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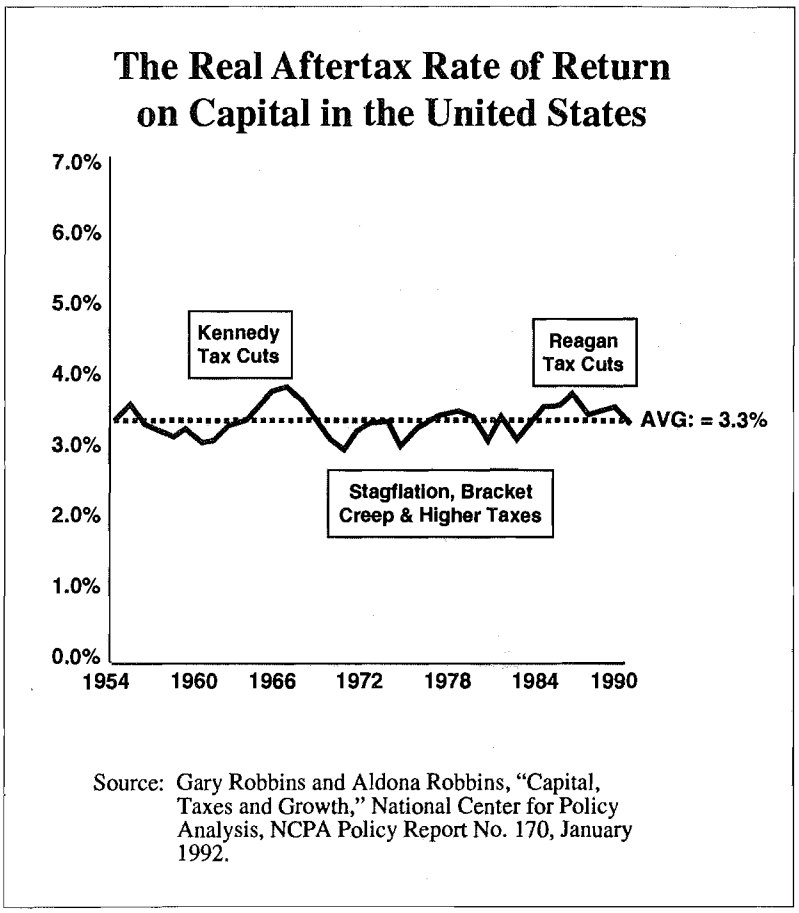
Are the Republican Tax Cuts Fair?

The most controversial provisions of the House Republicans' Contract With America are the tax cuts.

The question of whether to give parents a $500 child tax credit and, if so, at what income level is a political decision. But six proposals in the contract are designed specifically to increase economic growth in the United States. These include cutting the capital gains rate in half, indexing capital gains and depreciation expenses and expanding opportunities to contribute to IRA accounts.

Republicans claim that these tax reductions will lead to more jobs, higher wages and a higher living standard for all. Democratic critics claim that these tax changes are a giveaway to the rich that will have to be funded by higher tax burdens for everyone else.



Source: Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 170, January 1992.

The Case Against the Proposals. The Democrats' critique is based on two arguments. First, they claim that lowering taxes on investment income does not lead to more overall investment. Therefore, there will be no increase in GDP. While these policies may alter the way in which the national income pie is divided, they do not affect the total size of the pie, they say.

The critics do not deny that tax policy can change investment decisions. For example, they recognize that a cut in the capital gains tax rate will likely encourage the kinds of investments that generate capital gains and that more liberal rules on IRAs will lead to more IRA deposits. But these investments, they claim, come at the expense of others. On net, the amount of real capital in the economy as a whole will remain the same.

If you buy this argument, you almost have to accept the Democrats' charge that the Republican tax cuts are unfair. If reducing taxes on investment income does not stimulate overall investment, then all it does is shift the tax burden from investors to noninvestors. And in our economy, investors disproportionately are high-income people. Among those who earn more than $250,000 a year, for example, 65 percent of income comes from investments.

The critics cannot be dismissed lightly. Theirs are the same assumptions used by the Congressional Budget Office and the Joint Committee on Taxation to forecast the effects of proposed legislation. The assumptions also are endorsed by the Clinton administration's Office of Management and Budget and the U.S. Department of the Treasury.

