POLICY BACKGROUNDER No. 124
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For Immediate Release
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Why Bush Lost the Election: Ten Lessons for the Clinton Administration

According to the political pundits, a lackluster economy is the main reason President Bush lost the election. That judgment is based on solid economic evidence:

- Between January 1989, when George Bush took office, and November 1992, real gross domestic product (GDP) increased by only $82 billion.
- Real GDP grew at a rate of only 0.6 percent per year.
- On net, only 75,000 additional people were employed.
- Real investment over the period declined by 16.8 percent.

"While the private sector suffered, the federal government prospered."

While the economy and working Americans suffered, the federal government and those who worked for it prospered:

- Federal spending grew from $1.1 trillion during fiscal year 1989 to a projected $1.5 trillion for fiscal year 1993.
- Tax increases amounting to $167 billion over five years were enacted.[1]
- Almost $1 trillion was added to the federal debt.
- Major new regulations affecting the workplace were put into place and the staff of existing regulatory agencies was increased by 19 percent.[2]

"The first Reagan administration began with a steeper recession — but still outperformed the Bush presidency."

Americans are used to better economic times. As Table I shows, even the first Reagan term — which started with a steeper recession than the one we recently experienced — outperformed the Bush presidency. The combined records of both Reagan administrations or the Reagan record after 1983 — after the recession had ended and when the 1981 tax cuts took effect — compare even more favorably.[3]

TABLE I

Bush vs. Reagan: The Economic Record

(Amounts in billions of 1987 dollars; jobs in thousands)

	Real GDP	Real Private Investment	Jobs
1981-84 (Reagan)			
Total Change	**$305.4**	**$82.0**	**4,655**
Annual % Change	**2.6%**	**3.7%**	**1.5%**
1981-88 (Reagan)			
Total Change	**$875.5**	**$56.6**	**14,637**
Annual % Change	**3.0%**	**1.1%**	**1.9%**
1983-88 (Reagan)			
Total Change	**$812.0**	**$136.9**	**14,184**
Annual % Change	**3.8%**	**4.0%**	**2.6%**
1989-92 (Bush)			
Total Change	**$81.6**	**-$128.7**	**75**
Annual % Change	**0.6%**	**- 5.9%**	**0.0%**

Sources: Calculations for GDP and investment are based on the latest available National Income and Product Account data from the Commerce Department. The authors trended data for 1992 that goes through the third quarter to make an estimate for the entire year. Real GDP and investment are measured in 1987 dollars. Calculations on jobs are based on data from *Employment and Earnings,* Table A-1. It represents the number of people 16 years of age and older who are employed. The number used for 1992 was employment through September. Changes shown compare the last year indicated with the first year in each case.

In order to avoid repeating the mistakes of the last four years, Bill Clinton and his advisors must learn from George Bush's mistakes. The following are some important lessons.

Lesson No. 1: Marginal tax rates matter.

During the past year, some Democrats argued that marginal tax rates have no effect on the economy — that lowering the tax rates during the 1980s did no good and increasing tax rates would do no harm. Bill Clinton would do well to ignore this counsel.

Reversing the Progress of the Reagan Years. Remembering the Reagan tax cuts 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 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.

"The lower marginal tax rates that stimulated the economic boom of the 1980s no longer exist for the average investor and the average worker."

Moreover, despite the lowering of 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 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 most tax incentives created for investors in the early 1980s.

The economic boom of the 1980s was a supply-side expansion stimulated by lower marginal tax rates. Today, for the average investor and the average worker, those incentives no longer exist. The downward trend in labor and capital taxes was reversed in the last four years. In return, the economy paid a price. Increasing marginal tax rates helped produce the 1990-91 recession, just as they produced recessions in 1973-74 and 1981-82. This contrasts with the boom periods of the mid-1960s and mid-1980s, when the economy was stimulated by decreasing marginal taxes on labor and capital.

The Bush Years. Despite the legacy of the Reagan administration, George Bush presided over increased taxes on working and investing:[4]

- Taxes claimed 54.7 cents of the next dollar in capital income and 43.2 cents of the next dollar in labor compensation in 1989.

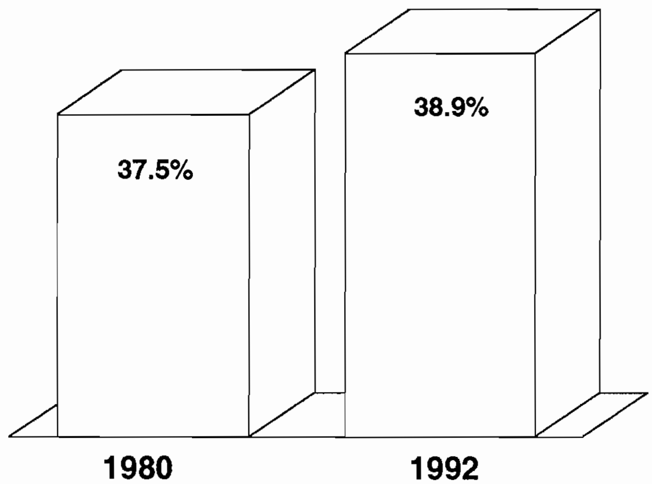
- By 1992, taxes took 55.7 cents of the next dollar of capital income and 44.2 cents of the next dollar of labor income.

- The marginal tax rate on national income — which is the average of labor and capital — increased from 46.6 percent to 47.6 percent.

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

FIGURE I

Share of National Income Taken By Government

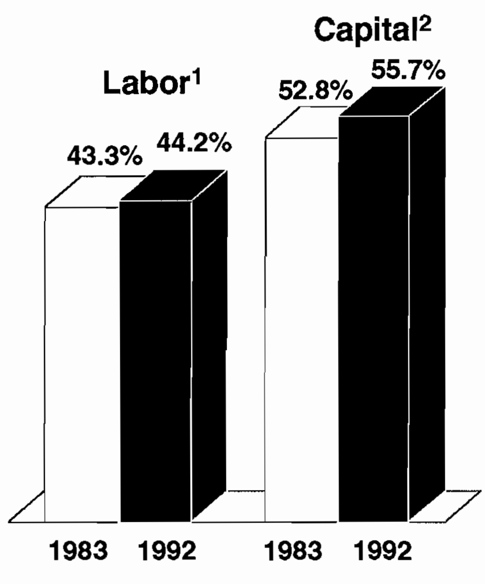


Source: Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

"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.

