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Budget Summit Issue:

WILL THE NEW BUDGET PACKAGE CREATE A RECESSION?

"Lesson of the 1980s: lower taxes stimulate; higher taxes depress."

Background. The United States has 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 Lawrence Lindsey has called the tax cuts of the early 1980s "The Growth Experiment" and noted the overwhelming evidence from that experiment:

> 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.[1]

The lesson of the 1980s is: lower taxes stimulate economy and higher taxes depress the economy. That lesson may be ignored as a new budget package threatens to push us into a recession, or make the recession already underway deeper and longer than it otherwise would be.

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ECONOMIC EFFECTS OF THE ORIGINAL SUMMIT AGREEMENT

The original budget summit agreement sought to impose $134 billion in new taxes over the next five years. About 70 percent of the tax burden would have been in the form of excise taxes — primarily on gasoline, petroleum, cigarettes and alcohol. The remainder would have consisted of a payroll tax increase of 2.9 percentage points for upper-middle income families[2] and an income tax increase of 0.84 to 0.99 percentage points for higher-income families.[3]

Depressing Economic Effects. In a forecast prepared for the National Center for Policy Analysis and the U.S. Chamber of Commerce, we showed that this tax package would have a depressing effect on the economy throughout the 1990s. Specifically:

"The budget summit agreement would lead to 408,000 fewer jobs and $168.6 billion less in GNP by 1995."

- Enactment of the agreement would lead to 408,000 fewer jobs by 1995 and almost 520,000 fewer jobs by the year 2000.
- Gross national product (GNP) would be $168.6 billion lower than otherwise over the next five years, and the loss of GNP would be more than $65.6 billion per year by the end of the decade.

Even if we manage to avoid a recession and follow the optimistic economic path predicted by the summiteers, the depressing effects of the new taxes would cause the package to fall short of its revenue goals. And the harm done to the private sector would be large relative to the revenue collected.

- Because tax payments would be lower in a depressed economy, the federal government would receive only 67 cents of each dollar of new taxes it tried to collect over the next five years.

"The reduced output would equal $2,700 for a family of four."

- For every $1 of new revenue, the private sector would lose $1.87 in reduced output of goods and services.
- Over the next five years the loss of output would equal about $675 per person, or $2,700 for a family of four.

"The effects of higher marginal tax rates would offset any pro-growth effects."

The Trade-off Between Higher Income Tax Rates and Pro-Growth Measures. President Bush's stated goals for the budget summit package were to (1) raise new revenue and (2) stimulate economic growth. To achieve the second goal, the summiteers agreed to $25 billion in selected tax cuts. Unfortunately, the "pro-growth" tax cuts come dangerously close to being "pro-tax-shelter" incentives.[4] Moreover, the increase in marginal tax rates would more than offset any stimulus the tax cuts would provide.

CAN A BUDGET AGREEMENT PREVENT A RECESSION BY LOWERING INTEREST RATES?

A major argument in favor of a budget agreement (including increased taxes) is that a reduction in the federal deficit will cause lower interest rates, which in turn will keep the economy out of a recession. Unfortunately, there is little convincing evidence that budget deficits affect market rates of interest and even less evidence that low interest rates prevent recessions or high interest rates cause them.

Deficits and Interest Rates. The idea that federal deficits affect interest rates is the argument of those who would raise taxes on the eve of a recession. This idea, however, has been disproven by experience. Over the past four years, for example, there has been virtually no relationship between the size of the federal deficit and interest rates. [See table.]

"There is no relationship between deficits and interest rates."

INTEREST RATES AND DEFICITS

Year	Interest on Long-Term Government Debt	Deficit as Percent of GNP
1987	8.64%	3.4%
1988	8.98%	3.2%
1989	8.58%	2.9%
1990	8.76%	2.3%

[1]Interest rate on long-term treasury securities (Average of issues 10-years or longer).

Source: Federal Reserve Board of Governors

"A $100 billion reduction in federal borrowing is puny in an $18 trillion credit market."

Further, there is no theoretical reason to believe that deficits have much effect on interest rates.

- Outstanding debt in U.S. credit markets is $13.2 trillion and is expected to rise to almost $18 trillion by 1995.[5]

- By comparison, a $100 billion per year reduction in federal borrowing is negligible.

