NCPA

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**POLICY BACKGROUNDER No. 120**
*For people with limited time and a need to know.*

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**FEDERAL BUDGET ISSUE:**

# Bill Clinton's Economic Plan

Democratic presidential candidate Bill Clinton's economic program[1] consists primarily of higher spending, higher taxes and private sector mandates. Although Clinton claims that his program would stimulate investment, create jobs, spur economic growth and reduce the federal deficit, we predict the opposite results. Based on a model that has proved highly accurate in forecasting the economic effects of public policy changes, we conclude that:

*"The Clinton plan would close off job opportunities and prolong the recession."*

- Because the Clinton plan imposes higher taxes on investment income, private sector investment in the U.S. economy would be $413 billion lower than otherwise over the next four years.

- Because of lower investment, the Clinton plan would lead to 747,000 fewer jobs by 1996 and a loss of more than one million jobs by the year 2000.

- The plan would slow the rate of economic growth, causing the nation's output of goods and services (GDP) to be $173 billion lower than it otherwise would have been by 1996 and $584 billion lower by the year 2000.

- Because of reduced output, the economy would generate less tax revenue and the overall federal deficit would increase by $113 billion over the next four years.

- more -

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It is important to note that the forecast presented in this report is conservative. The reality could be much worse. For example:

- Because no details are available, our forecast does not include the effects of Clinton's proposal for employer-mandated health insurance — which could put between 710,000 and 965,000 people out of work.[2]

- Nor does our forecast include the effects of Clinton's mandatory worker training program, which could cost between 175,000 and 350,000 jobs.

These two mandates alone could more than double the number of jobs lost as a result of implementing the Clinton plan. The forecast is generous to Governor Clinton in other ways. For example, it assumes a more generous capital gains tax cut than Clinton appears to have in mind. It also ignores the cost to the federal government (possibly as high as $100 billion) of Clinton's new health care program and the promise to extend Medicare to cover long-term care.

## Details of the Clinton Economic Plan

*"The plan calls for about $200 billion in increased domestic spending."*

The Clinton plan would increase domestic spending, cut defense spending and raise taxes. It would also impose mandates on employers and employees, while providing some limited tax relief. Although it includes some incentives to increase investment spending, these incentives are more than offset by higher taxes on investment income. The main stimulus envisioned by the plan is a thinly disguised return to pump priming and government work programs. The major features of the plan are summarized below.

**Higher Spending.** Clinton would increase federal spending on infrastructure and create or expand existing welfare programs. As Table I shows, Clinton estimates that these new programs would add about $50 billion a year to federal spending. However, given the broad scope and lack of details, the costs could be much higher. The plan would include:

- More spending for roads, bridges and railroads.

- Creation of a high-speed rail network linking major cities and commercial hubs.

- Development of "smart" highway technology to expand the capacity, speed and efficiency of major roadways.

- Putting public records, databases, libraries and educational materials on-line for public use.

- Putting 100,000 new police officers on the street, creating a National Police Corps, funding more drug treatment programs and establishing community boot camps.

- Fully funding programs like Head Start and Women, Infants and Children (WIC).

- Providing funds for violence-ridden schools to hire security personnel and purchase metal detectors.

- Helping communities open centers for high-school dropouts, developing a national apprenticeship training program for non-college-bound students and replacing the existing student loan program with a system that allows borrowers to choose how they would repay their loans.

**Investment Incentives.** Clinton has proposed certain tax cuts designed to encourage investment spending. These items, which are lumped together with new spending in Table I, consist of the following tax measures:

- Enterprise zones for stagnant inner cities.

- A targeted investment tax credit.

- Up to a 50 percent capital gains tax exclusion for small businesses and entrepreneurs for long-term investments.

- A permanent research and development tax credit.

Although the Clinton plan gives no details about the magnitude of the tax cuts, they are likely to be small for two reasons. First, the proposals are not new and in previous versions have involved relatively small sums. For example, the tax bill just approved by the Senate Finance Committee contains an enterprise zone provision amounting to only $2.5 billion over five years. Second, since only $50 billion a year is budgeted for the proposed spending programs, very little would be left over to provide tax relief.

*"Tax incentives to increase private investment are more than offset by penalties on investment income."*

By far the most important investment incentive is the proposed reduction in the capital gains tax. Unfortunately, the proposal is limited in two

ways. Apparently, it applies only to small businesses and entrepreneurs rather than to all investors, and its magnitude depends on the length of time an asset is held — a provision common to many capital gains reform proposals, including the one made by President Bush. The argument for making the tax rate conditional on the holding period is that people should be encouraged to invest in long-lived assets. But this argument confuses two separate issues: (1) the life of an asset and (2) the length of time an owner holds the asset. Current tax law discriminates against long-lived assets, and this discrimination should be removed. However, once people invest in an asset, there is no economic reason for us to care how long they hold it. Attempting to influence the length of the holding period introduces inefficient distortions into capital markets.

**Middle-Class Tax Relief.** Although Clinton promises middle-class tax relief, Table I shows that this tax relief would be very limited, averaging about $5.5 billion a year. Dividing by the number of all families, it amounts to about $55 per family per year. In particular, the economic plan mentions the following tax cuts:

- Either a children's tax credit or a significant reduction in the income tax rate for middle-income taxpayers.
- An increase in the Earned Income Tax Credit (EITC) to make up the difference between a family's earnings and the poverty level.

Again, no details are given. However, one of two things must be true. Either the intended tax relief must be very limited or the revenue effects shown in Table I are much too low. If Clinton is really proposing to give low-income workers the difference between what they earn and the poverty level income, the cost would be enormous. If the average income of all currently eligible EITC recipients were only 12.5 percent below poverty, such a proposal would cost $67.5 billion a year — even if it had no effect on work and earnings. But, of course, such a proposal would affect work and earnings. Although the current EITC gives people incentives to work, the proposal described here would establish effective marginal tax rates on additional work effort of 100 percent or more — since there would be no gain from increased work and no loss from reduced work.

*"The plan calls for more than $150 billion in new taxes."*

**Increases in Personal Income Taxes.** The Clinton plan would raise individual income taxes by $92 billion over the next four years. Targeted at the "rich," the tax increases would:

TABLE I

## Clinton's Description of the Clinton Plan

**(Amounts in $ billions; ± indicates effect on the deficit)**

| | 1993 | 1994 | 1995 | 1996 | Total |
|---|---|---|---|---|---|
| **Higher Spending (includes business tax cuts)[1]** | +38.4 | +48.9 | +52.7 | +57.1 | +197.1 |
| **Middle-Class Tax Relief** | + 3.5 | + 5.5 | + 6.5 | + 7.0 | + 22.5 |
| **Higher Personal Income Taxes** | - 19.8 | - 22.7 | - 23.9 | - 25.3 | - 91.7 |
| **Increases in Business Taxes** | - 11.3 | - 14.4 | - 15.3 | - 17.3 | - 58.3 |
| **Nondefense Cuts[2]** | - 15.1 | - 19.9 | - 22.3 | - 24.5 | - 81.8 |
| **Defense Cuts** | - 11.0 | - 12.5 | - 14.5 | - 20.5 | - 58.5 |
| **Higher Medicare Part B Premiums for Those Earning $125,000+** | - 0.6 | - 1.0 | - 1.0 | - 1.8 | - 4.4 |
| **Health Care Plan** | na | na | na | na | na |
| **Extension of Medicare to Long-Term Care** | na | na | na | na | na |

[1]Includes a capital gains tax cut, enterprise zones, a targeted investment tax credit and a permanent R & D tax credit.

[2]Includes some tax and user fee increases.

Source: "Putting People First: A National Economic Strategy."

- Increase the marginal tax rates of the top 2 percent of taxpayers.
- Raise the alternative minimum tax (AMT).
- Impose a surtax on millionaires.
- Prevent tax fraud with respect to the unearned income of the wealthy.

Once again, no details are provided. During the week of the Democratic convention, Clinton said that he would raise taxes only on people with incomes over $200,000.[3] Subsequent press reports, however, indicate that a

third tax rate of between 36 percent and 37 percent would begin at $90,000 for singles and $130,000 for couples.[4] A tax increase of that magnitude would be necessary to yield the (static) revenue estimates shown in Table I.

