NCPA

National Center for Policy Analysis

POLICY BACKGROUNDER NO. 112
For people with limited time and a need to know.

For Immediate Release
January 28, 1992

Federal Budget Issue:

DO WE NEED A TAX CUT?

As the economy languishes and the presidential election nears, politicians of both parties are searching for ways to stimulate the economy and promote economic growth. Since almost no one believes that an increase in federal spending will help, attention has turned to tax cuts. Do we need a tax cut and if so, what kind?

AREN'T TAXES ALREADY TOO LOW?

Remembering the Reagan tax cuts of the 1980s and the rhetoric proclaiming that these tax cuts created large deficits, many Americans will be surprised to learn that government takes more of our income today than it did in 1980, the last year of the Carter Administration. [See Figure I.]

"The supply-side incentives of the 1980s no longer exist."

The reason is that (federal, state and local) tax increases in the past four years have more than offset the tax reductions in the early 1980s. Moreover, despite the lowering of marginal income tax rates during the Reagan years, marginal tax rates on capital and labor are higher today than they were in 1983. [See Figure II.] The marginal tax rate on labor is up primarily because increases in the Social Security (FICA) tax rate more than offset the reductions in the income tax rate for the average worker. The marginal tax rate on capital is up primarily because the 1986 Tax Reform Act eliminated many of the tax incentives created for investors in the early 1980s.

The economic expansion of the 1980s was a supply-side expansion stimulated by tax incentives. Today, for the average investor and the average worker, those incentives no longer exist.

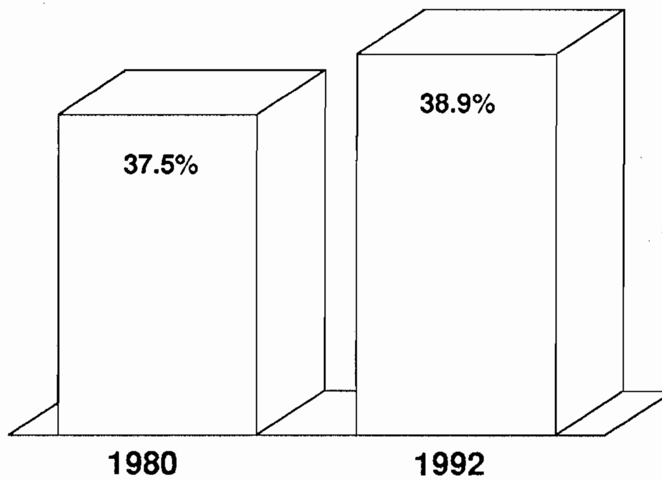
- more -

First Interstate Plaza 12655 N. Central Expy., Suite 720 Dallas, TX 75243-1739 (214) 386-NCPA FAX 386-0924

"Government takes more of our income today than it did in 1980."

FIGURE I

Share of National Income Taken By Government

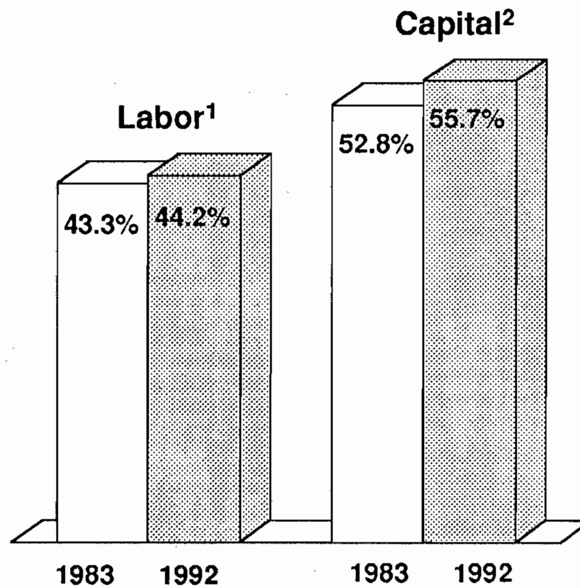


Source: Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

"Marginal tax rates are higher today than they were in 1983."

FIGURE II

Marginal Tax Rates



[1]The weighted average marginal tax rates in 1992 are 22 percent for the income tax, 15.3 percent for the Social Security (FICA) payroll tax and 6.9 percent for indirect business taxes.

[2]Includes all capital (including residential houses) and all taxes (including sales and property taxes).