Even if the budget summit targets were met, total outstanding debt in U.S. credit markets would be reduced by less than 1 percent by 1995. At most, this would lead to a reduction in interest rates of 1/4 of 1 percent.[6]

Recessions and Interest Rates. Immediately following the budget summit agreement, Federal Reserve Board Chairman Alan Greenspan announced that he would lower interest rates.[7] Many interpreted this to mean that the economy would avoid a serious recession. Yet, if the Federal Reserve could control interest rates, and if interest rates could direct the economy, the Federal Reserve on its own could sustain economic growth. Unfortunately, the idea that the Federal Reserve can fine-tune the economy by manipulating interest rates is inconsistent with the evidence.[8]

WHAT A RECESSION WOULD DO TO THE FEDERAL DEFICIT

Avoiding a recession is far more important than reducing the federal deficit. In fact, a recession can increase the size of the deficit more rapidly and more dramatically than any of the policy change can reduce it. For example:

- In the President's January budget, the five-year deficit was projected to be $212.3 billion.

- Yet because of deteriorating economic conditions, the projected five-year deficit jumped by almost $500 billion in July and another $200 billion by September. [See graphic.]

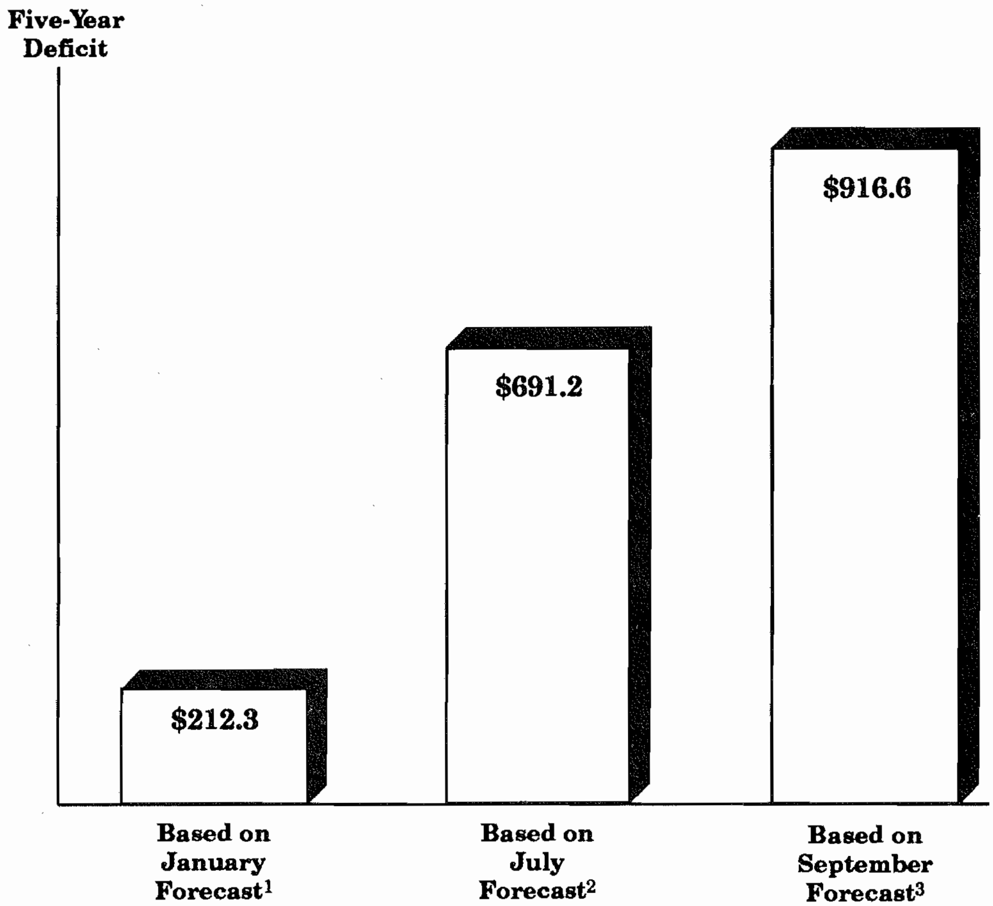
"A deep recession would increase the deficit far more than the summit package can reduce it."

In other words, the size of the projected federal deficit has more than quadrupled in the past nine months because of the deteriorating economy. If economic conditions deteriorate as much between now and next March as they have since July, the five-year deficit will grow by another $195 billion.