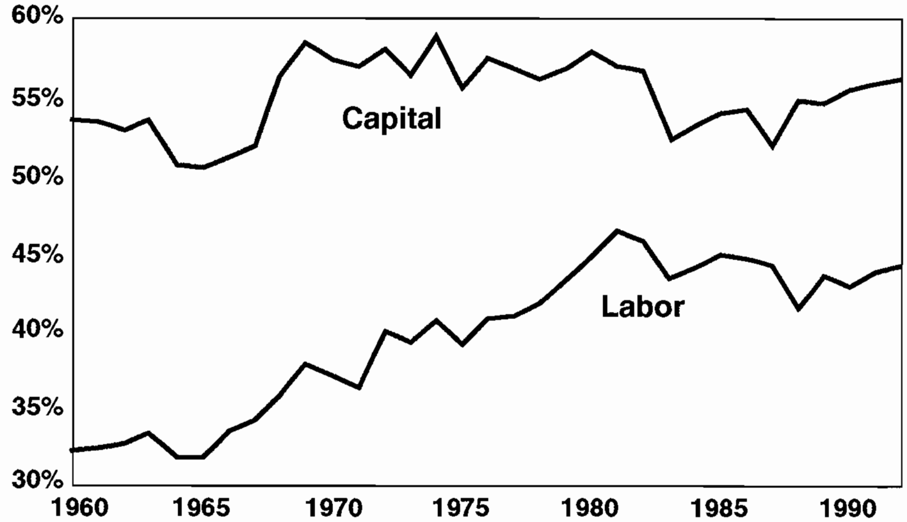
[2]Includes all capital (including residential houses) and all taxes (including sales and property taxes).

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

"Increasing marginal tax rates helped produce the 1990-91 recession, just as they did the recessions in 1973-74 and 1981-82."

FIGURE III

Marginal Tax Rates On Capital and Labor



Some of these tax increases were beyond the control of the Bush administration. For example, the 1990 increase in the Social Security payroll tax rate from 15.02 percent to 15.3 percent was legislated in 1977.[5] Furthermore, state and local governments were increasing taxes from 10.7 percent of GDP in 1989 to 11.1 percent in 1992.

The Infamous Budget Agreement. The Bush administration was responsible for other tax increases, however. The Omnibus Budget Reconciliation Act of 1990 (OBRA), crafted by administration officials and key members of Congress, contained new taxes that were supposed to raise $167 billion between 1991 and 1995. These tax increases included:

- Raising the income tax rate on the highest income earners from 28 percent to 31 percent.
- Disallowing $300 in deductions for every $10,000 in income above $100,000 (thereby increasing the marginal tax rate by as much as 1 percentage point).
- Phasing out personal exemptions for couples with income above $150,000 and for individuals above $100,000 (thereby increasing marginal tax rates by 1/2 percentage point per exemption).

- Increasing the maximum wage on which the Medicare Part A payroll tax is collected.[6]

- Imposing various excise and user fees, including the controversial 10 percent luxury tax on cars, boats and jewelry.

The poor economic performance of the last four years should come as no surprise.[7] Increasing taxes on labor and capital raises production costs. Because increased taxes do nothing to enhance sales, higher production costs inevitably lead to cutbacks in labor, capital and output.

Lesson No. 2: Regulation matters.

"Increased regulation probably added between $60 billion and $70 billion to business costs in 1991 and 1992."

Some within the Democratic Party apparently believe that increased regulation causes no economic harm. In fact, the burden of regulation is very similar to the burden of taxation, and during the Bush years increased regulation probably contributed as much to our problems as increased taxes. The most burdensome new regulations focused on the workplace and the environment:[8]

- The Fair Labor Standards Act raised the minimum wage twice and increased the cost of unskilled labor by 27 percent.[9]

- One study estimates that the Clean Air Act amendments, which greatly extended antipollution regulation, will reduce Gross National Product (GNP) by 0.4 percent by the year 2005.[10]

- The Americans with Disabilities Act, which requires structural changes in physical facilities to accommodate the disabled and regulates the hiring and firing of the disabled, could cost as much as $100 billion in the first five years.[11]

Overall, increased regulation probably added between $60 billion and $70 billion to business costs in 1991 and 1992.[12] This is the equivalent of adding 1.1 percentage points each to the marginal tax rates on labor and capital. It raises production costs and depresses economic growth.

Lesson No. 3: The only way to increase real wages is to increase private investment.

During the election campaign and at the Little Rock economic summit, much was said about the need to increase the real income of the average worker. In the minds of most voters, Clinton's promise to address this problem is probably the single most important promise he made. How can it be met? Practically speaking, real wages cannot be increased without increasing the nation's capital stock. And more capital requires more investment.

Real Wages and Private Investment. The only way that the real wages of workers can rise is if there is more capital per worker. As Figure IV illustrates:[13]

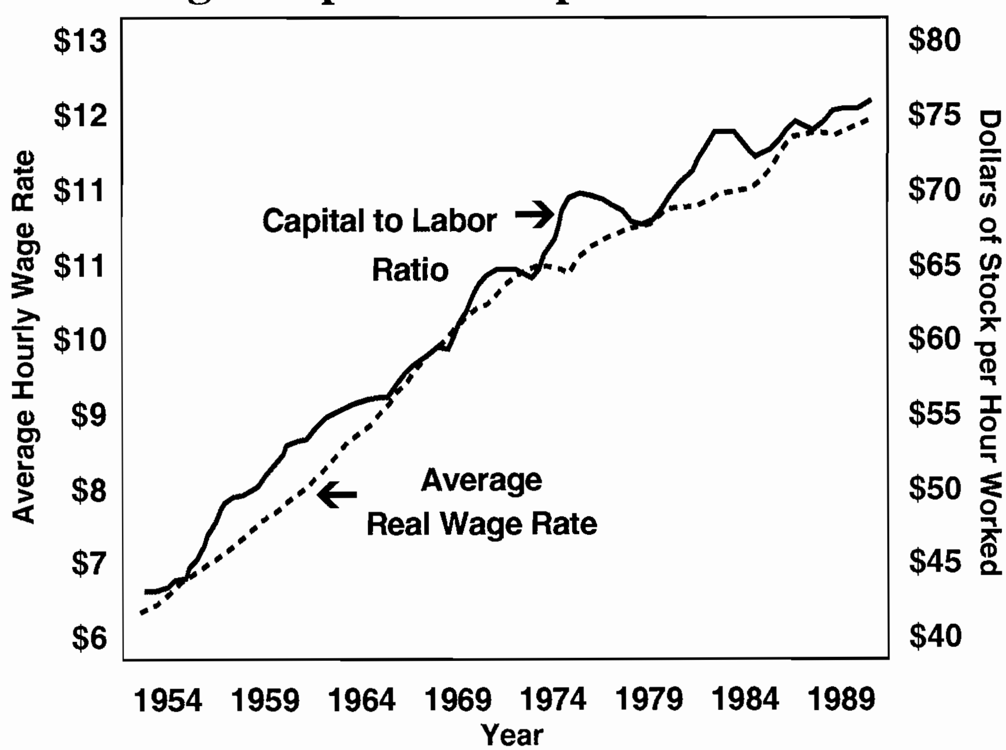
- About 98 percent of the variation in real wages over the past 37 years can be explained by the capital-to-labor ratio alone, without reference to any other economic factor.
- For every 10 percent increase in the average amount of capital per worker, the real wage rate increases by 11.9 percent.