Raising the AMT is perceived as a way of closing tax loopholes. However, the AMT is not based on the real income or real expenses of taxpayers. Instead, it is based on the way in which income and expenses appear in a portfolio. Attempts to collect revenue based on the appearance of a taxpayer's books rather than on the underlying economic activity have consistently failed. Individuals and corporations inevitably adjust their portfolios in response to tax changes in order to avoid the higher taxes. For this reason, such measures historically bring in less than one-third of the estimated revenue.[5]

**Increases in Business Taxes.** The Clinton plan would also raise business taxes by $58 billion over the next four years. The proposals include:

- Preventing tax avoidance by foreign corporations ($45 billion over four years).
- Increasing fines and taxes for corporate polluters ($10.1 billion).
- Ending incentives for opening plants overseas ($1.5 billion).
- Limiting executive pay deductions ($1.3 billion).
- Eliminating the tax deduction for lobbying expenses ($0.4 billion).

Cracking down on foreign corporations accounts for 77 percent of the expected revenue increase. Like the AMT increase, however, this tax is based on the appearance of company books rather than on economic reality. If a company is taxed more depending on who owns it, people have an incentive to transfer ownership to the person with the lowest tax rate. For this reason, the Treasury Department estimates that actual revenue would be one-tenth of the forecasted amount. Similarly, measures designed to prevent domestic companies from opening plants in other countries won't keep the plants from opening and won't raise much revenue. They will simply encourage foreign ownership of those plants. The other measures also largely amount to cosmetic loophole-closing and would raise far less revenue than the Clinton plan predicts.

*"Attempts to close loopholes will raise only one-third of what is projected."*

**Spending Cuts.** The Clinton plan provides much more detail on spending cuts. It proposes cuts totaling $82 billion over four years from domestic spending through measures such as:

- Instituting a line-item veto to cut pork barrel projects ($9.8 billion over four years).
- Reforming Resolution Trust Corporation (RTC) management ($17.1 billion).
- Reducing federal workers by 100,000 ($15.3 billion).
- Achieving administrative savings ($22 billion).

*"Only 75 percent of the spending cuts are realistic."*

These cuts take the traditional "smoke and mirrors" approach to cutting government spending. In this approach, savings are credited before the fact to justify increases in other spending. Then the savings never materialize and the deficit gets even larger. Past experience suggests that only a small portion of these spending cuts would ever come to pass.

For example, the Clinton plan would exact an additional $58.5 billion in defense cuts. These would include:

- Cuts in defense beyond those proposed by President Bush ($37.5 billion more over four years).
- Intelligence services cuts ($5.5 billion).
- Defense Department management reforms ($15.5 billion).

But, because of growing congressional concern over displacing defense workers, many of these spending cuts also could fail to materialize.

Just as some tax cuts were counted as spending increases, some tax increases are mistakenly included here as spending reductions. These include ending tax subsidies for honey producers ($40 million) and indexing nuclear waste disposal fees for inflation ($200 million).

**Health Care.** The Clinton plan would radically alter the current U.S. health care system. A health standards board would set annual health budget targets. It also would specify a guaranteed core benefits package. The basic package would include coverage for doctors, hospitals, prescription drugs and mental health care. Access to this guaranteed package would occur either through the workplace [see the discussion on mandates below] or through a new public program. Clinton does not provide a cost estimate for any of these changes, not even for the new public program. Nor is there a cost estimate for

the promise to extend Medicare to long-term care. *Changes such as these could well increase annual government spending by $50 billion to $100 billion or more every year.*

**Mandates.** The Clinton plan would place mandates on American business and workers. In the area of health care, employers and employees would be required to either purchase private insurance or opt into a public program. Although no details are given, Clinton has endorsed a play-or-pay approach to health care. Versions of this idea introduced by congressional Democrats would place a payroll tax initially estimated at 7 to 9 percent on employers who did not purchase health care for their workers. The payroll tax revenues would fund a new public program for people who lack private health insurance.

*"Clinton's health care proposals could add $100 billion a year to the federal deficit and cost almost one million private sector jobs."*

Without specifics, it is impossible to assess the Clinton plan. However, no one doubts that a play-or-pay plan would have adverse economic effects. The minority staff of the Joint Economic Committee places initial job loss from a 7 percent payroll tax at 710,000 and the job loss from a 9 percent tax at 965,000.[6] Because of greater unemployment and because many employers would find it less costly to pay (a tax) than to play (by providing insurance), this plan would force millions of Americans into a public health care program that would probably resemble Medicaid. Overall:

- The NFIB Foundation calculates that almost all small businesses would pay the payroll tax rather than provide health insurance.[7]
- And the Urban Institute estimates that 35 percent of workers currently covered through employers would lose their private insurance and end up in the public program.[8]

Moreover, because the payroll tax rate would collect insufficient revenue to pay the real cost of insuring below-average-income workers, a play-or-pay plan would eventually require even higher tax rates for employers and employees.

Another Clinton mandate would require every employer to spend 1.5 percent of payroll on education and training. With current U.S. wages and salaries running at $2.9 trillion, the mandate would add almost $45 billion a year to labor costs. These higher labor costs would reduce the number of jobs. Assuming every employer had to spend an additional 1.5 percent, the job loss from this mandate alone could be between 350,000 and 700,000 by the end of the decade.[9]

# Clinton's Forecast of Clinton's Plan

Bill Clinton claims that the Clinton plan would reduce the current federal deficit from almost $400 billion to less than $100 billion in just four years.[10] In fact, even if the Clinton plan followed the exact script shown in Table I, the 1996 federal deficit would be only $30 billion lower than it is otherwise expected to be. Any serious deficit reduction under the Clinton plan comes about only because the Clinton team asserts that the economy miraculously would grow faster during a Clinton presidency. If it did so, it would be in spite of — not because of— the Clinton economic plan.

**Effect on the Deficit.** If we accept the estimates from Table I, the Clinton plan would provide modest deficit reduction. Simply adding up the tax increases and spending cuts and then subtracting the spending increases and tax cuts, we find that the Clinton plan would reduce the deficit by

**Table II**

## Clinton's Forecast of the Effect of the Clinton Plan on the Deficit

**($ billions)**

| | 1993 | 1994 | 1995 | 1996 | 1993-96 |
|---|---|---|---|---|---|
| **Baseline Deficit[1]** | **$323.0** | **$268.0** | **$212.0** | **$193.0** | **$996.0** |
| **Clinton's Program Changes[2]** | **-16.5** | **-18.1** | **-21.1** | **-30.3** | **-86.0** |
| **New Deficit without Change in Economic Growth** | **306.5** | **249.9** | **190.9** | **162.7** | **910.0** |
| **"Moderate Growth" Deficit[3]** | **295.7** | **243.0** | **174.0** | **141.0** | **853.7** |
| **"Strong Growth" Deficit[3]** | **282.6** | **207.0** | **125.5** | **75.8** | **691.0** |

[1]Deficit figures are those given in the Clinton economic plan and are supposedly based upon Congressional Budget Office (CBO) growth assumptions. Actual CBO deficit projections for the period are $327, $260, $194 and $178 billions. See Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1993-1997," Washington, DC, January 1992, Table 3.

[2]Calculated as the net sum of the spending increases, tax increases and tax cuts given in Table I plus interest savings, assuming an annual interest rate of 8 percent.

[3]Deficit figures are given in the Clinton economic plan, but no explanation is provided as to how they were derived.

$75.2 billion over the four-year period 1993 to 1996. Adding in the savings from reduced interest brings the total to $86 billion.

The Clinton campaign, however, claims up to two-and-one-half times more deficit reduction. As Table II shows, under the Clinton "moderate growth" scenario, the deficit,would be reduced by $142.3 billion over the next four years. Under the "strong growth" scenario, the deficit would be reduced by $305 billion. No explanation is given for these higher deficit reduction numbers. The implication is that the Clinton plan would spur growth.