Put another way, a deteriorating economy is adding almost $1 trillion to the five-year federal deficit — at a time when new tax measures would cause further deterioration in order to reduce the deficit by half that much.

"Worsening economic conditions have increased the five-year deficit by $700 billion in the past nine months."

HOW WORSENING ECONOMIC CONDITIONS HAVE INCREASED THE SIZE OF THE FEDERAL DEFICIT ($ Billions)



[1]OMB projection in the 1991 Budget, January 29, 1990.

[2]Mid-Session Review, July 16, 1990.

[3]OMB projection, September 30, 1990.

Note: All forecasts assume no budget summit agreement.

CAN INCREASED TAXES BE AVOIDED?

The budget negotiators generally assume that the deficit cannot be eliminated, even over five years, without tax increases. Yet there are alternatives.

By selectively cutting taxes, the federal government can raise just as much revenue as the summiteers hoped to generate by tax increases. One package, similar to the proposals made by Newt Gingrich and others, would:

1. Lower the maximum capital gains tax rate to 15 percent with inflation indexing.

2. Index depreciation schedules for investment in equipment.

3. Create "IRA Plus" accounts which permit aftertax deposits and tax-free withdrawals.

4. Allow aftertax deposits and tax-free withdrawals from 401(k) plans.

5. Expand the earned-income tax credit for working families with children.

"Selected tax cuts can stimulate the economy and increase federal revenue."

A package consisting of these five proposals would stimulate the economy significantly. Specifically, such a package would:[9]

- Increase the U.S. capital stock by $6.0 trillion by the end of the decade.

- Raise the U.S. economic growth rate by about 1 percentage point over the decade, leading to a cumulative increase in the nation's GNP of more than $4.0 trillion over the next ten years.

- Increase national economic output by $16,000 for every man, woman and child in the country.

- Produce 1.2 million new jobs by 1995 and 2.2 million by the end of the decade.

"The federal government can raise just as much revenue through tax cuts as it plans to gain through tax increases."

These selective tax cuts would produce $15 billion in new revenue in the first year and $142 billion over the next five years. When combined with an extension of existing excise taxes plus user fees (proposed by President Bush in January), the proposal would raise $25.8 billion in the first year and $187.9 billion over five years — exceeding all of the revenue goals of the budget summit.

"Through tax cuts, the government can exceed the revenue goals of the budget summit."

HOW TAX CUTS GOT US OUT OF THE LAST RECESSION

The last U.S. recession occurred in 1981. The recovery was one of the quickest and strongest ever. In order to end the recession, the 1981 tax law incorporated new economic incentives, of which the marginal tax rate reductions and the Accelerated Cost Recovery System (ACRS) were the most important. The results were dramatic:[10]

- 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.

"Tax cuts spurred investment to end the 1981 recession."

Tax reforms in 1986 repealed ACRS and raised the capital gains tax rates — and both measures have contributed to the current economic slowdown. To repeat the experience of the early 1980s, we need to create new incentives to save and invest. Yet that option may no longer be available.

WHY A PRO-GROWTH PACKAGE MAY NOW BE IMPOSSIBLE

Any tax cut that stimulates the economy leads to a federal revenue increase which partly offsets the direct revenue loss from the tax cut. For example:[11]

"Every reduction in the highest marginal tax rate and every reduction in capital gains rates has led to greater government revenue."

- The tax reductions enacted in 1981 would have produced a revenue loss of $115 billion if there had been no dynamic economic response.

- But because the economy responded to the tax cuts, the actual revenue loss was only $33 billion.

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"Government forecasters routinely assume that taxes do not affect behavior."

- As a result, 70 percent of the potential revenue loss was regained.

As noted above, some selective tax cuts produce so much economic stimulus that the government actually gains more revenue than it loses. For example, every significant tax *rate* reduction for the highest income earners has always produced *more* revenue for the federal government.[12] Similarly, every significant reduction in the capital gains tax *rate* has always led to *greater* capital gains tax revenues.[13]

Static vs. Dynamic Forecasts. Virtually all economists outside Washington, DC acknowledge that tax increases depress economic activity and tax cuts stimulate economic activity. Thus, it is essential to take account of the *dynamic* response of the economy to those changes.

The federal government's major forecasting agencies, however, do not incorporate the behavioral effects of taxes. The economists of the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) employ *static* methods and assume that tax rate increases do not harm the economy and tax rate decreases do not help it.