In this context, capital means physical assets such as buildings, machines, equipment, etc.[14] The nation's capital stock is the sum total of all of its capital goods. Because it loses value over time, some level of investment is necessary to maintain the capital stock at its current size. Beyond that level, additional investment will cause the capital stock to grow, whereas less

"About 98 percent of the change in real wages is explained by the change in the amount of capital per worker."

FIGURE IV

Wages Depend on Capital Per Worker



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

investment will cause it to shrink. Where do new investment funds come from? One source is increased savings by U.S. citizens. A second is investment by foreigners. A third is the repatriation of funds invested in other countries by U.S. citizens.[15]

Why Public Investment Usually Doesn't Help. Some maintain that government spending on public works and infrastructure can serve as a substitute for private investment. The argument is that public sector investment operates much like private sector investment — creating jobs and increasing wages.[16] 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.[17]

Lesson No. 4: Changes in private investment in the U.S. economy are almost completely determined by taxes on investment income.

Understandably, the advisors who recently gathered in Little Rock devoted considerable attention to the need to increase investment in order to increase wages and the number of jobs. A major question was: Can government policy substantially affect the amount of private investment in the economy? The answer is: Yes.

"Small variations in the tax rate on capital income lead to large changes in the nation's capital stock."

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. 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. As Figure V shows:[18]

- 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.

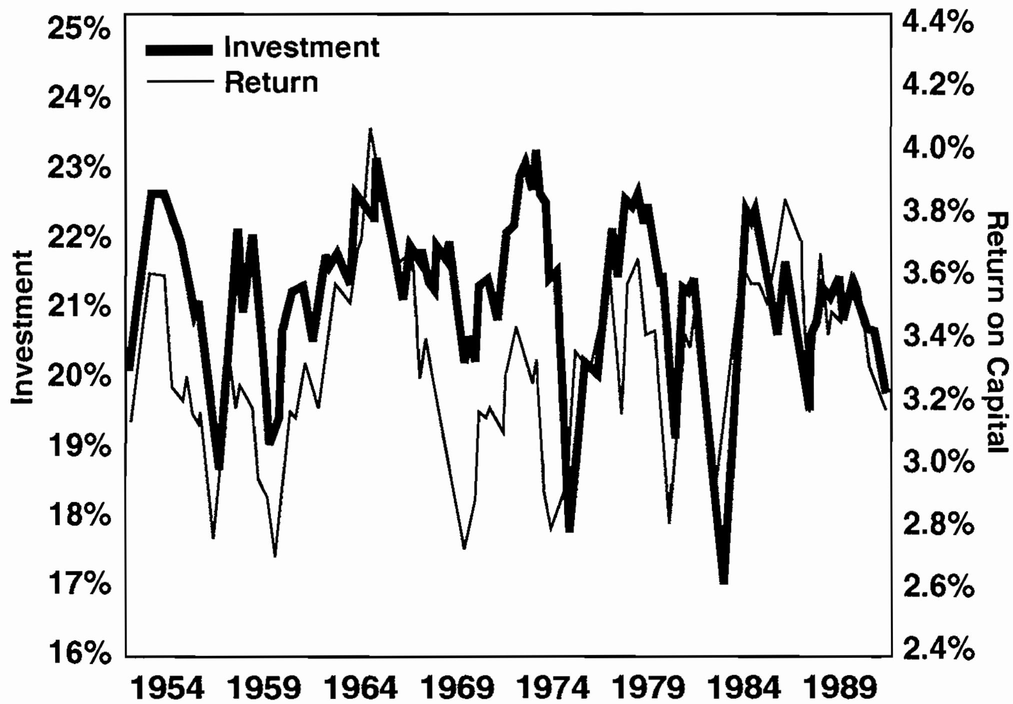
The recent recession was man-made — the result of unwise federal policies. Important policy mistakes were made in the Tax Reform Act of 1986, which increased marginal tax rates on investment income.[19] But just as bad policies have created bad economic times, good policies can produce more growth and more prosperity.

A targeted investment tax credit, already endorsed by Bill Clinton, is one way to stimulate investment. Neutral cost recovery (which includes depreciation for inflation and the time value of money) would create ten times as much stimulus. In addition, the Clinton administration should consider

"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.

lowering the capital gains tax rate on all gains (not just on selective investments) and restoring the right of all workers to make deposits to IRAs and to 401(K) plans.[20]

Lesson No. 5: Some tax cuts really do pay for themselves.

"Almost any tax cut for investors will pay for itself."

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 governments that impose new taxes on capital almost always collect much less total revenue than they anticipate. Not only does the tax base (the capital stock) shrink, but so does aggregate output and national income.

The reverse is also true. In general, *almost any reduction in taxes on capital will result in a net revenue gain for government.* For example:[21]

- A 10 percent cut in the tax rate on all investment income will cost government about $10 billion a year in lost revenue.
- Because of the tax cut, however, the cost of capital will fall by about 5 percent and, in response, new investment will increase the capital stock by 5 percent.
- This means that the economy as a whole will receive an infusion of about $750 billion in new capital, leading to an increase in the nation's output of goods and services of about $250 billion (net of depreciation).
- Of the $250 billion in increased national income, about $120 billion will go to government in taxes and about $120 billion will consist of an increase in aftertax wages.

Thus in return for giving up $10 billion in annual taxes, the government will increase its revenues by $120 billion a year — a $110 billion profit — and wage earners will realize a $120 billion increase in aftertax income.

