budget Office (CBO) recently released its mid-session review of the Clinton economic policy. Compared to its January 1993 forecast, issued before Clinton's program was enacted, the current CBO forecast shows deterioration across the board. By 1997, every major economic indicator will be worse than it would have been had Bill Clinton done nothing. Unemployment will be higher, inflation will be higher and real economic growth will be lower. Let's take a closer look.

Fewer-Than-Normal New Jobs. The administration repeatedly states that 4.3 million new jobs have been created since it took office. But the country is emerging from a recession, and new jobs are always created in the expansion phase of the business cycle. The problem is that the economy is not expanding as quickly as it has after other recessions.

FIGURE I

The Current Expansion vs. A Typical Expansion



Source: Bureau of Labor Statistics.

As Figure I shows, at this point in the business cycle, the unemployment rate typically has dropped by twice as much as it has in this expansion. If this were a typical expansion, the current unemployment rate would be 5.1 percent instead of the actual 6.1 percent.

The slow decline in unemployment is a result of the fact that total employment is expanding at only about half the rate it would in a normal recovery. If we had done as well as we usually do, over 1.2 million more Americans would have jobs today.

The only reason why the unemployment rate has fallen at all is that the labor force — the number of Americans either working or looking for work — has grown much more slowly than usual. Whereas the labor force would typically have grown by 7.9 percent at this point, it has in fact grown just 4.2 percent.

Higher Marginal Tax Rates. One explanation for the unusually slow labor force growth is that the Clinton tax increases have discouraged workers from looking for work. Although Clinton said that he was raising tax rates only on the wealthiest Americans, his policies have increased marginal income tax rates (the tax on each additional dollar earned) for workers earning between $10,000 and $50,000. This is confirmed by the CBO's most recent "Green Book."

In large part, marginal rate increases reflect the expansion of the Earned Income Tax Credit (EITC). Ironically, while the EITC reduces tax payments for low-income workers, it also reduces the after-tax return on each additional dollar they earn. [See Figure II.] The reason is that the credit is phased out once a family has earned $11,000. The effect of this phase-out is to impose a de facto marginal tax rate of about 21 percent on low-income families with two or more qualifying children. While workers may be better off, they are discouraged from improving their situations further by seeking higher wages, better jobs or working overtime.

The Clinton tax increases also affect the incentives of many others who are not "rich." First, Clinton applied

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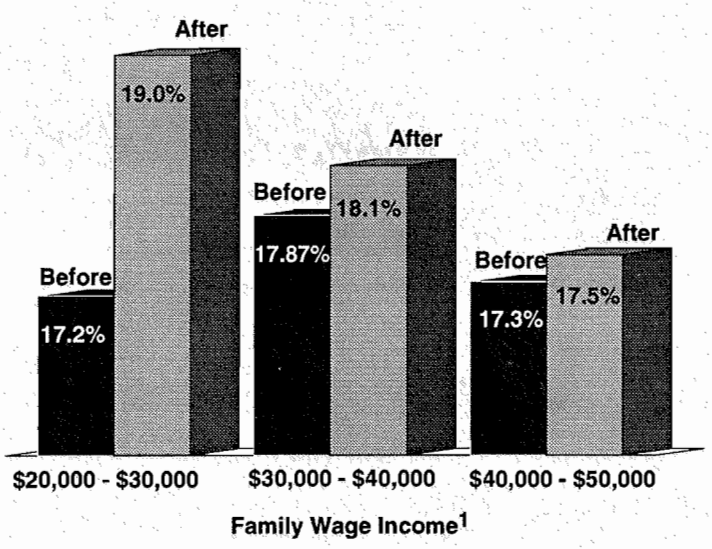
the so-called millionaire's surtax to only $125,000 of income for married couples filling separately. Second, he imposed higher taxes on many elderly Americans by subjecting more of their Social Security benefits to the federal income tax. Third, he imposed higher taxes on all Americans in the form of higher gasoline taxes. These taxes are paid not only by drivers, but by everyone who buys products delivered by trucks.

Higher-Than-Promised Interest Rates. The Clinton administration claimed that the need to lower the budget deficit justified raising taxes. Lower budget deficits, the administration argued, would lead to lower interest rates — especially lower long-term rates — which would greatly stimulate economic growth. Yet today's lower deficit has not led to lower interest rates. In fact, interest rates began to rise at the precise moment the Clinton tax plan took effect. *Interest rates on the Treasury's 30-year bond are now significantly higher than they were when Clinton took office.*

FIGURE II

Effects of the Clinton Plan: Higher Marginal Tax Rates For the Middle Class



[1] Does not take into account higher taxes on nonwage income.

Source: Congressional Budget Office.

A Decline in Personal Savings. Although the Clinton administration blames the rising interest rates entirely on the Federal Reserve, another important explanation is the sharp decline in personal savings since Clinton took office. In 1992, the personal savings rate averaged 5.5 percent. In the first half of 1994, it averaged just 3.7 percent. In aggregate terms, personal savings fell from $247.9 billion in 1992 to an annual rate of just $183.4 billion in the first half of 1994. Over this same period, the federal budget deficit declined from $340.5 billion in FY 1992 to $273.7 billion in FY 1994. Thus personal savings declined by an amount almost exactly equal to the decline in the deficit: $64.5 billion versus $66.8 billion.

The Clinton tax plan caused the decline in personal savings in two ways. First, it took money people might have saved out of everyone's pockets. Second, and more importantly, by raising tax rates most sharply on those with high incomes, it took money from those Americans who have the greatest capacity and inclination to save. It is true that the wealthy are paying higher taxes. But all Americans are paying the price in the form of lower savings and higher interest rates.

Other Signs of Stagflation. Other economic indicators are also deteriorating. Productivity fell by 2.5 percent in the second quarter of 1994 (latest period available), and the dollar has fallen sharply against every major currency. The dollar, which would buy 124 Japanese yen in December 1992, today buys fewer than 100. The price of gold and other advance indicators of inflation are also rising, leading many business economists to predict a return to 1970s-style stagflation. If it does occur, Clinton's tax policies will be largely to blame.

This Brief Analysis was prepared by Bruce Bartlett of the Alexis de Tocqueville Institution.