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

WHY A TAX CUT IS NEEDED

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

Most economists agree that a tax cut today would do little to speed the economic recovery already underway. A tax cut is needed not to end the current recession but to promote a higher rate of long-term economic growth.

Forecasts of Slow Growth. According to the forecasters, America's economic future is not bright:[1]

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

Effects of Slow Growth. The forecasted sluggish growth rate will impose a heavy burden on American families:[2]

- If the economy grows at only 2.5 percent over the next five years, instead of at the 3.3 percent rate posted from 1985 through 1989, the loss of output will equal $2.3 trillion. [See Figure III.]
- The slower growth rate will mean fewer jobs created, 44 million man-years of lost labor and $875 billion in lost wages.
- The federal government will collect $520 billion less revenue, and state and local governments will receive $350 billion less.
- As a result, the cumulative federal deficit over the next five years will be in excess of $1 trillion.[3] [See Figure IV.]

Causes of Slow Growth. The reasons for slow 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 man-made, not natural, and the price Americans are paying is high. A number of factors have combined to slow the economy:

- A substantial Social Security payroll tax rate increase, combined with an unexpectedly large increase in covered earnings, raised the tax on working and the cost of hiring labor.

- Increased regulations, especially in environmental areas, increased future costs of production.

- State and local governments 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 agreement.

- Home ownership and commercial property became far less attractive as the real estate market absorbed a substantial, retroactive increase in capital gains tax rates.

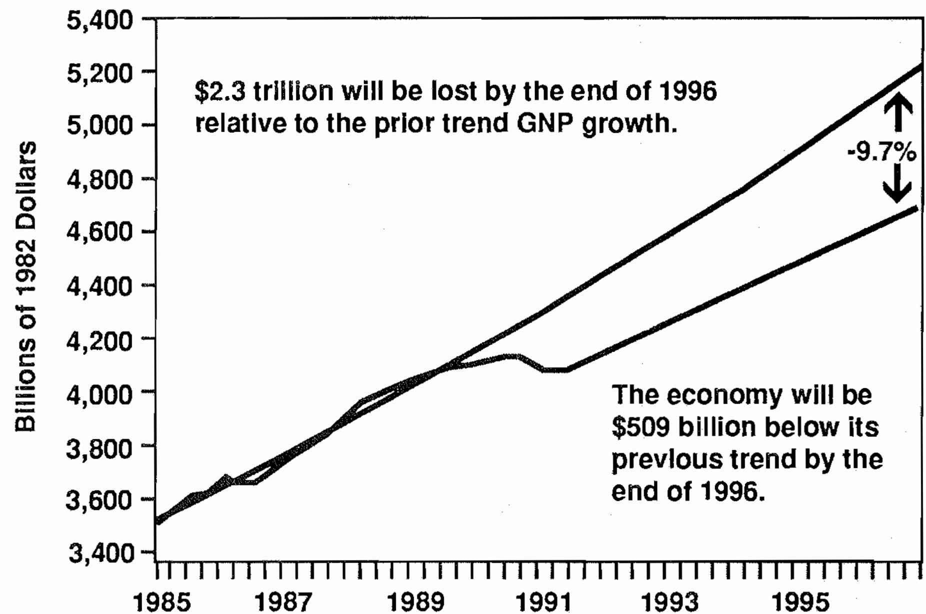
The current downturn is a natural reaction of the U.S. economy to higher levels of production costs resulting from these government policy reversals. Businesses have adjusted investment and hiring to reflect the lowered prospects for sales and profits. Their responses have resulted in lower GNP, fewer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

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

FIGURE III

Potential GNP Loss With Low Growth

Prior Trend vs. 2.5 Percent



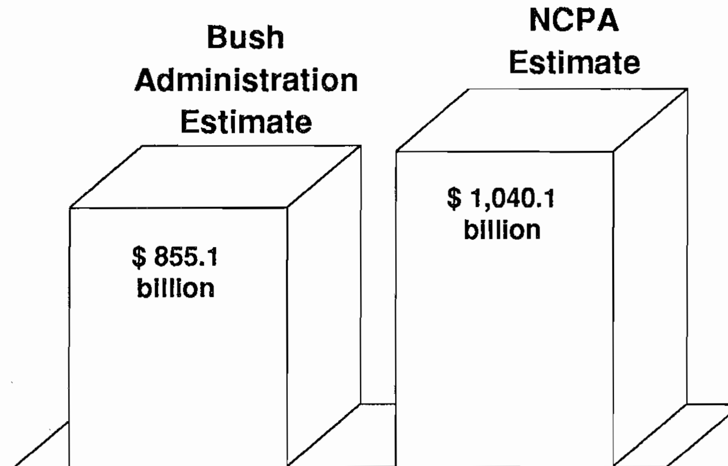
Source: "Statement of Gary Robbins" in John C. Goodman, ed., "Pro-Growth: The Proceedings of the Senate Republican Conference Task Force on Economic Growth and Job Creation," National Center for Policy Analysis, NCPA Policy Report No. 167, January 1992.