The Capital Gains Tax. As an example of tax cuts that pay for themselves, consider the capital gains tax. Historically, there has been a negative relationship between capital gains tax rates and capital gains revenue collected by the federal government.[22] Whenever the tax rate has been increased, tax revenue has dropped, and vice versa.[23]

The Top Personal Income Tax Rate. Similarly, there is a negative relationship between the highest personal income tax rate and taxes paid by

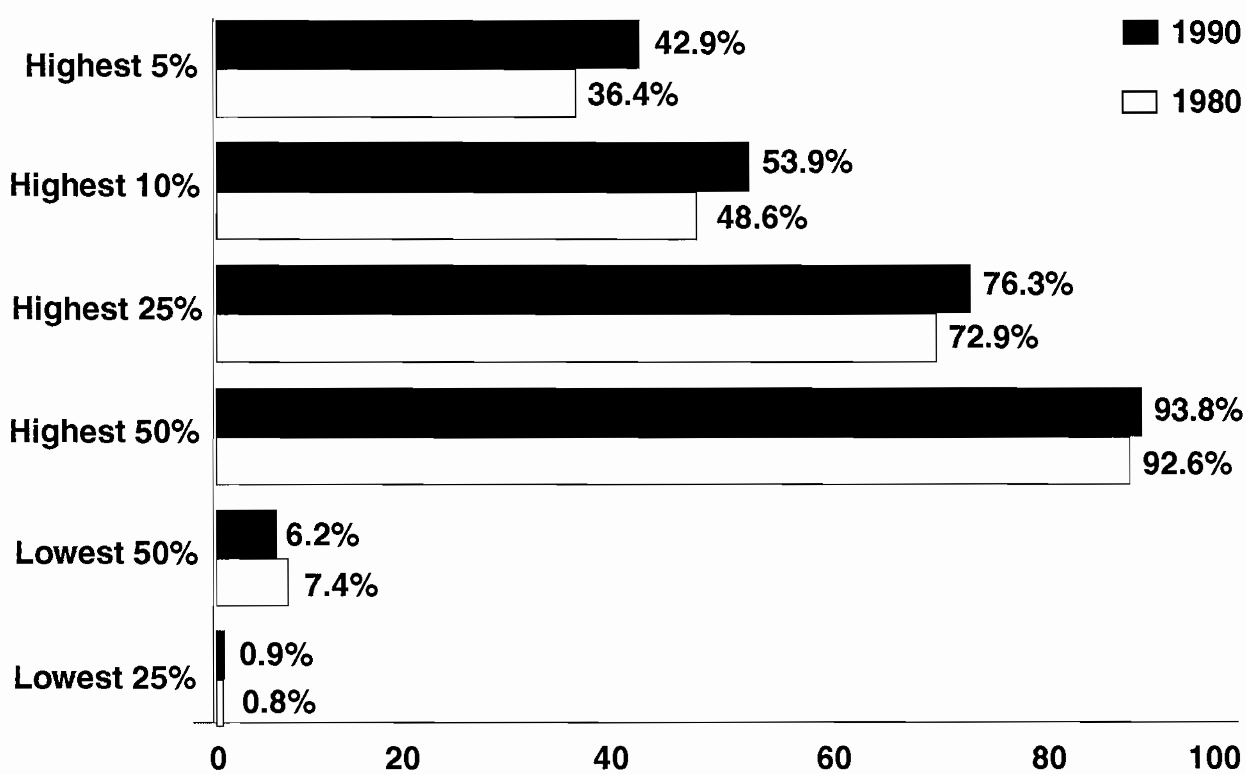
"Lowering the top income tax rate results in more revenue for government."

the highest income earners. Increasing tax rates for the rich (as Clinton promised during the election campaign) results in less revenue for government. Lowering tax rates for the rich produces more revenue. For example, between 1980 and 1990, the highest personal income tax rate fell from 70 percent to 28 percent, and the wealthiest taxpayers paid more taxes and a larger share of all taxes. Specifically:[24]

- The top 5 percent of all taxpayers paid 42.9 percent of all federal individual income taxes in 1990, up from 36.4 percent in 1980.
- The top 10 percent paid more than half, 53.9 percent, up from 48.6 percent in 1980.
- By contrast, the lowest 50 percent of income earners saw their share of income taxes decline from 7.4 percent in 1980 to 6.2 percent in 1990.

FIGURE VI

Percent of Federal Individual Income Taxes Paid



Source: Tax Foundation computations based on *Statistics of Income,* Internal Revenue Service, U.S. Department of the Treasury.

Lesson No. 6: The federal deficit is caused by too much spending.

The year President Bush took office, 1989, the federal government spent a little over $1.1 trillion. Projected spending for the fiscal year that started last September is $1.5 trillion, an increase of almost one-third. This increase in spending, combined with a weak economy, has caused the federal government's claim on the economy to be close to a 30-year high, at 24.5 percent of GDP.

Federal spending, adjusted for inflation, grew much faster than did the budgets of average Americans. Furthermore, the disparity between federal spending and economic growth was much greater than in previous administrations. As Figure VII shows, real federal outlays under Bush averaged 2.4 percent a year while the economy grew at a rate of only 0.6 percent. While federal spending averaged about 3 percent annual growth during the Carter and first Reagan administrations, the real economy grew at over 2 percent. During the second Reagan administration, the economy averaged 3.3 percent real growth while federal spending grew at less than 1 percent a year.

"The federal government's claim on the economy is near a 30-year high."

Domestic programs benefited most from the increased spending over the past four years. For example, real domestic spending increased by 16.5 percent during fiscal years 1991 and 1992. Some of this spending was on much-publicized pork barrel projects. Most of it, however, went to entitlements. Programs such as Aid to Families with Dependent Children (AFDC), Social Security, Medicare and food stamps grew by 23 percent in real terms between 1989 and 1992. Medicaid grew by 85 percent over the same period.[25]

Lesson No. 7: The deficit is unlikely to be reduced by increasing taxes.