Yet despite the cachet of the critics, the economic theory they rely on is anything but mainstream. Every president since Franklin D. Roosevelt has believed that the federal government's fiscal policy can affect national income. And — prior to Bill Clinton — every president since John F. Kennedy believed that reducing taxes on investment income can increase total investment and benefit the nation as a whole.

Evidence That Tax Cuts Spur Growth. The other side of this argument can be summed up in two words:

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taxes matter. Proponents of supply-side tax cuts believe that changes in tax rates do not merely shift the tax burden among different taxpayer groups but also can induce people to alter their work effort and their savings and investment plans. These changes cause national income to grow or shrink.

Some Democrats claim that this position is voodoo economics, a.k.a. trickle-down economics. Its theoretical underpinnings, they say, were totally discredited during the Reagan administration — witness the mounting federal debt in the 1980s.

In fact, the experience of the 1980s strongly supports the power of tax policy to affect the economy. For example, the liberal Urban Institute concluded that the 23 percent across-the-board reduction in personal income tax rates in the first Reagan term substantially increased labor market participation — especially among marginal workers including teenagers, the elderly and women in two-earner households. Other studies show that throughout the 1980s, investment in equipment and residential and nonresidential structures responded to tax rate increases and decreases.

The Rate of Return on Capital. Another way to test the validity of the two views is to look at the returns earned by investors. If the capital stock does not change when taxes on investment income change, this implies that the government can permanently increase or decrease the aftertax rate of return. Does the evidence support this prediction? Hardly.

Gary Robbins and Aldona Robbins, two former U.S. Treasury economists, have calculated the economy-wide aftertax rate of return on capital in the United States over the past 40 years. The figure depicts this calculation, showing that the return on capital tends to be a constant 3.3 percent over time. This finding is consistent with U.S. Department of Commerce measurements of the rate of return earned in manufacturing.

The calculation supports the following conclusion: *Not only is the capital stock not fixed, it appears to be infinitely elastic.* Specifically, the world capital market appears willing to supply unlimited investment funds to the U.S. economy so long as investors can earn an aftertax average rate of 3.3 percent. In response to a major tax change, the flow of investment funds expands or contracts until the rate of return reaches 3.3 percent.

Moreover, the response to a major tax change is relatively quick. Sixty percent takes place within two years, and the full effect is felt within five years.

Why Most of the Benefits Go to the Nonrich. If the aftertax rate of return on capital is constant, then investors will earn roughly the same return regardless of what government does. This implies that the benefits of a larger capital stock tend to go to wage earners rather than owners of capital. Currently, our economy generates $12 in aftertax wages for every $1 of aftertax income to investors. As long as we can give an extra dollar to investors and walk away with $12 in wage income, what difference does it make whether the investors are Wall Street fat cats, Japanese businessmen or little old ladies in tennis shoes? No matter who provides the capital, it's a deal we can't afford to turn down.

Based on the assumption that the rate of return on capital tends to be constant, the Robbinses have forecast that the Republican contract would increase the U.S. economic growth rate by 2 percentage points and over the next five years create 3.2 million new jobs, increase the aftertax wage rate by 10.3 percent and produce a total of $3.9 billion in additional aftertax wages.

Other evidence in favor of the power of taxes to spur economic growth comes from a series of studies showing that the overall tax rate significantly affects economic growth. These include studies of the differences in growth rates among nations and among the 50 states as well as studies of the U.S. growth rate over time.

For example, a study by Gerald Scully of the University of Texas at Dallas shows that a total tax rate (federal, state and local) that takes more than 23 percent of gross national product lowers the rate of economic growth in the United States. Had we maintained the 1949 level of 23 percent of GNP instead of allowing the rate to climb to its current 40 percent level, higher growth would have produced twice the national income we currently enjoy. Moreover, at that higher income level, 23 percent of GNP would generate enough tax revenue to pay for all existing federal programs with no federal debt.

One does not have to accept the results of any particular study in order to accept the conclusion that lower taxes can raise national income. Any other conclusion is inconsistent with history, economic evidence and common sense.