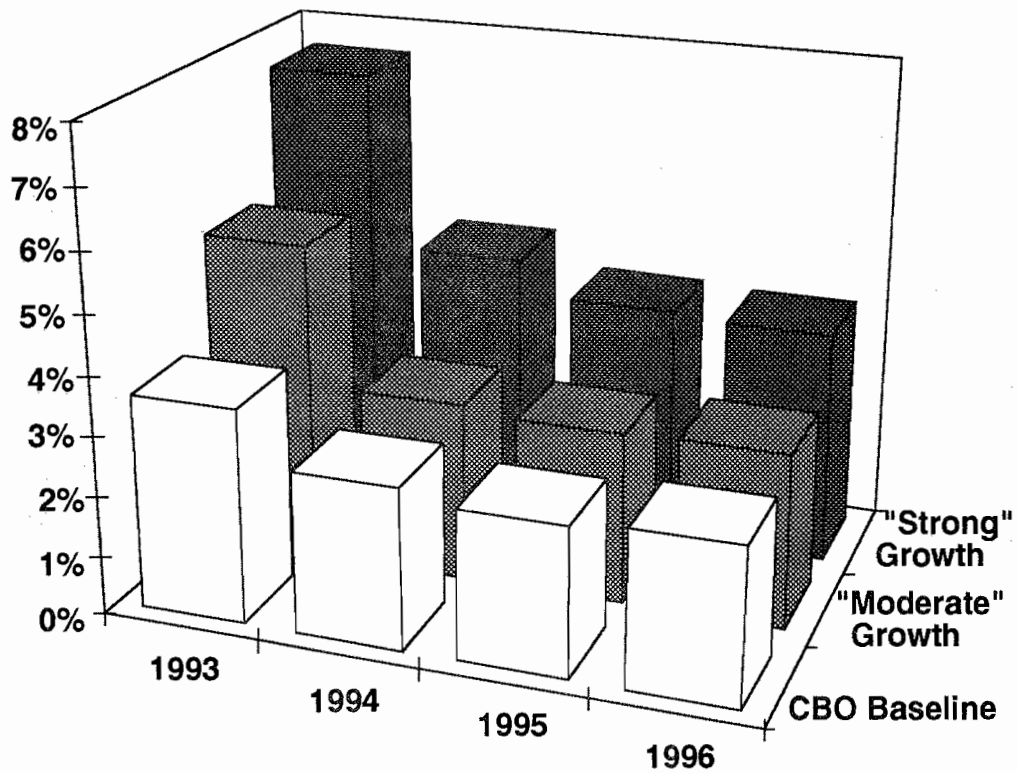
As Figure I shows, the deficit reduction claimed by the Clinton plan would require up to a 75 percent increase in economic growth. The Congressional Budget Office (CBO) baseline forecast assumes that real GDP growth will average 2.85 percent from 1993 to 1996.[11] To achieve the deficit reduction attributed to the "moderate growth" scenario would require an average growth rate of 3.6 percent. To achieve the "strong growth" deficit reduction would require an average rate of 5 percent.[12]

**The Historical Relationship between Taxes and Growth.** Since 1960, the U.S. economy has experienced four-year average growth rates in the range of what Clinton is forecasting only three times:

*"Clinton's forecast requires the economic growth rate to almost double."*

FIGURE I

**What Clinton Assumes His Plan Will Do To Economic Growth**



- Economic growth averaged around 5 percent during the 1960s, following the sizable Kennedy tax cuts.
- Tax cuts on capital and the end of the oil crisis helped growth average 4.2 percent during the mid-1970s.
- Between 1983 and 1986, average growth of 4 percent was due to the Reagan tax cuts combined with recovery from the 1981-82 recession.

In contrast, tax relief in the Clinton plan is minimal. On net, the plan attempts to raise taxes by more than $132.5 billion over four years,[13] and much of this burden would fall on capital. [See the discussion below.]

**Recent Experience with Growth and Tax Policy.** After beginning the 1980s with a recession, the U.S. economy experienced its longest peace-time expansion only to fall again into recession as the decade came to a close. The economy is currently giving mixed signals as to whether it is recovering. In either case, most forecasts call for weak growth over the next several years.

FIGURE II

## Economic Growth and Tax Policy

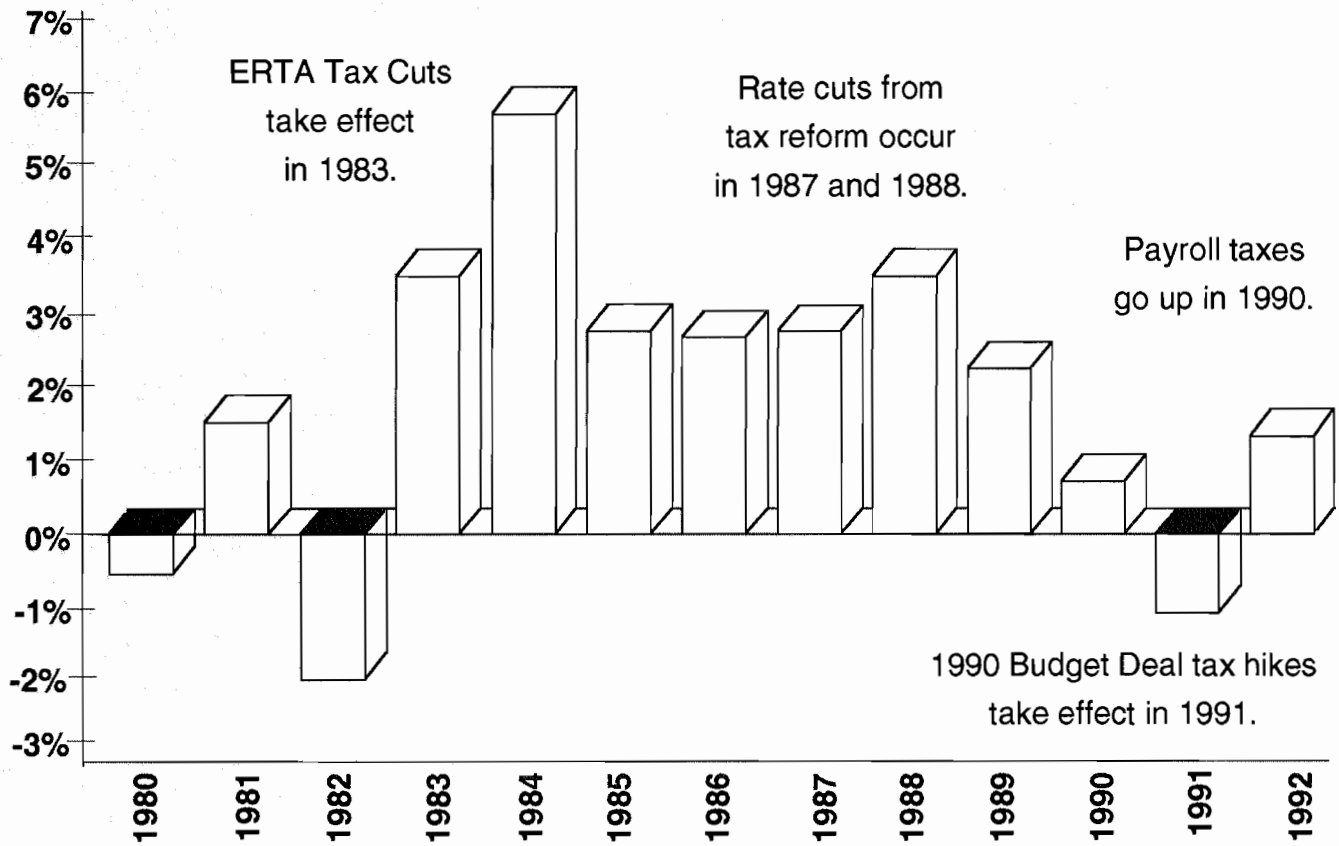
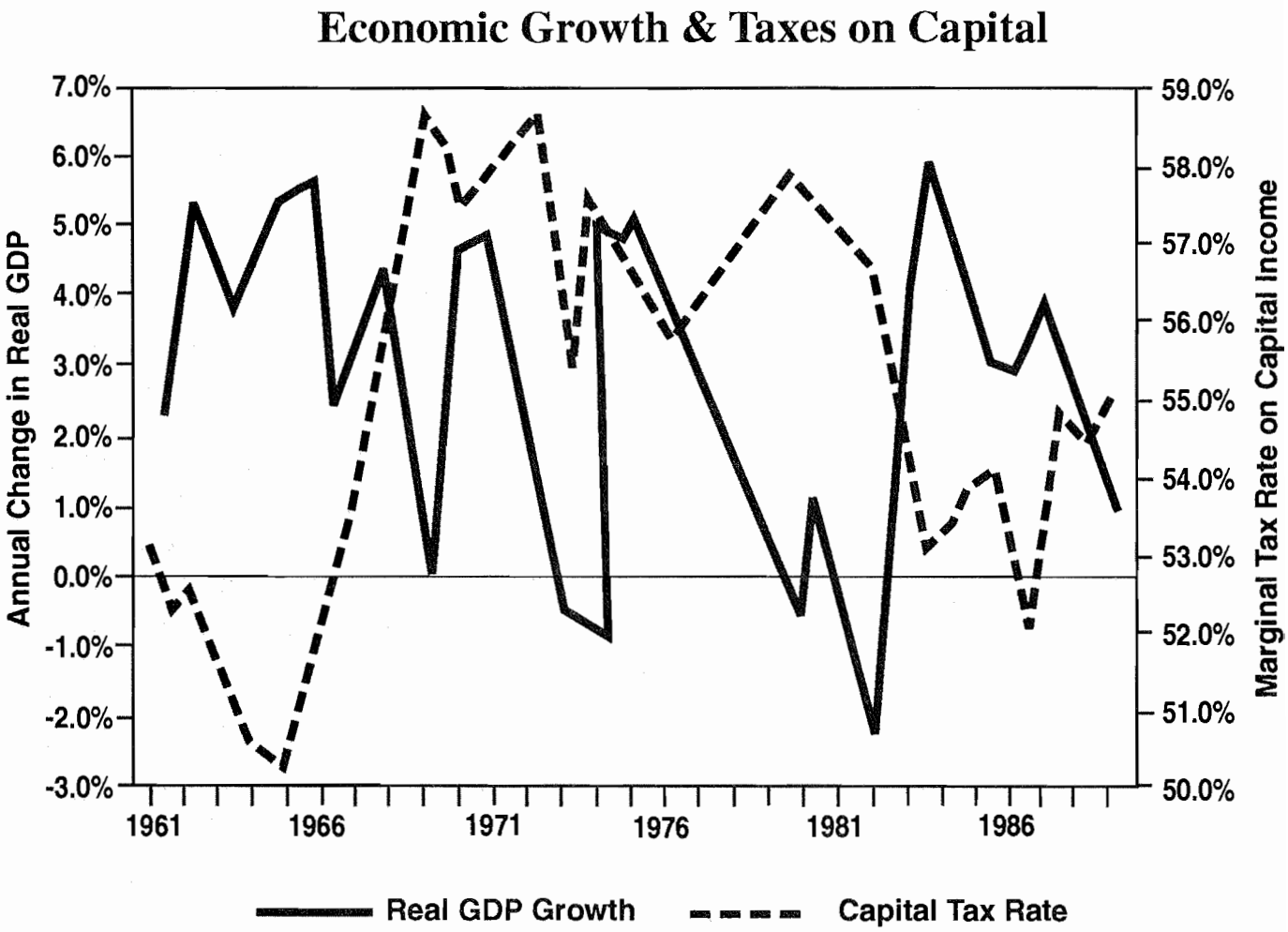