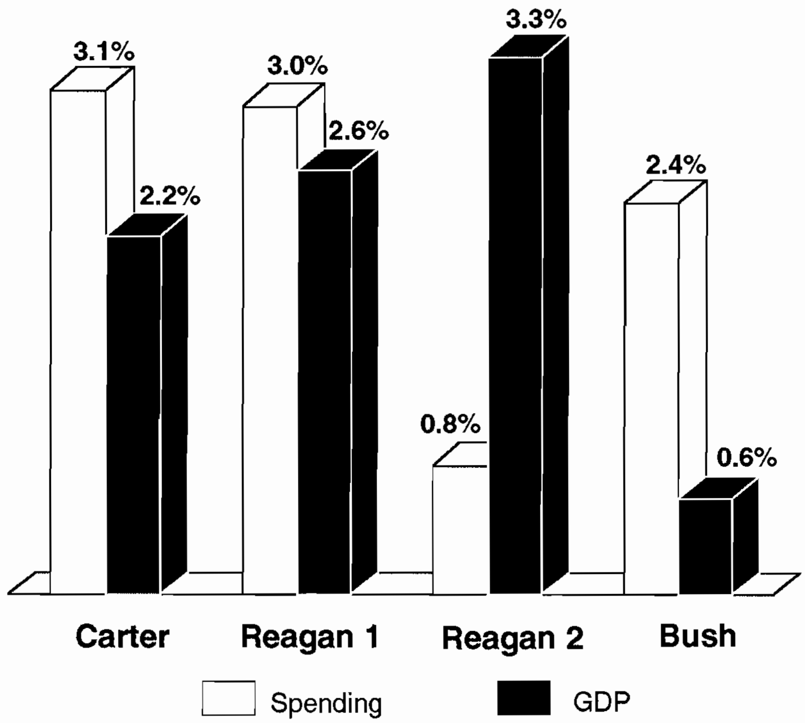
When the Omnibus Budget Reconciliation Act (OBRA) was passed in October 1990, President Bush considered it the keystone of his domestic policy achievements. During the 1992 campaign, however, he called it a mistake — and rightly so. Instead of shrinking, the deficit grew by more during the Bush administration than it ever had before. As Figure VIII shows, between 1989 and 1992 the federal deficit grew by almost $1.2 trillion.

Why Bush's Broken Promise Was a Mistake. Under the Gramm-Rudman-Hollings budget law, the federal deficit for 1991 through 1995 was projected to total $62.3 billion. However, the belief that federal government was "drowning in red ink" and, more importantly, would face across-the-board spending cuts prompted President Bush to break his "no new taxes" pledge in

"Real federal spending averaged 2.4 percent annual growth under Bush, while the economy grew at a rate of only 0.6 percent."

FIGURE VII

Government Spending vs. the Economy
(Inflation-adjusted Average Annual Growth)[1]



[1] Fiscal years.

the spring of 1990. After toiling through the summer, the administration and Congress came up with a budget summit agreement which eventually became OBRA. The agreement called for *immediate* tax increases, an *immediate* spending increase and *promised future* spending restraint.[26] The results were disastrous:

- Since January 1990, federal revenue projections for fiscal years 1991 through 1995 have deteriorated by $768.8 billion, not improved by the $166.5 billion in new tax revenues that the OBRA negotiators promised.

- Instead of being restrained by a promised $345.3 billion, federal spending has increased by $605.5 billion.

- As a result, instead of decreasing by a promised $511.8 billion, the five-year federal deficit has increased by almost $1.4 trillion. [See Figure IX.]

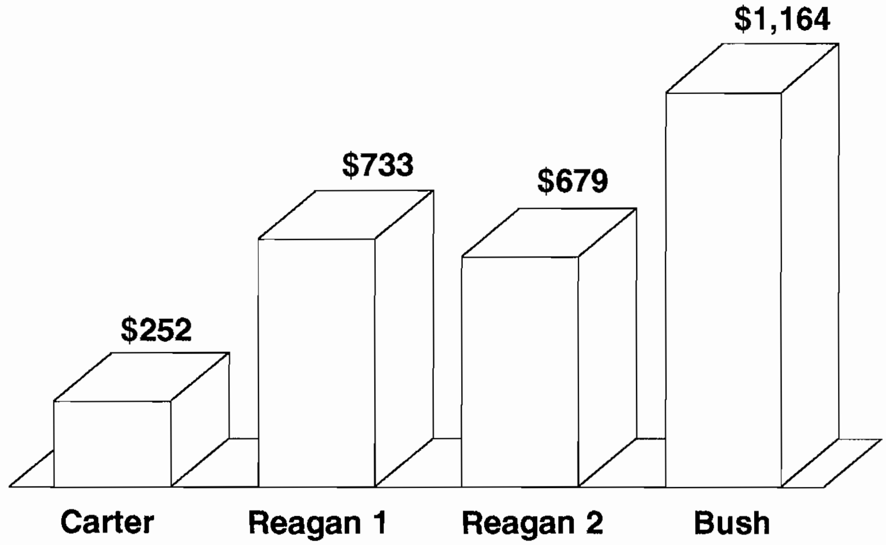
"Bush's decision to raise taxes led to larger— not smaller— deficits."

FIGURE VIII

Increase in the Federal Deficit

The Record of Four Administrations[1]

($ billions)



[1] Fiscal years.

The Record of Other Budget Agreements. OBRA was not unique. During the 1980s virtually every budget summit agreement led to higher, not lower, deficits. In six of the eight years between 1982 and 1989, the federal budget was set by budget summit agreements between the president and Congress:[27]

- In all six budget summit years, new taxes were agreed to in return for an agreement on a lower federal deficit.
- Despite the agreement and despite the higher taxes, in five of the six years the deficit rose.
- In all six cases, the actual deficit produced was higher than the deficit that had been agreed to.

By contrast, in the two years (1984 and 1987) with no summit agreement and no new taxes, the deficit fell by $22.5 billion and $71.5 billion, respectively.

The Record of Other Tax Increases. That higher taxes produce more spending — not smaller deficits — should come as no surprise. Numerous studies have shown that historical pattern.[28] For example, one recent study discovered that:[29]

- Between 1948 and 1986, every dollar in increased taxes led not to lower subsequent deficits but to 58 cents in *higher* levels of red ink.
- This was because spending tended to rise by roughly $1.58 in response to each new $1.00 of taxes.

Lesson No. 8: The effect of the economy on the deficit is much larger than the effect of the deficit on the economy.

