BRIEF ANALYSIS
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The Republicans' Pro-Growth Contract

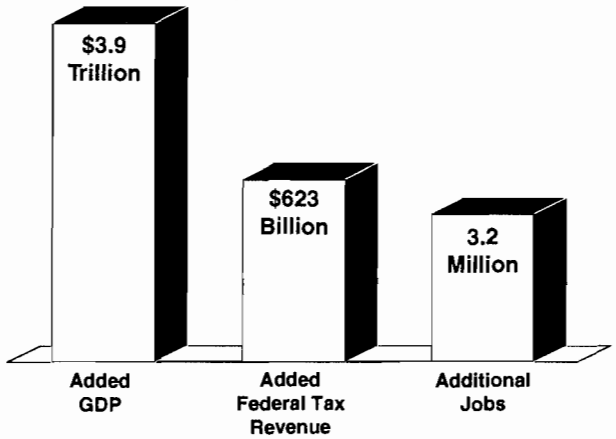
The partisan battle over the Republicans' "Contract With America" has obscured the fact that at least six of the contracts proposals would, if enacted, stimulate economic growth. [See Figure I.]

- Cumulatively, the six pro-growth measures would increase Gross Domestic Product (GDP) by $3.9 trillion by the end of the decade.
- They would create an additional 3.2 million jobs over the next five years.
- They would raise $623 billion in additional federal revenue during the same period.

The additional revenue would be more than enough to pay for the contract's other proposals — including a $500 per child tax credit and removal of the marriage penalty — and would go a long way toward achieving a balanced budget with no increase in spending.

FIGURE I

Economic Effects of the Republican Pro-Growth Proposals[1] (1995 - 2000)



[1] Excludes balanced budget amendment and other spending cuts.

Source: TaxAction Analysis.

Although the six proposals come from Republicans, most have also attracted support from many Democrats. Let's see why.

Expanded Individual Retirement Accounts (IRAs). The Tax Reform Act of 1986 limited tax-free IRA contributions to people with no employer-provided pension and those with incomes less than $25,000 for individuals and $40,000 for couples. As a result, we have a lower national savings rate. When Secretary of the Treasury Lloyd Bentsen was a senator, he cosponsored a bill to restore the right of every American to contribute up to $2,000 a year to an IRA. Senator John Breaux (D-LA) is another prominent Democrat who favors the idea.

These proposals would create a "backended" IRA option, under which IRA deposits would be made with aftertax dollars, but withdrawals at retirement would be tax free. This is important because middle-income Americans can expect to face higher marginal tax rates during retirement than during their working years.

Previous NCPA studies have shown that IRAs do not reduce government revenue. Instead, they result in additional investment, which results in additional output, which results in additional taxable income. Not only would the IRA proposal not cost the government any revenue, but it would increase federal tax revenue by an estimated $50 billion between 1995 and 2000 — even without any new savings — because it would induce people to pay taxes on their current IRA deposits in order to switch to a backended account.

Reducing the Capital Gains Tax. Because the tax brackets are indexed, wage earners cannot be pushed into a higher tax bracket by the effects of inflation alone. However, savers have no comparable protection. People who sell assets are forced to pay taxes on inflation-created profits, even if there has been no real profit.

To correct this defect in the tax law, the contract proposes excluding 50 percent of capital gains from taxation and indexing capital gains for inflation. Previous NCPA studies have shown that almost any capital gains tax rate reduction would produce more revenue when the effects of increased investment are taken into account.

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Neutral Cost Recovery. The tax code also fails to index the depreciation of productive assets in order to allow for their replacement. If inflation averages, say, 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 of the replacement cost.

The contract proposes that businesses be allowed to increase their depreciation expenses each year for investments in plant and equipment to compensate for the effects of inflation and the time value of money. It also increases the amount of assets that could be expensed from $17,500 to $25,000, thus helping small businesses.

Reducing the Social Security Benefits Tax. Before 1993, Social Security recipients above a certain income level were taxed on half of their benefits. In 1993, the taxable amount was raised to 85 percent for single people with $34,000 or more and married couples with $44,000 or more in income. As a result, elderly taxpayers in the 28 percent bracket now face a marginal tax rate of 51.8 percent (28% x 1.85). The contract would phase out the 1993 changes, dropping it back to 50 percent by 1999.

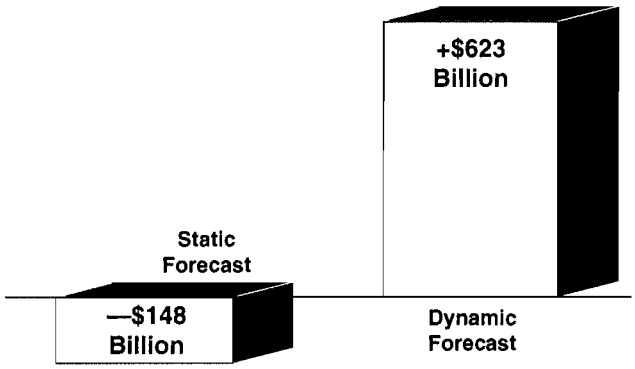
The Social Security benefits tax is mainly a tax on investment income. No tax is paid unless a taxpayer's income reaches a certain level. Beyond that point, the tax rises as income rises. Since 85 cents of benefits is taxed for each additional $1 of income, elderly taxpayers pay taxes on $1.85 for each additional dollar of income.

Increasing the Social Security Earnings Limit. Under this proposal, people between the ages of 65 and 70 who receive Social Security benefits could earn up to $30,000 without penalty in 1995. Currently, if they earn more than $11,160 in a year, they lose one dollar in benefits for every three dollars in earnings. This 33 percent tax rate makes the total marginal tax rate more than 100 percent for some older workers.

Raising the amount that retirees can earn without loss of benefits 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.

FIGURE II

Projected Impact of Proposals on Government Revenue (1995 - 2000)



Source: Congressional Budget Office, TaxAction Analysis.

Raising the earnings limit would increase federal outlays for Social Security benefits by $6.8 billion between 1995 and 2000, but higher economic growth created by the move would generate an extra $15 billion in federal revenue.

Increasing the Estate Tax Credit. The first $600,000 of an estate has been excluded from tax since 1987. As incomes and asset values have risen, it has become more likely that the tax would reach the estates of middle-income taxpayers. The contract would increase the exclusion to $750,000 in 1995 and index it for inflation thereafter.

Net Economic Effects. If increased investment is ignored, the Congressional Budget Office predicts that making all the tax cuts the contract calls for would reduce federal revenue by $150 billion over five years. [See Figure II.] However, NCPA Senior Fellows Gary Robbins and Aldona Robbins have calculated the dynamic — as opposed to static — effects in a study for TaxAction Analysis and have concluded that the measures would add 2 percentage points to our annual growth rate, resulting in a higher GDP, more jobs and more tax revenue.