"*Federal deficits over the next five years will exceed $1 trillion.*"

FIGURE IV

Five-Year Federal Deficit

(1992-1996)



Source: Aldona Robbins and Gary Robbins, "Strategy For Growth," National Center for Policy Analysis and the U.S. Chamber of Commerce, NCPA Policy Report No. 170, January 1992.

THE WRONG KIND OF TAX CUT

Economists are almost unanimous in the belief that, by itself, a temporary transfer of money from the federal government to taxpayers will do nothing to stimulate the economy or promote higher growth. Simply taking money out of one pocket and putting it in another creates no new jobs. This belief is confirmed by recent experience. The 1968 surtax did little to slow the economy, and the 1975 tax rebate did little to stimulate it.

"*Policymakers have enormous power to influence the economy by changing taxes on investment income.*"

Thus, Republican and Democratic proposals to raise the personal exemption and pay for it with cuts in defense spending are not pro-growth. In fact, in the short run, such proposals will lead to fewer jobs as the defense industry lays off workers who must then find new work in the civilian economy.

By contrast, the right kind of tax cut will create new incentives for people to work, save and invest.

HOW TAX CUTS CAN MAKE A DIFFERENCE

Policymakers have enormous power to influence our economy, though many in Washington deny it. The reason why they have this power is that investment in the United States is highly sensitive to taxes on investment income. Small variations in the tax rate on capital income lead to large changes in the nation's capital stock.

Taxes on Investment Income. Consider the decision to invest $1 billion in plants and equipment in a foreign country rather than in the United States. As Table I shows, the loss of capital from the foreign investment would reduce our nation's output by about three-quarters of $1 billion, leading to almost one-third of $1 billion in lost wages and in lost government revenues and $30 million in lost income for investors.

Now, consider a tax cut for investors of only $10 million. If it causes investors to choose to invest the $1 billion in the United States rather than in a foreign country, the tax cut would create 18,500 new jobs, $325 million in take-home pay for American workers and $315 million in new revenue for government.

"A $10 million tax cut can attract $1 billion in new investment."

Table I

Consequences of Investing $1 Billion in a Foreign Country Rather Than in the United States[1]

Effects on the U.S. Economy	Annual Economic Loss ($ millions)
Loss of Output	$ 750
Loss of Wages	325
Loss of Tax Revenue	315
Loss of Profit	30

[1]Investment in plants and equipment by nonfinancial corporate businesses. Note: These calculations differ somewhat from those shown in Figure VII, which is based on capital investments of all types.

Can a $10 million tax cut change investors' minds about where to invest $1 billion? History shows that, on the average, it would be more than enough to make global investors prefer the U.S. to the rest of the world.

In general, the world investment community is willing to supply virtually any amount of capital to the United States so long as investors can earn at least a 3.3 percent real, aftertax rate of return (e.g., $33 million per year in the example illustrated in Table I). As Figure V shows:

- When the rate of return rises to 3.3 percent or more, say because of reduced taxes on investment income, there is always an increase in investment.
- Conversely, when the rate of return falls below 3.3 percent, there is always a decrease in investment.
- Over the past 37 years, 75 percent of the variation in investment spending can be explained by changes in the rate of return on capital alone.

Because the government can increase the rate of return for investors (and thus attract new capital) with only small reductions in taxes on investment income, policymakers have enormous power to stimulate the economy at a very low cost.