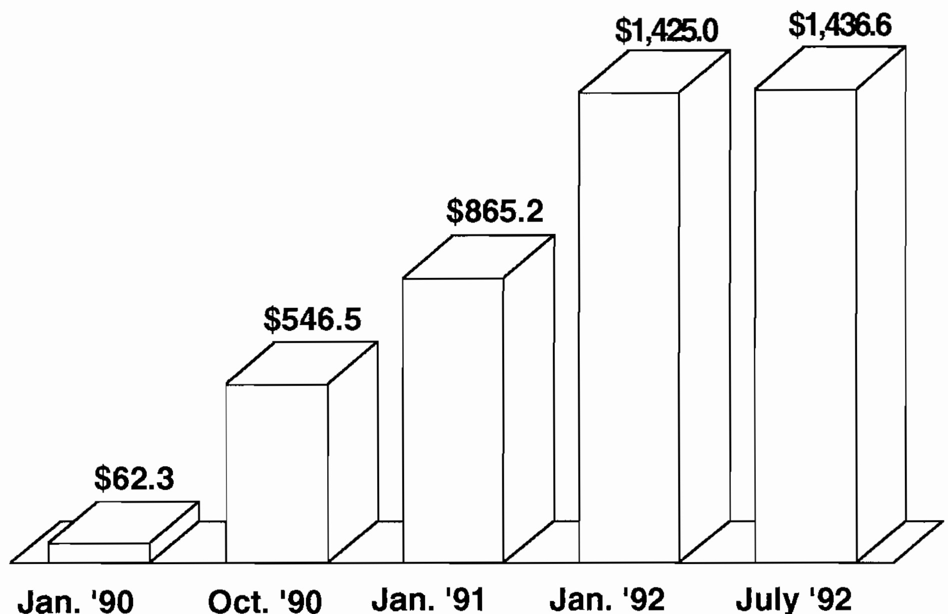
Early followers of John Maynard Keynes believed that large deficits have powerful stimulative effects on the economy. Many modern neo-Keynesians believe that large deficits are harmful to the economy

"The deficit reduction originally promised never materialized."

FIGURE IX

Bush Administration Predictions[1] of the Five-year Deficit, 1991-1995

($ billions)



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[1] Office of Management and Budget.

because they divert funds from private investment. Both groups fail to realize that the size of the deficit is more likely a consequence than a cause of the economy's performance.

Although federal tax rates went up under the Bush administration, federal tax revenues did not. Nothing hurts governmental coffers like an economic slowdown or recession. Despite increases in federal income, payroll and excise tax rates, federal receipts, after inflation, grew only 0.8 percent a year between 1989 and 1992. As Figure X shows, that is far less than the 3.5 percent annual growth during the Carter administration and the 3.6 percent annual growth during the second Reagan administration. Even the first Reagan administration, hamstrung by a steep recession, managed 1.3 percent annual growth. The deteriorating federal deficit under Bush was due in large part to the recession — made worse by OBRA. Poor economic performance completely thwarted deficit reduction goals.

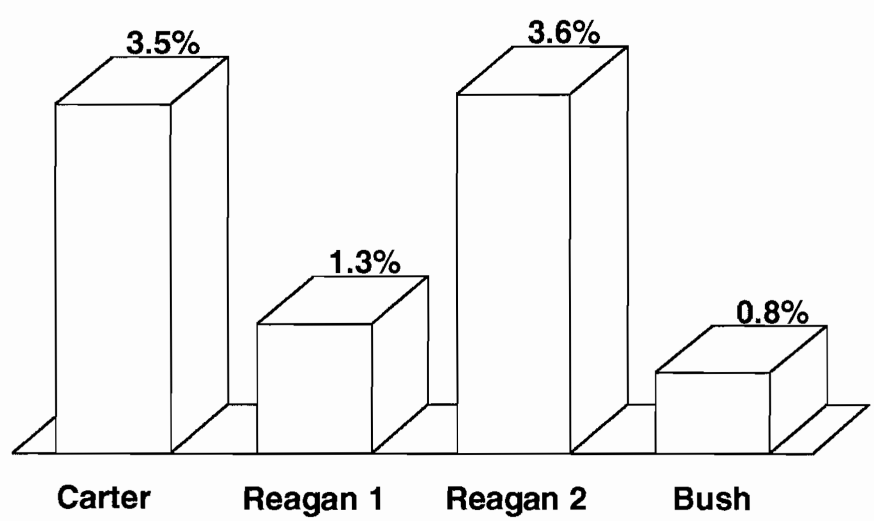
Lesson No. 9: The least painful way to reduce the deficit is through economic growth.

Most private and government forecasters are projecting a long-run, real growth rate in the range of 2.5 percent — far less than the 3 percent to 3.5 percent range of the last three decades. That slower rate of growth has dramatic implications for government revenues:[30]

"Because the tax increases slowed economic growth, government collected less revenue."

FIGURE X

Real Rate of Growth in Government Revenue[1]



[1] Inflation–adjusted average annual growth.

- If the economy averages 2.5 percent growth between 1992 and 1996 instead of the 3.3 percent rate posted from 1985 through 1989, the loss of output will equal $2.3 trillion.

- 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.

One way to add $870 billion to government coffers over the next five years, then, is to increase the economy's growth rate from 2.5 percent to 3.3 percent. That will be far easier than attempting to raise $870 billion by either cutting spending or raising taxes.

Lesson No. 10: Taxing investment income isn't "fair."

"Increasing the economy's growth rate is more palatable than either cutting spending or raising taxes."

Claiming to promote "tax fairness," many Democrats over the past two years have called for higher taxes on the rich. Bill Clinton is among them. But are higher taxes on the rich really fair to the rest of us?

Taxes on High Incomes Are Almost Always Taxes on Investment Income. During the election campaign, Bill Clinton announced his intention to raise the taxes of the "rich," defined by Clinton as people with incomes over $200,000. He also promised to impose a special surtax on income in excess of $1 million.[31] But the rich also are investors who derive most of their income from investments. Taxing the rich, for the most part, means taxing investment income. On the average:[32]

- People with annual incomes over $200,000 receive 60 percent of their income from investments and only 40 percent from wages.

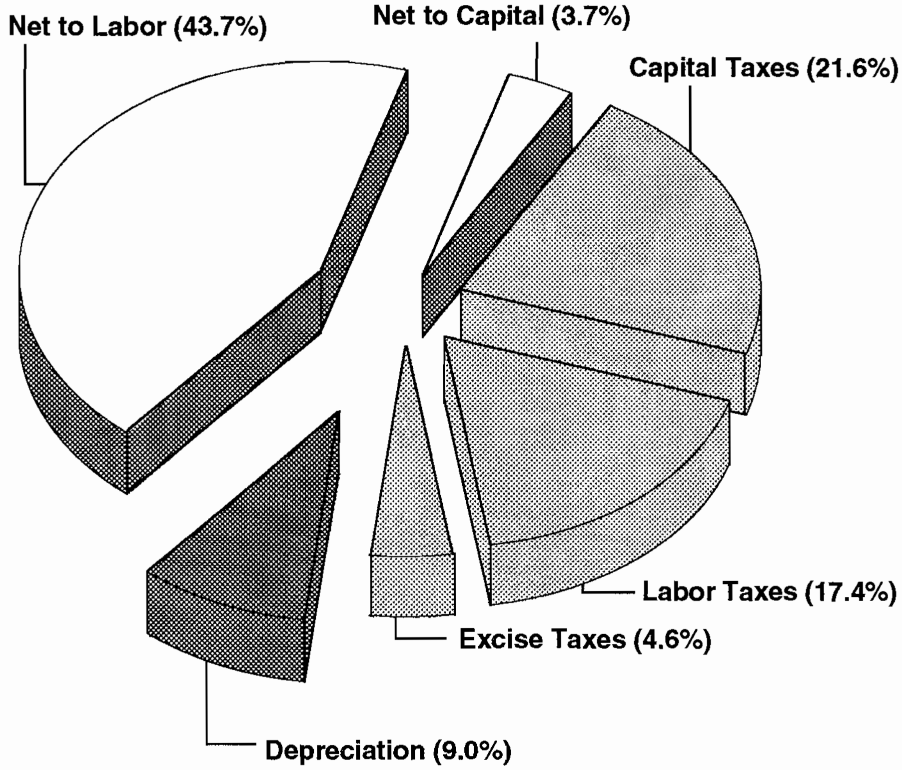
- People with annual incomes of $1 million or more receive about 75 percent of their income from investments and only 25 percent from wages.