The difference between the two types of forecasting is enormous. As the accompanying table shows:

- Based on a static forecast, a capital gains tax cut will lose $9.4 billion in federal revenue through 1995 and $75 billion through the year 2000.

- Based on a reasonable dynamic forecast, however, a capital gains tax cut would increase government revenue by $63.5 billion through 1995 and $211.0 billion through the year 2000.

The Unholy Agreement. President Bush and leading Republicans have repeatedly told the public they want a capital gains tax cut and other tax measures to promote economic growth. Yet in a little-noticed, behind-closed-doors agreement with leading Democrats, they agreed to use static forecasts in order to project the effects of these measures on the economy. In other words, while publicly supporting pro-growth policies, the Republicans privately agreed to budget forecasts which assume those policies will have *no impact on economic growth*.

EFFECTS ON FEDERAL REVENUE OF THE KASTEN / MACK / SHELBY CAPITAL GAINS TAX CUT PROPOSAL

Calendar Year	Static Federal Revenue ($bil.)	Dynamic Federal Revenue ($bil.)
1991	$ 2.5	$ 6.6
1992	0.0	8.0
1993	-1.7	12.2
1994	-3.8	16.3
1995	-6.4	20.4
1996	-9.3	23.1
1997	-12.6	25.0
1998	-13.6	28.9
1999	-14.6	33.1
2000	-15.6	37.2
1991-1995	-9.4	63.5
1991-2000	-75.0	211.0

"The dynamic economic response converts a $75 billion revenue loss into a $211 billion revenue gain."

This agreement makes the adoption of any pro-growth tax measure virtually impossible. Any reduction in tax rates on capital or labor will produce *static* revenue losses. Since the purpose of a budget agreement is to reduce the deficit, any tax rate reduction must be offset by some other tax rate increase. And *static* forecasts always assume that tax rate increases will produce more revenue.

"Publicly the Republicans promoted pro-growth tax cuts; privately they agreed to assume the tax cuts have no effect on growth."

To make matters worse, the "rules of the game" to which Republican negotiators agreed guarantee that any pro-growth tax cut will be viewed as unfair. Static forecasts assume that the only beneficiary of a tax cut is the taxpayer. If there is no effect on general economic activity, no one else can benefit. Therefore, every government forecast of a lower tax on capital not only shows large revenue losses, but also shows that only the wealthy benefit.

"Under the agreement, almost any pro-growth tax cut will also appear to be unfair."

These rules would have precluded the Kennedy income tax cut, the Carter capital gains tax cut and the Reagan reduction in marginal tax rates — measures acknowledged worldwide as beneficial to the U.S. economy.

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WHY A RATIONAL POLICY RESPONSE TO THE COMING RECESSION ALSO MAY BE IMPOSSIBLE

Congressional negotiators are not merely agreeing to a five-year plan. They are adopting rules that will govern the political system's response to unfavorable economic events. Suppose that next year we are in a deep recession. What can Congress do?

- A supply-side response will be extremely difficult, since any tax cut including a payroll tax reduction will require a 60 percent majority in both houses of Congress.

"Congress has tied its own hands — making a tax cut almost impossible, even in a deep recession."

- A Keynesian demand-side response will be equally difficult, because any increase in spending above budget agreement levels will require a 60 percent majority.

- A monetarist response of increasing the money supply may have little effect because widespread indexing tends to make the real economy immune from changes in the general price level.

WHAT TO EXPECT FROM THE NEW BUDGET PACKAGE

"Some Congressional Democrats are calling for higher tax rates for high-income taxpayers."

Congress rejected the original budget summit agreement and is drafting a plan of its own. The magnitude of the tax increases and spending reductions in the new plan will be similar to those in the rejected plan, with one notable exception: Congressional Democrats are eager to raise income tax rates for higher-income taxpayers. If they succeed, the new budget package will be even more harmful than the one that was rejected.

Because the highest income taxpayers can control the timing and size of their taxable income, a higher tax rate will certainly cause their pool of taxable income to shrink. The harm to the economy will be substantial, and in the long run the measure will be self-defeating. Consider the proposal to create a 33 percent tax bracket for high-income taxpayers:[14]

"A 33 percent tax bracket would push us even deeper into recession, destroying 377,000 jobs."

- Between 1990 and the year 2000, the imposition of a 33 percent tax bracket would reduce GNP by $518 billion.

- The economy would generate 377,000 fewer jobs.