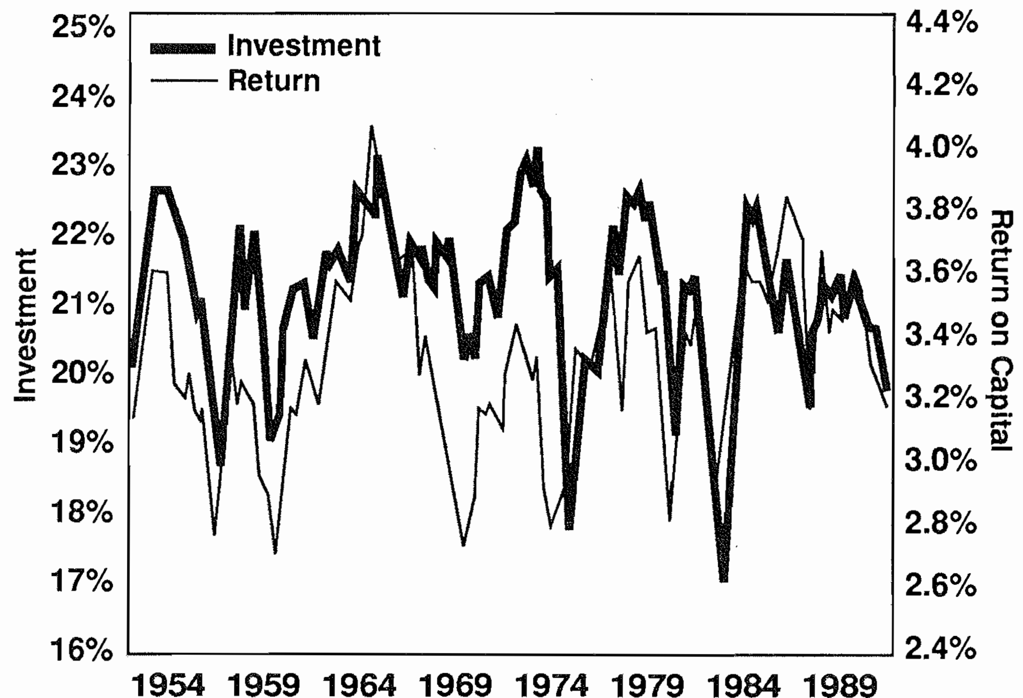
Taxes on Labor Income. An expanding capital stock can create great benefits for the U.S. economy. But the benefits of more capital will diminish over time unless there is a corresponding increase in labor.

Over the decade of the 1980s, the American economy expanded by a third in real terms. Evidence suggests that one 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.[4]

"About 75 percent of the change in investment spending can be explained by changes in the aftertax rate of return."

FIGURE V

Investment as a Percent of Private GDP and the Real Aftertax Rate of Return on Capital[1]



[1]The aftertax rate of return is the return on real capital, which is measured annually by the Fiscal Associates tax model.

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

PRO-GROWTH TAX CUTS

In an almost unlimited number of ways, tax cuts can be used to stimulate the economy and promote economic growth. A brief summary of the principal ways follows.

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, the owners of capital have no such protection. 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. Recent increases in taxes on capital have contributed to the current economic slowdown. In particular, the 1986 Tax Reform Act raised the tax rate on capital gains by 40 percent[5] and limited the ability of people to save through IRAs and 401(k) plans.[6] The Social Security benefits tax (which is actually a tax on elderly investment income) has eroded the value of all tax-deferred savings for a majority of American workers.[7] These policies need to be changed.

"Almost any tax cut for investment income will pay for itself many times over in terms of increased output and more jobs."

Lowering Taxes on Labor. For millions of American workers 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 is encouraging elderly workers to retire at a time when American industry desperately needs their skills.[8] These policies also need to be changed.

A Pro-Growth Package. Numerous proposals before Congress combine elements of these needed changes. For example, a proposal made by the National Center for Policy Analysis and the U.S. Chamber of Commerce in 1990 and again in 1992 was introduced in Congress by Tom DeLay (R-TX) and Malcolm Wallop (R-WY). This growth package would stimulate the economy and reduce the deficit at the same time:

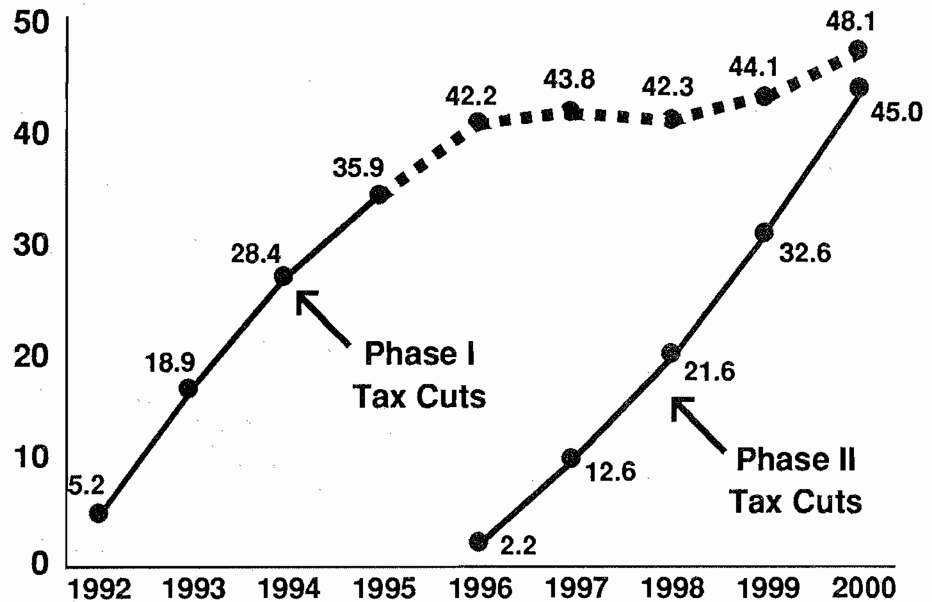
- The NCPA/U.S. Chamber proposal would raise the U.S. economic growth rate by more than a percentage point over the remainder of the decade.

- At the same time, the proposal would increase government revenue in each and every year [see Figure VI] and, when combined with modest spending cuts, would eliminate the federal deficit by 1996.

- more -

"By selectively reducing taxes we can generate more revenue for government."

FIGURE VI



[1]Based on the National Center for Policy Analysis/U.S. Chamber of Commerce Pro-Growth Proposal.

Source: Aldona Robbins and Gary Robbins, "A Strategy for Growth," National Center for Policy Analysis and the U.S. Chamber of Commerce, NCPA Policy Report No. 170, January 1992.

TAX CUTS AND THE FEDERAL DEFICIT

Because of their effects on investment and on the size of the capital stock, taxes on capital severely affect the economy as a whole. This is why new taxes on capital often produce less total revenue, not more. Not only does the tax base (the capital stock) shrink, but so do aggregate output and national income. Conversely, a reduction in taxes on capital has the reverse effect — usually leading to increased government revenue.

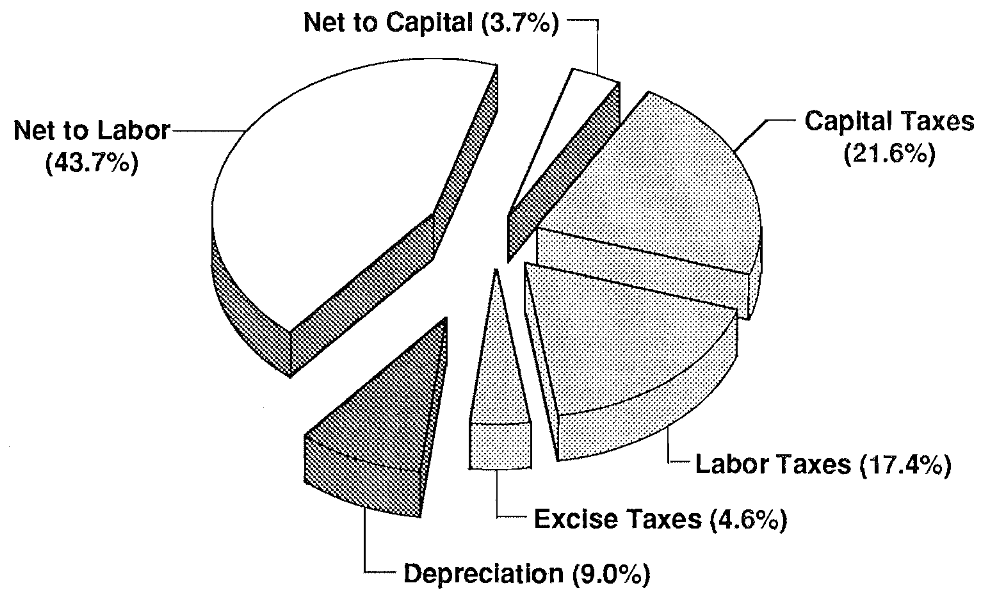
In general, almost any (targeted) reduction in taxes on capital results in a net gain in revenue for government. Under the current tax system:

- For every $1 billion cut in taxes on investment income, we can expect about $25 billion in increased production.
- Government will receive about $12 billion in additional revenue — making an $11 billion "profit." [See Figure VII.]