FIGURE III




*"Higher taxes on investment income invariably cause slower economic growth."*

The changing fortunes of the economy have coincided with changing tax policy. As Figure II shows, the growth spurt beginning in 1983 occurred as the Reagan tax cuts (contained in the Economic Recovery and Tax Act of 1981) took effect.[14] Some of these cuts were repealed as part of deficit reduction legislation during the mid-1980s.[15] Coincidentally, economic growth slowed somewhat until 1988, when most of the cuts in tax rates enacted in the Tax Reform Act of 1986 became effective. Growth dropped off in 1990, a year that began with an increase in the Social Security payroll tax rate.[16] In 1991, tax increases from the 1990 budget deal went into effect and real growth was negative for the year.[17]

Tax policy affecting capital is particularly important. Although aggregate labor income in the economy is twice the size of capital income, investor responses to changes in aftertax returns on capital are much larger than worker

responses to changes in aftertax wages.[18] Tax increases on capital are quickly answered with reduced investment, while decreases in capital taxes bring forth increases in investment.[19] Historically, as the marginal tax rate on capital has increased, real GDP growth has fallen, and as that tax rate has decreased, real GDP growth has risen. [See Figure III.]

**The Evidence on Public Sector Spending.** An argument used in defense of Clinton's position is that public sector investment operates much like private sector investment — creating jobs and increasing wages.[20] While some past economic studies have supported that contention, most recent research refutes it. The latest finding is that public capital spending increases have no effect on private sector output, productivity or capital formation.[21]

# The NCPA Forecast of the Clinton Plan

In contrast to the claims of the Clinton campaign, we have concluded that the Clinton plan will reduce economic growth, slow job growth and worsen the federal deficit. This forecast is based on the Fiscal Associates general equilibrium model of the economy. As Table III shows, forecasts based on this model have proved very accurate — more accurate than, for

*"NCPA forecasts of policy changes have proved to be very accurate."*

TABLE III

## Forecasts of Economic Growth after Enactment of the 1990 Budget Agreement[1]

| | 1991 | 1992 |
|---|---|---|
| **Actual Real GDP Growth[2]** | **- 1.2%** | **1.5%** |
| **National Center for Policy Analysis Forecast[3]** | **- 0.5%** | **2.7%** |
| **Office of Management Budget Forecast** | **- 0.3%** | **3.1%** |
| **Congressional Budget Office Forecast** | **0.0%** | **3.3%** |

[1]All three forecasts were made in January 1991.

[2]Based upon the Commerce Department's latest GDP figures released on July 30, 1992. The estimate for 1992 is second quarter annualized GDP in 1992 over second quarter GDP in 1991.

[3]Our baseline forecast used a modified version of the July 1990 mid-session review. The modification was to assume a recession, beginning in the third quarter of 1990 and ending in the last quarter of 1991, that was one-half the depth of the 1981-82 recession.

example, the forecasts of either the Congressional Budget Office (CBO) or the Office of Management and Budget (OMB).

**Assumptions.** To do a forecast of the Clinton plan, we first had to fill in some details concerning the Clinton tax measures. Using media reports and similar congressional proposals, we used the following specifications:

*Middle-Class Tax Relief*: A tax credit of $250 per child under age 18 is similar to that proposed by the Senate Finance Committee last March.

*Third Personal Income Tax Rate:* A 36.5 percent federal income tax rate starting at $90,000 of taxable income for individuals and $130,000 for couples.

*"The Clinton plan would reduce economic growth, slow job growth and worsen the federal deficit."*

*Millionaire Surtax:* A 10 percent surtax on taxpayer income in excess of $1,000,000 is the same as the measure contained in the tax bill passed by Congress last March.

*Capital Gains:* A 10 percent exclusion for each year an asset is held after purchase, up to a maximum exclusion of 50 percent after five years. At the end of the phase-in, the effective average exclusion rate is 16 percent.[22]

**Effects on Marginal Tax Rates.** The primary reason why the Clinton plan would have a negative effect on the economy is that it would raise marginal tax rates for both labor and capital. As Figure IV shows, it would lead to a 4.2 percent increase in the average marginal tax rate on labor compensation and a 1.5 percent increase in the average marginal tax rate on capital relative to present law. These tax increases would raise the cost of capital and labor to business and lower the rate of economic growth.