- Over the next five years, a 33 percent tax bracket would increase federal revenue by $13 billion.

- Yet between now and the year 2000, federal revenue would decrease by $22 billion. [See table.]

"A 33 percent tax bracket would raise $13 billion in new revenue by 1995, but lose $22 billion over the decade."

EFFECT OF A 33 PERCENT TAX BRACKET
($ billions)

Year	Change in Federal Revenue
1990	+ $7.5
1991	+ 5.6
1992	+ 3.2
1993	+ 1.1
1994	- 1.4
1995	- 3.0
1996	- 4.5
1997	- 5.8
1998	- 7.1
1999	- 8.2
2000	- 9.4
Total	- $22.0

Source: Aldona Robbins and Gary Robbins, "Will Raising Taxes Reduce the Deficit?" Institute for Policy Innovation, IPI Policy Report No. 105, May 1990.

CONCLUSION

The emerging consensus among economists is that we are entering a recession. New taxes being considered in Washington will make that recession deeper and longer. New budget rules may also make it impossible for Congress to pass any pro-growth tax cuts in the future to get us out of a recession. Fortunately, there is still time for Washington to change course.

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

Footnotes

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

[2]The Medicare portion of the Social Security (FICA) tax would be extended to cover wage income between $51,300 and $73,000. The rate increase would be 1.45 percentage points for both the employer and employee share of the tax.

[3]Above $100,000 of income, taxpayers would lose 3 cents of itemized deductions for each $1 of income. For a taxpayer in the 28 percent income tax bracket, this amounts to a marginal tax rate of 0.84 percent (3 x 28%). For a taxpayer facing a 33 percent tax rate, this amounts to a marginal tax rate of 0.99 percent (3 x 33%).

[4]David Wessel and Jeffrey H. Birnbaum, "Tax Shelters for the Rich Could Return in Plan to Aid Small Businesses," *Wall Street Journal*, October 2, 1990.

[5]Based on Federal Reserve Bulletin, September 1990; and Office of Management and Budget, "Summit Agreement," September 30, 1990.

[6]Assumes an elasticity of 1.0 in the demand for credit.

[7]David Wessel and David Rogers, "Greenspan Backs Budget Accord, Sees Rate Cut," *Wall Street Journal*, October 4, 1990.

[8]Michael D. Bradley and Dennis W. Jansen, "Understanding Nominal GNP Targeting," *Federal Reserve Bank of St. Louis Review*, Vol. 71, No. 6, Nov/Dec 1989, pp. 31-40.

[9]Gary Robbins and Aldona Robbins, "Lowering Taxes to Promote Growth," National Center for Policy Analysis and U.S. Chamber of Commerce, September 1990.

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

[11]Lindsey, *The Growth Experiment*.

[12]John C. Goodman, "Should Income Tax Rates for the Wealthy be Increased?" National Center for Policy Analysis, NCPA Policy Backgrounder No. 102, July 20, 1990.

[13]John C. Goodman, "Would a Capital Gains Tax Cut Increase or Reduce Government Revenue?", National Center for Policy Analysis, NCPA Policy Backgrounder No. 103, July 27, 1990.

[14] Aldona Robbins and Gary Robbins, "Will Raising Taxes Reduce the Deficit?", Institute for Policy Innovation, IPI Policy Report No. 105, May 1990.

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THE NATIONAL CENTER FOR POLICY ANALYSIS

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute, funded exclusively by private contributions. The NCPA originated the concept of the Medical IRA (which has bipartisan support in Congress) and merit pay for school districts (adopted in South Carolina and Texas). Many credit NCPA studies of the Medicare surtax as the main factor leading to the the 1989 repeal of the Medicare Catastrophic Coverage Act.

NCPA forecasts show that repeal of the Social Security earnings test would cause no loss of federal revenue, that a capital gains tax cut would increase federal revenue and that the federal government gets virtually all the money back from the current child care tax credit. These forecasts are an alternative to the forecasts of the Congressional Budget Office and the Joint Committee on Taxation and are frequently used by Republicans and Democrats in Congress. The NCPA also has produced a first-of-its-kind, pro-free-enterprise health care task force report, representing the views of 40 representatives of think tanks and research institutes.

The NCPA is the source of numerous discoveries that have been reported in the national news. According to NCPA reports:

- Blacks and other minorities are severely disadvantaged under Social Security, Medicare and other age-based entitlement programs;
- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

What Others Say About the NCPA

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