- By contrast, middle-income families tend to receive 75 percent of their income from wages and 25 percent from capital.

Taxes on Investment Income Are Ultimately Taxes on Wages. Many people believe that owners of capital get most of the benefits that capital creates. This is not true. One of the most surprising findings of the economics of capital is that the overwhelming bulk of the extra income

FIGURE XI

Distribution of a Dollar of Sales



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

"For every $1 of aftertax income received by investors, wage earners receive $12 and government receives $12."

generated by capital accumulation flows to people in their role as wage earners, rather than to the owners of capital. As Figure XI shows:

- For every additional dollar of income produced by a larger capital stock, two-thirds goes to labor and only one-third to capital.
- After taxes and depreciation, the discrepancy is even greater: labor receives 43.7 cents of each additional dollar of sales, while owners of capital receive only 3.7 cents.
- In other words, workers get to keep $12 in aftertax wages for every $1 of additional aftertax income to investors.

These facts have dramatic public policy implications. Public policies that promote capital accumulation primarily benefit wage earners, while policies that discourage capital accumulation primarily penalize wage earners. In general, more than 90 percent of the cost of a smaller capital stock is borne by wage earners rather than by owners of capital.

Changing Course

A poor economy was the main reason George Bush lost the election. The economy will be the primary factor in the success or failure of the Clinton administration as well.

"Slow growth will cost the economy $4.4 trillion by the end of the decade."

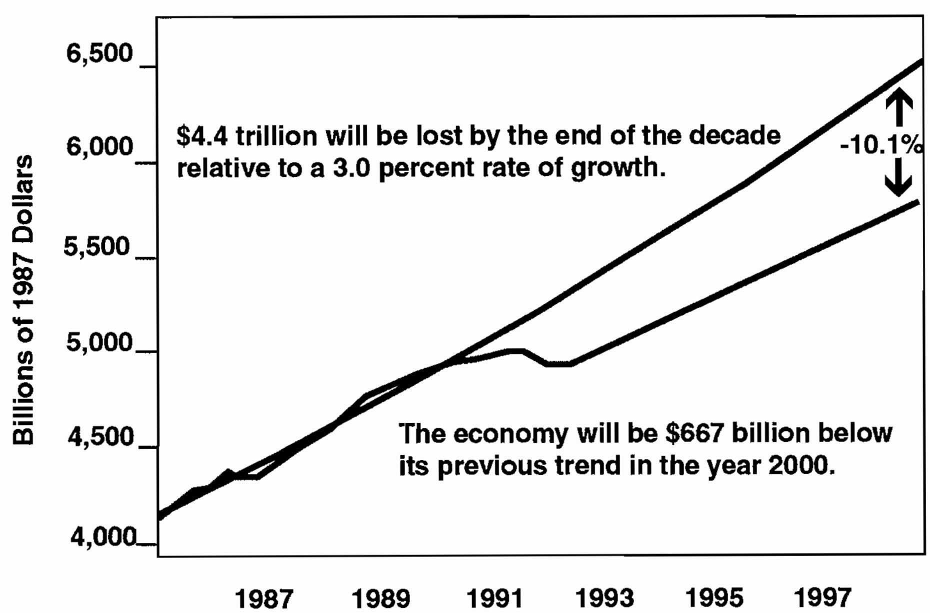
The 1990 recession combined with a weak recovery and continued slow growth have serious implications for the future. As Figure XII shows, we will lose $4.4 trillion of output relative to what GDP would have been if the trend of the 1980s had continued.[33]

- This forgone GDP translates into $1,500 less annual output for every man, woman and child in the U.S. by the end of 1993.
- The annual loss rises to $2,500 per person by the end of the decade.
- The cumulative loss between 1992 and the year 2000 is $16,500 per person.

FIGURE XII

Potential GNP Loss With Low Growth

3.0 Percent vs. 2.5 Percent



Restoring the economy will not be easy. In order to reach the previous long-run trend by 1996, our economy's real growth will have to average about 5 percent a year for four years. It has not done so in at least three decades. The closest the economy came was during the mid-1960s after the Kennedy tax cuts and during the mid-1980s after the Reagan tax cuts.

"The cost of slow growth is $16,500 for every man, woman and child in the country."

Reversing the upward course of taxes on labor and capital and the increasing regulatory burden is essential to restoring a healthy U.S. economy. In particular, the trend toward higher taxes on saving and investing must be reversed.[34] Tax policy cannot be timid. Limited business tax credits will not do the job. Much more dramatic proposals are necessary to sharply boost the long-term growth rate.

Without a bold change in policy, the economy will continue stagnant, the growth of real wages and employment will remain sluggish, and the American people will not enjoy the standard of living they have come to expect.

Aldona Robbins
Gary Robbins

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] The attempt to raise these revenues failed, partly because of economic contraction due to the tax rate increases. See the discussion below.

[2] William G. Laffer III and Nancy A. Bord, "George Bush's Hidden Tax: The Explosion in Regulation," Heritage Foundation, Backgrounder No. 905, July 10, 1992.

[3] For analyses of the success of Reagan economic programs, see Robert L. Bartley, *The Seven Fat Years and How to Do It Again* (New York: The Free Press, 1992) and Lawrence B. Lindsey, *The Growth Experiment* (New York: Basic Books, 1990).