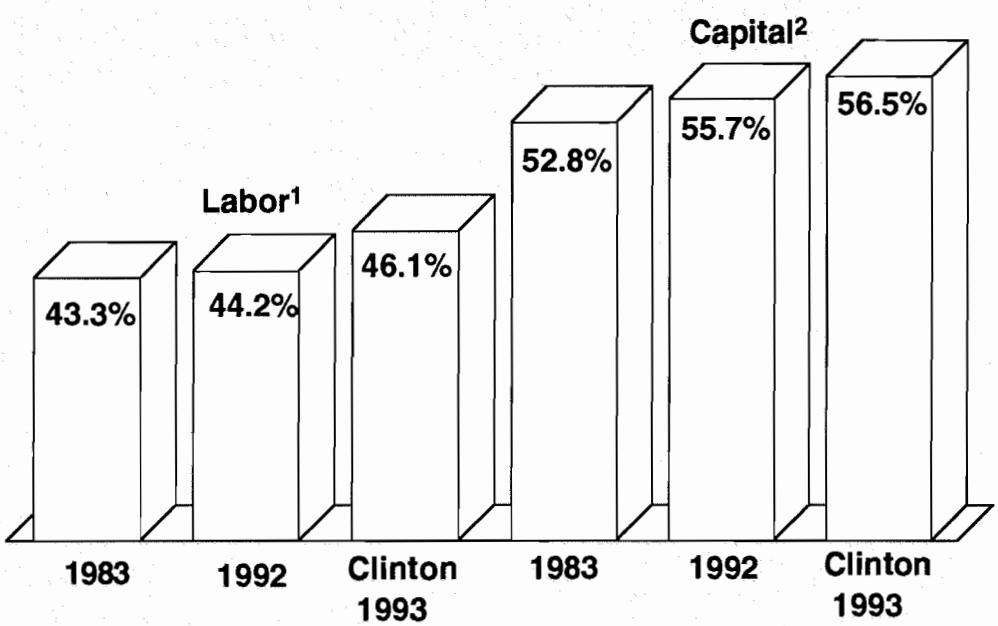
**Effects on the Federal Deficit.** Table IV summarizes the effect of the Clinton plan on the federal budget. On a static basis, the plan yields $132.5 billion in net revenue increases between 1993 and 1996, while increasing net spending by $56.7 billion. Taking into account economic and political reality, we conclude that:

- The Clinton plan would actually lose $7.1 billion in revenue, while increasing spending by $91.8 billion over the next four years.
- Rather than narrowing by $87.1 billion, the federal deficit would widen by $113.2 billion.

*"The Clinton plan would raise marginal tax rates for capital and labor."*

FIGURE IV

## 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: For 1983 and 1992, see Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

**Effects on the Distribution of Income.** An announced goal of the Clinton plan is to raise taxes on the "rich," defined by Clinton as people with incomes over $200,000. But the rich also happen to be investors who derive most of their income from investments. Taxing the rich, for the most part, means taxing investment income. On the average:[23]

- People with annual incomes over $200,000 receive 60 percent of their income from investments and only 40 percent from wages.
- People with annual incomes of $1 million or more receive about 75 percent of their income from investments and only 25 percent from wages.
- In contrast, middle-income families tend to receive 75 percent of their income from wages and 25 percent from capital.

Raising taxes on the rich, then, means increasing taxes on investment

TABLE IV

## Effect of the Clinton Plan on the Federal Deficit

($ billions)

| Year | Clinton's Forecast of Change in Revenues | NCPA Forecast of Change in Revenues[1] | Clinton's Forecast of Change in Spending | NCPA Forecast of Change in Spending[2] | Clinton's Forecast of Change in Deficit | NCPA Forecast of Change in Deficit[3] |
|---|---|---|---|---|---|---|
| 1993 | $27.6 | $1.6 | $12.3 | $18.8 | -$15.9 | $17.9 |
| 1994 | 36.6 | - 0.1 | 16.4 | 24.5 | - 22.2 | 27.0 |
| 1995 | 32.7 | - 2.6 | 15.9 | 25.1 | - 20.4 | 32.2 |
| 1996 | 35.6 | - 6.1 | 12.1 | 23.4 | - 28.6 | 36.2 |
| 1993-96 | 132.5 | - 7.1 | 56.7 | 91.8 | - 87.1 | 113.2 |

[1]Includes the dynamic economic effects described in Table III. Also assumes that loophole closers, which affect bookkeeping rather than economic activity, will raise only one-third of the amounts projected in the Clinton plan.

[2]Assumes that only 75 percent of the spending cuts detailed in the Clinton plan will be forthcoming.

[3]Calculated as the difference between the change in revenues and the change in spending plus interest savings, assuming an annual interest rate of 8 percent.

income. As noted above, higher taxes on investment income cause reduced investment and a lower rate of economic growth. But do the higher taxes produce the intended result — a redistribution of income from rich to middle- and lower-income taxpayers? As Table V shows, the answer is no.

- The Clinton plan would reduce national income[24] by $93.3 billion between 1993 and 1996.
- The rich in their role as owners of capital would bear only 1.5 percent of that loss.
- The lion's share of the loss — 92 percent — would fall on lower- and middle-income taxpayers in their role as wage earners.
- Even the government does worse than the rich and would suffer 6.5 percent of the loss.

*"Clinton's attempt to tax the rich would create larger burdens for ordinary wage earners."*

TABLE V

## Who Is Hurt Most by the Clinton Plan?

**(1993-1996)**

| | Amount ($ billions) | Percent of National Income |
|---|---|---|
| **Aftertax Capital Income** | **- $1.4** | **1.5%** |
| **Aftertax Labor Income** | **- 85.9** | **92.0%** |
| **Government Revenue** | **- 6.1** | **6.5%** |
| **Total Change in National Income** | **- 93.3** | **100.0%** |

## Clinton vs. Bush

In his State of the Union message, President Bush proposed a new tax package that he said would promote economic growth and create jobs. On closer inspection, however, this plan turned out to be so weak that even congressional Republicans were unable to support it.

Instead, Republicans in the House of Representatives fashioned their own fast-track version of the president's proposals.[25] The key elements of the proposal, which Bush subsequently endorsed, are: (1) a lowering of the maximum capital gains tax rate from 28 percent to 15.4 percent,[26] (2) new incentives for investment in equipment,[27] (3) a tax credit for first-time home buyers[28] and (4) the removal of certain passive loss restrictions in real estate.[29]

The Bush proposal, even as modified by the House Republicans, is relatively modest — especially when compared to alternatives that might be politically acceptable.[30] Nonetheless, the plan is definitely pro-growth. It is also self-financing. The new investment it would encourage would increase output, national income and, therefore, tax revenues — more than enough to offset the static losses from the tax cuts after seven years. The Bush plan is also considerably better for the economy than the Clinton proposal. The following is a brief summary.

**Jobs.** As Table VI and Figure V show, the Bush plan leads to job creation while Clinton's plan leads to job losses. Specifically:

- The Bush plan would lead to the creation of 369,000 new jobs by 1996 and 604,000 by the end of the decade.

- By contrast, Clinton's plan would lead to a net loss of jobs — reaching 747,000 lost jobs in 1996 and 1.1 million by the year 2000.

Note that the Clinton plan has an immediate negative impact on the economy — which becomes cumulatively worse throughout the decade.

**Private Investment.** The biggest difference in the two plans is the effect on investment spending. On net, Bush would reward investors while Clinton would punish them. Specifically:

*"Whereas the Clinton plan would destroy jobs, the Bush plan would create them."*

TABLE VI

## A Comparison of the Clinton and Bush Plans[1]

**(Financial totals are in nominal dollars)**

| | Jobs (thousands) | | Gross Domestic Product ($ billions) | | Federal Deficit[2] ($ billions) | |
|---|---|---|---|---|---|---|
| | Bush | Clinton | Bush | Clinton | Bush | Clinton |
| 1993 | + 26 | - 217 | + 13.9 | - 14.9 | + 6.9 | + 17.9 |
| 1994 | + 91 | - 375 | + 40.7 | - 33.3 | + 10.2 | + 44.9 |
| 1995 | + 232 | - 577 | + 71.7 | - 53.6 | + 11.1 | + 77.1 |
| 1996 | + 369 | - 747 | + 100.0 | - 71.2 | + 9.5 | +113.3 |
| 1997 | + 493 | - 864 | + 128.9 | - 86.4 | | |
| 1998 | + 602 | - 957 | + 152.9 | - 97.0 | | |
| 1999 | + 609 | -1,028 | + 172.2 | - 108.3 | | |
| 2000 | + 604 | -1,071 | + 191.3 | - 119.3 | | |

[1]Job totals are the net increase or reduction in jobs as of the year indicated. GDP numbers are annual changes. Federal deficit totals are cumulative as of the date indicated. Bush deficit totals reflect the results of dynamic economic growth; changes in pension liabilities are ignored.