"For every additional $1 of aftertax income received by investors, workers will get $12 and government will get $12."

FIGURE VII

Division of Additional GNP Under the Current Tax System



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

TAX CUTS AND FAIRNESS

Almost any tax cut for investment income pays for itself many times over in increased output, new jobs and more revenue for government. If a pro-growth package results in a net increase in federal revenue, who pays the higher taxes? Primarily they are paid by higher-income taxpayers. For example, about one-half of the increase in personal income taxes that will result from 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 will flow to wage earners and to government, rather than to owners of capital. As Figure VII shows, wage earners will receive about $12 billion in additional aftertax wages for every $1 billion received by investors.

The NCPA/U.S. Chamber Growth Package. If a growth package has a substantial impact on the economy, these relationships may change somewhat over time. Take the NCPA/U.S. Chamber growth package, for

example. 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.

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

- Of the $845 billion increase in national income in the year 2000, $500 billion will go to labor, $315 billion to government and only $30 billion to owners of capital.

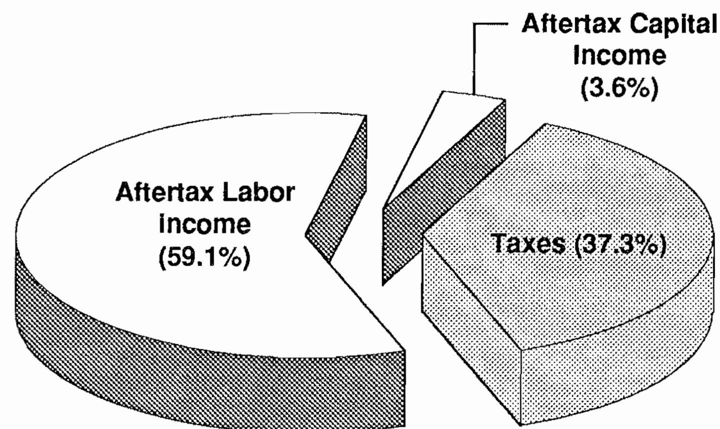
- For every $1 of additional aftertax income created for investors that year, wage earners will receive $16 and government will receive $10.

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

FIGURE VIII

Division of Additional National Income In the Year 2000

(Under the NCPA/U.S. Chamber of Commerce Pro-Growth Plan)



Source: Aldona Robbins and Gary Robbins, "A Strategy for Growth," National Center for Policy Analysis and the U.S. Chamber of Commerce, NCPA Policy Report No. 170, January 1992.

"A carefully designed growth package can reduce the deficit and increase growth at the same time."

CONCLUSION

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 would surely increase the deficit. Instead, we should selectively reduce tax rates on capital and labor, creating an economic stimulus that will sustain economic growth and meet the revenue needs of the federal government at the same time.

Gary Robbins
Aldona Robbins
John Goodman

- 30 -

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] "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.

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

[3] Aldona Robbins and Gary Robbins, "A Strategy for Growth," National Center for Policy Analysis and the U.S. Chamber of Commerce, NCPA Policy Report No. 170, January 1992.

[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: A Case for a Lower Capital Gains Tax," U.S. Chamber of Commerce, August 1990.

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

[6] See Gary Robbins "Taxing Capital Gains," National Center for Policy Analysis, NCPA Policy Report No. 143, October 1989.

[7] See Aldona Robbins and Gary Robbins "The Case for IRAs," National Center for Policy Analysis, NCPA Policy Report No. 112, April 1991.

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

[9] See Aldona Robbins and Gary Robbins, "Paying People Not to Work," National Center for Policy Analysis, NCPA Policy Report No. 133, July 1988.

[10] Robbins and Robbins, "A Strategy for Growth."

[11] Robbins and Robbins, "Taxes, Capital and Growth."

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

Economic Experts

1. Gary Robbins (NCPA Senior Fellow)
   (President) Fiscal Associates — 703-979-1371

2. Aldona Robbins (NCPA Senior Fellow)
   (Vice President) Fiscal Associates — 703-979-1371

3. John Goodman (President)
   National Center for Policy Analysis — 214-386-6272

4. Lawrence Hunter (Acting Chief Economist)
   U.S. Chamber of Commerce — 202-463-5620

5. Lawrence Kudlow (Chief Economist)
   Bear Stearns and Co., Inc. — 212-272-2000