[4] Marginal tax rates on labor and capital are from the Fiscal Associates tax model. Calculations of marginal taxes on capital include property taxes; personal income taxes on dividends, capital gains, net business income, rental income and interest; and corporate income taxes (usually income less tax depreciation). Marginal taxes on labor compensation include personal income taxes on wages and salaries and payroll taxes. Indirect business taxes, such as sales or value-added taxes, are split between labor and capital based on the contribution of each to output. Historically, labor receives two-thirds and capital one-third.

[5] The 15.3 percent rate for 1990 had been part of the 1977 Social Security Amendments. The 1983 Amendments called for an intermediate increase to 15.02 percent in 1988 before going to 15.3 percent in 1990.

[6] In 1992, wages and salaries up to $130,200 (instead of $55,500) were subject to the 2.9 percent tax rate.

[7] At the time of the agreement, we estimated that the OBRA tax increases would deepen and lengthen the recession that had begun in July 1990. See Aldona Robbins and Gary Robbins, "Taxes, Deficits and the Current Recession," National Center for Policy Analysis, NCPA Policy Report No. 156, January 1991.

[8] Much of the increased federal regulatory burden was due to the Fair Labor Standards Act of 1989, the Americans with Disabilities Act of 1990, the Clean Air Act amendments of 1990 and the Civil Rights Act of 1991. For a discussion of these regulatory costs, particularly on small business, see Lowell Gallaway and Gary Anderson, "Derailing the Small Business Job Express," prepared for Representative Dick Armey, Ranking Republican, Joint Economic Committee, November 7, 1992.

[9] The minimum wage increased from $3.35 to $3.80 in April 1990 and to $4.25 in April 1991.

[10] Dale W. Jorgenson and Peter J. Wilcoxen, "Impact of Environmental Legislation on U.S. Growth, Investment, and Capital Costs," in *U.S. Environmental Policy and Economic Growth: How Do We Fare?* American Council for Capital Formation, Center for Policy Research, March 1992.

[11] Robert Genetski, *Wall Street Journal,* February 19, 1992, p. A-10.

[12] Robert Genetski, *Economics of the Presidential Candidates*, Robert Genetski and Associates, September 4, 1992.

[13] This estimate is based on the following ordinary least squares regression for the period 1954 to 1990:

$$\log W = \underset{(-92.1)}{-2.66107} + \underset{(41.6)}{1.186851} \log K/L \qquad R^2 = 0.98$$

where W is the real hourly U.S. wage rate, K/L is the real capital stock divided by the number of hours worked and t-statistics are in parentheses.

[14] In terms of the economy's ability to produce goods and services, the constraint is not paper money, which we can print in unlimited quantity. The contraint is the number and quality of physical assets that labor can use in the production process.

[15] Just as foreign investors have part of their porfolios in U.S. assets, so many U.S. citizens have investments overseas. When investment opportunities in the United States become more attractive relative to options in the rest of the world, U.S. investors will allocate more of their funds to the United States and less to other countries.

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

[17] 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.

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

[19] Tax reform repealed the 60 percent capital gains exclusion for individuals and broadened the corporate tax base through repeal of the investment tax credit, limits on depreciation deductions, restrictions on the use of net operating losses and a number of other punitive measures aimed at capital income.

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

[21] Ibid.

[22] See the literature review in John C. Goodman, Aldona Robbins and Gary Robbins, "Elderly Taxpayers and the Capital Gains Debate," National Center for Policy Analysis, NCPA Policy Report No. 153, July 1990.

[23] Perhaps because capital gains taxes have become a political issue, the major forecasting agencies of Congress have (1) denied the existence of this historical relationship, (2) gone to great lengths to explain it away or (3) maintained that the past relationship would not hold in the future. For example, both the Congressional Budget Office and the Joint Committee on Taxation resolutely maintained that the 40 percent increase in the capital gains tax rate in the 1986 Tax Reform Act would increase rather than reduce government revenue. This prediction has proved to be a considerable embarrassment to both agencies. Before the tax hike took effect, there was a huge jump in capital gains income in 1986. For the past four years, however, capital gains income has been lower than it was in 1985. See Congressional Budget Office, "Effect of Lower Capital Gains Taxes on Economic Growth," *CBO Papers*, August 1990; Joint Committee on Taxation, "Explanation of the Methodology Used To Estimate Proposals Affecting the Taxation of Income From Capital Gains," March 27, 1990; and Rep. Dick Armey and the Joint Economic Committee Republican Staff, "Distorting the Data Base: CBO and the Politics of Income Redistribution," April 1991.

[24] The top 5 percent of taxpayers includes anyone with an adjusted gross income of $80,867 or more. The top 10 percent includes anyone with an adjusted gross income of $63,818 or more. See *Tax Features*, Tax Foundation, Vol. 36, No. 8, September 1992.

[25] Stephen Moore, "Crime of the Century: The 1990 Budget Deal After Two Years," Cato Institute, Policy Analysis No. 182, October 15, 1992.

[26] OBRA also included elaborate mechanisms for determining spending limits, "pay-as-you-go" constraints placed on new spending programs or tax cuts and rules about how government forecasts would be done. Another departure from Gramm-Rudman-Hollings was that official forecasts that changed due to economic conditions or technical revisions would not count against the new ceilings.

[27] Tax Foundation, "A Decade of Budget Summitry," 1990.

[28] See the review in Stephen Moore, "Do We Need New Taxes?" National Center for Policy Analysis, NCPA Policy Backgrounder No. 105, September 1990.

[29] Richard Vedder, Lowell Gallaway and Christopher Frenze, "Federal Tax Increases and the Budget Deficit, 1947-1986; Some Empirical Evidence," Report to the Republican Members of the Joint Economic Committee of Congress, 1987.

[30] "Statement of Lawrence Kudlow" and "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.

[31] See"Putting People First: A National Economic Strategy," Clinton campaign document, June 20, 1992; and see the discussion in Gary Robbins and Aldona Robbins, "The Clinton Economic Plan," National Center for Policy Analysis, NCPA Policy Backgrounder No. 120, August 1992.

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

[33] The economy had averaged 3.2 percent annual real growth during the mid-1980s, as it had since 1960. The assumed long-term trend growth rate in Figure XII is slightly less at 3 percent.

[34] See Robbins and Robbins, "A Strategy for Growth," for discussion of a proposal designed for the U.S. Chamber of Commerce and NCPA that includes neutral cost recovery. See Aldona Robbins and Gary Robbins, "Jerry Brown's Tax Plan," National Center for Policy Analysis, NCPA Policy Backgrounder No. 117, April 1992, for analysis of the proposal Jerry Brown made during the primary campaign.

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