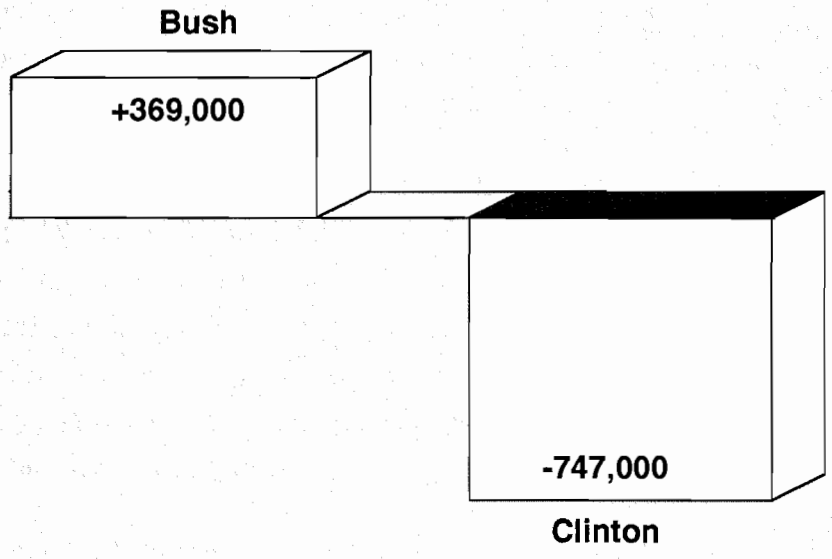
[2]Not estimated beyond 1996 because Clinton's federal spending and revenue amounts are unavailable.

*"The difference between the two plans is more than one million jobs in just four years."*

FIGURE V

## Effects on Jobs

**(1993 - 1996)**




- The Bush plan would increase investment spending by more than $200 billion a year through 1996.

- By contrast, Clinton's higher taxes on high-income investors would more than offset the stimulus provided by a capital gains tax cut and would decrease investment spending by about $100 billion a year through 1996.

- Cumulatively, the Bush plan would create $855 billion in new investment in the U.S. economy through 1996, while Clinton's plan would decrease investment spending by $413 billion over the same period. [See Figure VI.]

**Output.** Because of increased investment under the Bush plan, the nation's annual output of goods and services would grow. By contrast, reduced investment under Clinton's plan would cause contraction. Specifically:

- The Bush plan would increase domestic output (GDP) by $226 billion through 1996 and by $871 billion by the end of the decade. [See Figure VII.]

- By contrast, Clinton's plan would reduce GDP by $173 billion through 1996 and by $584 billion by the end of the decade.

- The difference in the two plans between now and the year 2000 is worth about $5,820 to every man, woman and child in the country.

*"Whereas the Bush plan is ultimately self-financing, the Clinton plan would increase the federal deficit."*

**Federal Deficit.** By 1998, the additional revenues caused by greater output would offset the revenue loss from the Bush tax cuts. Thus in the long run the Bush plan is self-financing.[31] Clinton's plan, by contrast, would result in a net loss of revenue, adding $113 billion to the federal deficit by 1996.

**The Fairness Debate.** We calculate that the Bush plan would add $5.7 billion to the aftertax income of investors over the next five years. As a consequence, investors would invest about $1.1 trillion in the economy. (For the most part, investors do not gain unless they invest.) This new private sector investment would expand the national income by $245 billion, creating $140 billion in new wages for workers and almost $100 billion in new tax revenue for government at all levels. As a result:

- For every $1 in additional income received by investors, workers under the Bush plan would receive $25 in additional aftertax wages. [See Figure VIII.]

- For every $1 in additional income received by investors, government would receive about $17 in new revenue.

By contrast, because the Clinton plan reduces the aftertax income of investors by $1.4 billion, the economy would pay a heavy price. Total private sector investment would be reduced by $413 billion, leading to a $173 billion contraction in national output by 1996. Moreover:

- For every $1 reduction in the income of investors, workers under the Clinton plan would lose $61 in wages. [See Figure IX.]

- For every $1 reduction in the income of investors, government at all levels would lose about $4 in revenue.

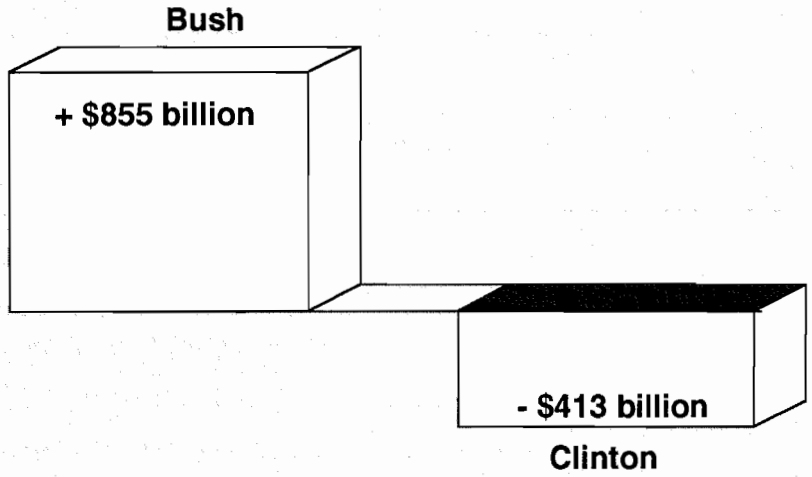
Under the Bush plan, investors would receive 2.3 percent of the increase in national income. Under Clinton's plan, investors would lose 1.5 percent of the decrease in national income. Clinton's "fairness" argument focuses on these almost trivial changes in the fortunes of a few — and ignores the huge impact of the two plans on the rest of us.

*"The difference in the two plans is equal to $1.3 trillion in investment over four years."*

FIGURE VI

## Effects on Investment

**(1993 - 1996)**

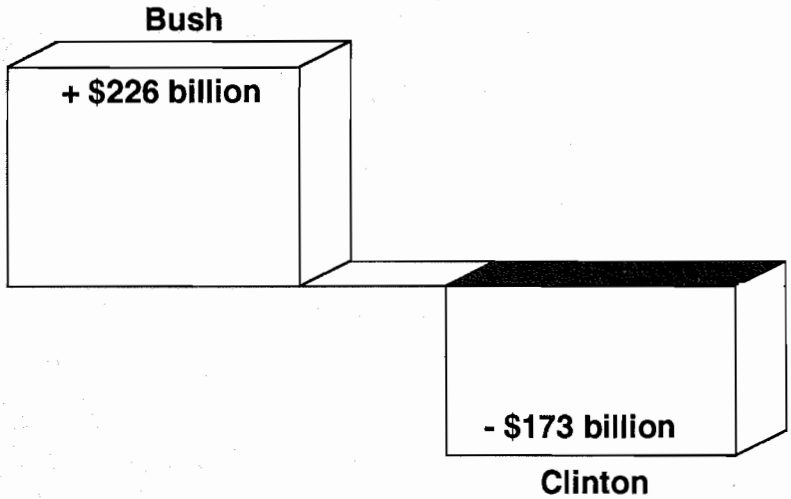



*"Through the year 2000, the difference in the two plans is worth $5,820 for every man, woman and child in the country."*

FIGURE VII

## Effects on Gross Domestic Product

**(1993 - 1996)**



## Clinton vs. the Congressional Democrats

Some have argued that the nomination of Bill Clinton represents significant change for the Democratic Party — a shift from the desire to redistribute income to a commitment to economic growth. Clinton's economic plan, however, furnishes no evidence of a shift. As Figures X and XI show, Clinton's plan would do far more harm to the economy than any of the plans proposed by Democrats in Congress this spring.

## Clinton vs. the 1990 Budget Deal

*"The Clinton plan bears an eerie resemblance to the 1990 budget deal."*

The Clinton economic plan is very similar to the Omnibus Reconciliation Budget Act enacted in October 1990. That "deficit reduction" package — the result of a budget summit compromise in which George Bush rescinded his promise of no new taxes — was supposed to reduce the deficit by $500 billion over five years through higher taxes and spending limits. Instead, the five-year deficit will more than double, spending has increased and promised tax revenues have failed to materialize.[32] Specifically:

- Over the last two years, federal spending has grown more than seven times as fast as the economy as a whole.
- In order to pay for new spending, the 1990 budget deal enacted $166 billion in new taxes — mainly on the "rich."
- Yet partly in response to higher taxes, a slowdown in the economy has contributed to a $147 billion shortfall in revenues — virtually wiping out the expected gains from new taxes.
- The net result is a cumulative deficit in the first five years of the budget summit agreement that will exceed $1 trillion.

Like the 1990 budget summit agreement, the Clinton economic plan promises higher spending and special tax breaks for favored sectors and favored activities — all to be paid for by taxes on the rich and spending cuts unlikely to materialize. The irony is that the Clinton plan bears an eerie resemblance to the economic policies Clinton seeks to replace.

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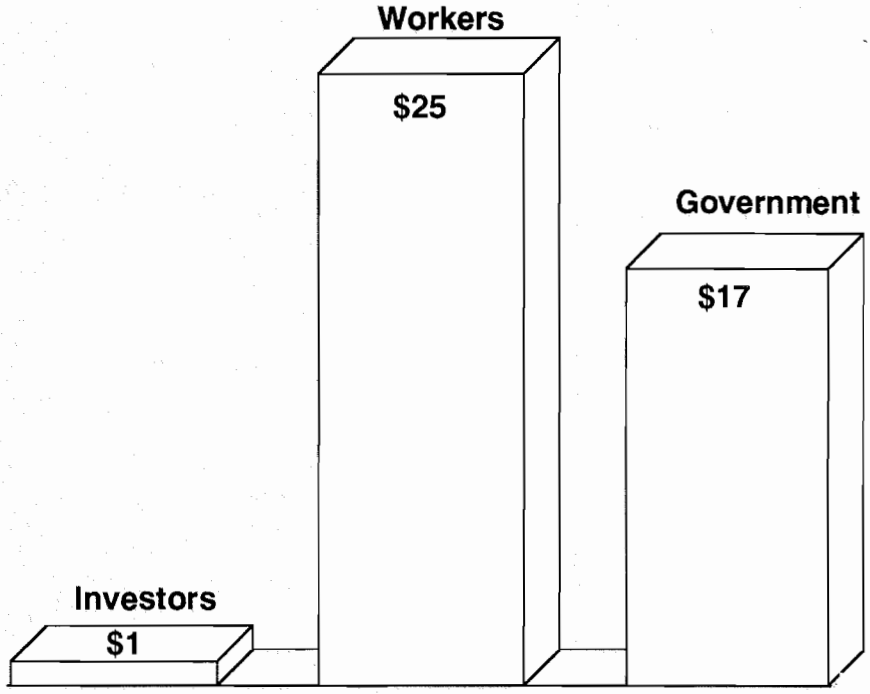
*"For every $1 the Bush plan gives to investors, wage earners get $25."*

FIGURE VIII

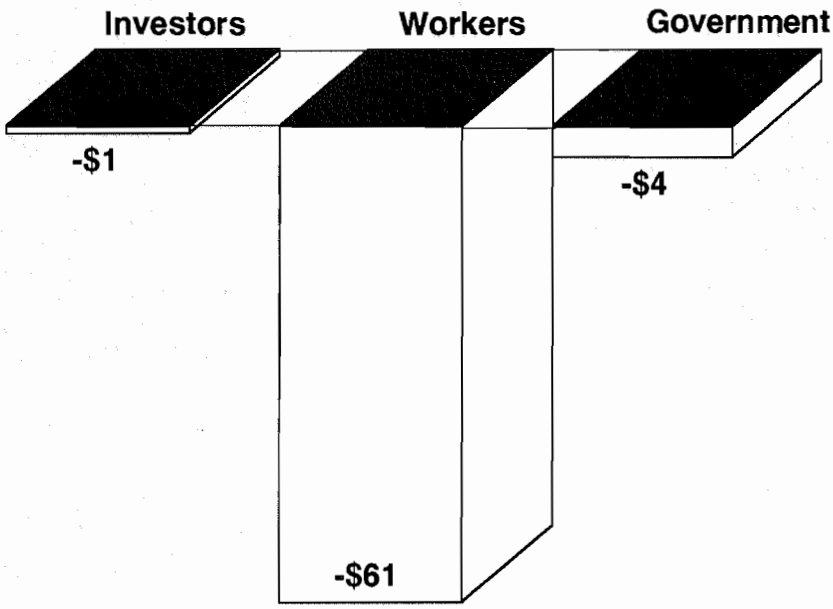
## Relative Gains under the Bush Plan




*"For every $1 the Clinton plan takes away from investors, wage earners lose $61."*

FIGURE IX

## Relative Losses under Clinton's Plan

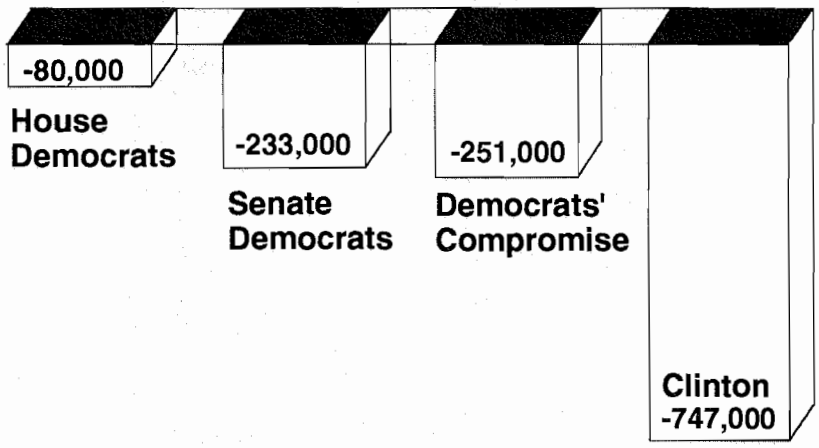


*"The Clinton plan would lose three times as many private-sector jobs as the congressional Democrats' proposal."*

FIGURE X

## Number of Jobs

(1992 - 1996)

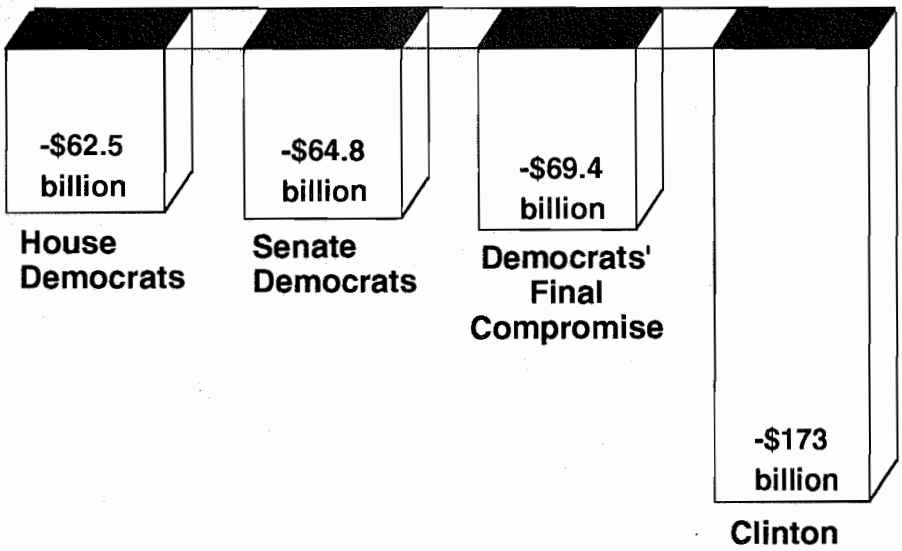



*"There is no evidence that the Democratic Party is making growth its highest priority."*

FIGURE XI

## Effect on Gross Domestic Product

(1992 - 1996)



# Conclusion

Even though George Bush's economic recovery plan is less stimulative than many would like, it moves us in the right direction. If adopted, the plan would lead to more investment, more jobs and a higher output of goods and services.

*"Clinton should give economic growth higher priority than redistribution of income."*

Governor Clinton's plan combines measures that would stimulate investment with an attempt to extract more taxes from high-income taxpayers. But since high-income taxpayers derive most of their income from investments, the higher taxes would discourage private savings and investment. The net result would be to prolong the current recession and reduce jobs for the foreseeable future.

In general, those left-of-center parties around the world that have won the right to lead their countries have abandoned the politics of redistribution in favor of the economics of growth. They have learned that economic growth is the most effective antipoverty program ever discovered. One can only hope that if the Democratic Party in the United States regains the presidency, it too will learn this lesson.

**Aldona Robbins**
**Gary Robbins**

# Footnotes

[1] "Putting People First: A National Economic Strategy," June 20, 1992.

[2] These are estimates of the effects of a pay-or-play mandate, which is discussed below. See Joint Economic Committee, Republican staff, "Run from Coverage: Job Destruction from a Play or Pay Health Care Mandate," Health Care Briefing Paper No. 5, April 9, 1992.

[3] According to the latest tax return data from 1989, taxpayers with adjusted gross incomes of $200,000 and over account for 0.7 percent of all taxpayers. Internal Revenue Service, *Statistics of Income Bulletin*, Spring 1991, Washington, DC, 1991, Table 1.

[4] The first two tiers in the tax code are rates of 15 percent and 28 percent. As part of the 1990 budget agreement, the Bush administration created a third rate, which currently is 31 percent for higher income taxpayers.

[5] For example, prior to passage of the Tax Reform Act of 1986, government forecasters predicted that the increase in the corporate minimum tax would raise $3.1 billion in 1987 and $5.4 billion in 1988. These projections missed the mark widely. Assuming a 10 percent annual growth in the $1.1 billion that was collected in 1986, the corporate minimum tax would have raised $1.2 billion in 1987 and $1.4 billion in 1988 without tax reform. Actual tax collections were $2.2 billion in 1987 and $3.4 billion in 1988. Thus, tax reform raised $1 billion rather than $3.1 billion in 1987 and $2 billion rather than $5.4 billion in 1988. For government forecasts, see *Tax Reform Act of 1986: Conference Report to Accompany H.R. 3838,* Vol. II, Washington, DC, 1986, Table A.2. For actual corporate alternative minimum tax revenues, see Internal Revenue Service, *Statistics of Income Bulletin,* Summer 1991, Washington, DC, 1991, Table 13.

[6] Joint Economic Committee, Republican staff, "Run from Coverage: Job Destruction from a Play or Pay Health Care Mandate."

[7] William J. Dennis, "It's Cheaper to Pay Than to Play," NFIB Foundation, October 1991.

[8] Sheila Zedlewski, Gregory Acs, Laura Wheaton and Colin Winterbottom, "Pay or Play Employer Mandates: Effects on Insurance Coverage and Costs," unpublished paper for the U.S. Department of Labor, Washington, DC, The Urban Institute, January 8, 1992.

[9] The extent of the job loss depends on how much employers and workers value the mandated training. If they place the value at zero, the full 1.5 percent is a tax, and the job loss would be 700,000. If the value is one-half, a reasonable estimate assuming a demand elasticity of -1.0 for education, job loss would be 350,000. If the requirement is that employers spend 1.5 percent, including amounts that are already being spent, the job loss could be as low as 175,000. Employment estimates are based on those in Aldona Robbins and Gary Robbins, "Reducing Social Security Taxes: Sound Policy for Today and Tomorrow?" The Institute for Policy Innovation, IPI Policy Report No. 110, March 1991.

[10] In February of this year, the Bush administration estimated the 1992 deficit at $399.7 billion. Because of a change in the timing of savings and loan bailout expenses, the administration's July estimate was $333.5 billion.

[11] Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1993-1997," Washington, DC, January 1992, Table 2.

[12] To calculate the real GDP growth rates implied by the "moderate growth" and "strong growth" deficits, we used the sensitivity analysis of economic assumptions given in the administration budget. This analysis shows the effect on the deficit of changes in the economic assumptions, such as a sustained 1 percent higher real GDP growth rate. See Executive Office of the President, *Budget of the United States Government,* Fiscal Year 1993, Washington, DC, January 1992, Table 3-6.

[13] This equals $155 billion in tax increases (including higher user fees and higher Medicare premiums) minus $22.5 billion in middle-class tax cuts. Investment incentives are not included in these totals because no detail is given in the Clinton plan.

[14] Although passed in August 1981, ERTA tax cuts did not take immediate effect. For example, the across-the-board reduction in individual income tax rates of approximately 23 percent was phased in over 33 months.

[15] For example, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) instituted a half-basis adjustment for investment tax credits in calculating depreciation and repealed the accelerated depreciation scheduled in 1985 and 1986 by ERTA. The Deficit Reduction Act of 1984 (DEFRA) increased the minimum recovery period for real property from 15 years to 18 years.

— more—

[16] The combined employer-employee tax rate increased from 15.02 percent to 15.3 percent. The payroll tax increase that took effect in 1988 was more than offset by the significant drop in federal marginal income tax rates on wages and salaries contained in the Tax Reform Act of 1986.

[17] See Aldona Robbins and Gary Robbins, "Will the New Budget Package Create a Recession?" National Center for Policy Analysis, NCPA Policy Backgrounder No. 108, October 16, 1990; and Gary Robbins, Aldona Robbins and John C. Goodman, "Do We Need a Tax Cut?" National Center for Policy Analysis, NCPA Policy Backgrounder No. 112, January 28, 1992.

[18] Labor receives two-thirds of output and capital receives the remaining one-third. Labor supply elasticities range between -0.2 and -0.4 whereas the supply elasticity of capital is essentially infinite.

[19] See Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," NCPA Policy Report No. 105, January 1992, Figure IV, p. 10.

[20] See Peter Passell, "More Concrete, More Growth?" *New York Times,* July 30, 1992.

[21] For a review of the literature and empirical estimates, see John A. Tatom, "Public Capital and Private Sector Performance," *Federal Reserve Bank of St. Louis Review,* May/June 1991, pp. 3-15.

[22] This is a weighted average, based on the proportion of assets held for each of the five holding periods.

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

[24] Gross domestic product less depreciation of the capital stock.

[25] For the evolution of the Bush plan and an analysis of how it compares to Democratic alternatives, see Aldona Robbins, Gary Robbins and John C. Goodman, "Reviving the Economy: Bush vs. the House Democrats," National Center for Policy Analysis, NCPA Policy Backgrounder No. 113, February 28, 1992; and Aldona Robbins, Gary Robbins and John C. Goodman, "Bush vs. the Congressional Democrats: Whose Tax Plan is Better?" National Center for Policy Analysis, NCPA Policy Backgrounder No. 116, April 7, 1992.

[26] Forty-five percent of capital gains income would be excluded from taxation. Thus, given a maximum tax rate of 28 percent, the actual tax would be 15.4 percent (65% x 28%). This rate applies only to assets held for three years, however. The rate would be 19.6 percent for assets held for two years and 23.8 percent for assets held for one year.

[27] Accelerated first-year depreciation would reduce taxable income by an additional 15 percent of investment, but the revenue loss would be made up with lower deductions in later years.

[28] A 10 percent tax credit, up to a maximum of $5,000, would be allowed for a home purchased by anyone who had not owned a home in the past three years. This temporary provision would expire on June 30, 1993.

[29] "Passive loss" is the tax term applied to business losses claimed by shareholders who do not actively manage an investment. The Tax Reform Act of 1986 deems all owners of real estate as passive regardless of their involvement in the project. This provision limits the ability of taxpayers to deduct losses against current income from other sources. Losses must be deferred (without adjustment for inflation or the time value of money) until the project generates income sufficient to cover the losses. Real estate projects typically experience initial losses. The passive loss provision has dramatically affected the structure of real estate projects, making them less profitable and lowering their value. The Bush provision would apply to real estate the same passive loss rules applied to other investments. This would allow investors with a direct management role to deduct losses as they are incurred.

[30] The proposal with the greatest support is one developed by the authors for the National Center for Policy Analysis and the U.S. Chamber of Commerce. See Aldona Robbins and Gary Robbins, "Strategy for Growth," National Center for Policy Analysis and U.S. Chamber of Commerce, NCPA Policy Report No. 170, January 1992. Jerry Brown's proposal provides almost as much stimulus as the NCPA/U.S. Chamber proposal, but does so in a different way. See Gary Robbins and Aldona Robbins, "Jerry Brown's Tax Plan," National Center for Policy Analysis, NCPA Policy Backgrounder No. 117, April 16, 1992.

[31] This is the case even without the accounting gimmicks the Republicans adopted to "pay" for their plan. See Robbins and Robbins, "Reviving the Economy: Bush vs. the House Democrats."

[32] See Aldona Robbins and Gary Robbins, "Will the New Budget Package Create a Recession?"; Gary Robbins and Aldona Robbins, "If the Budget Summit Was a Success, Why Is the Five-Year Deficit Heading Toward $1 Trillion?" National Center for Policy Analysis, NCPA Policy Backgrounder No. 109, March 1991; and Aldona Robbins and Gary Robbins, "Taxes, Deficits and the Current Recession," NCPA Policy Report No. 156, January 1991.