POLICY BACKGROUNDER No. 125
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President Clinton's Economic Plan

The National Center for Policy Analysis (NCPA) has completed a formal forecast of the effects of President Clinton's economic plan. The forecast assumes adoption of the plan in full, including all tax and spending changes.

"The plan will cost the economy about $1,000 in reduced output for every man, woman and child in the country."

We conclude that the minor incentives created for private investment will be more than offset by higher taxes on investment income. As a result, the plan will reduce investment in the U.S. economy over the next five years. Because of lower investment, the output of goods and services will be less, incomes lower and jobs fewer than if the plan were not adopted. Specifically:

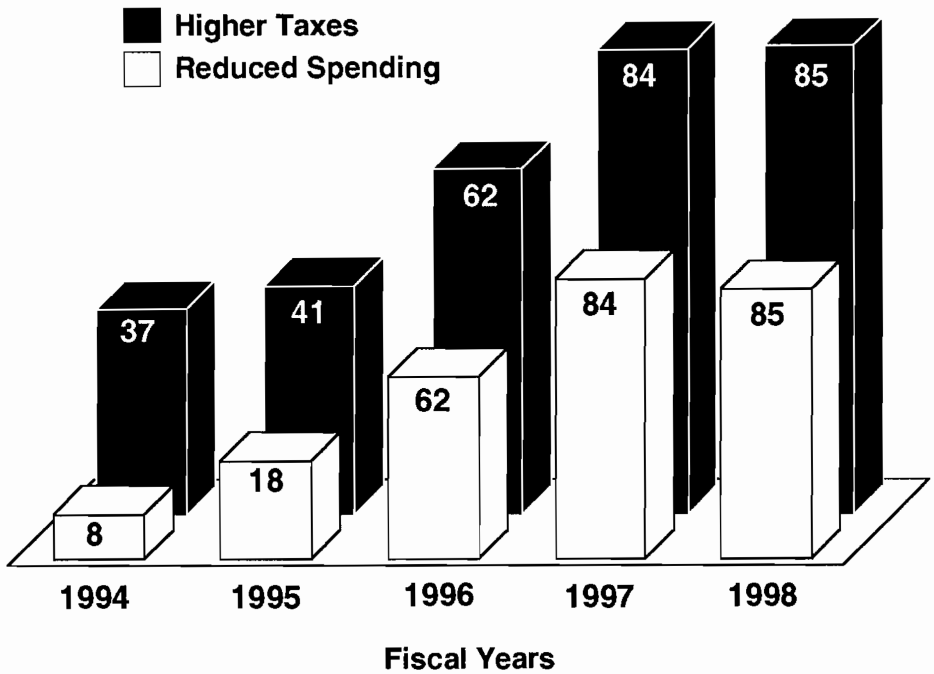
- Reduced investment will lower capital formation by $1.8 trillion relative to what it would have been through 1998.
- Annual gross domestic product will be $260.6 billion less than it would have been — an amount equal to about $1,000 for every man, woman and child in the country.
- Over the next five years, 1.4 million fewer jobs will be created, and total wages in the economy will be $483 billion lower.

"In 1994, the first full year, we will get almost $5 of new taxes for every $1 of spending cuts."

FIGURE I

New Taxes Outweigh Spending Cuts By an Average of 2 to 1

($ billions)



Summary of the Plan

President Clinton outlined his comprehensive economic plan before a joint session of Congress on February 18, 1993. The plan consists of spending reductions and spending increases, tax reductions and tax increases. Specifically:

- To "reduce the deficit," the plan calls for spending cuts of $332 billion and tax increases of $328 billion.
- To "stimulate the economy," the plan calls for spending increases of $153 billion and tax reductions of $77 billion.

On net, Clinton claims that his plan will reduce spending by $222 billion[1] and increase taxes by $251 billion over the next five years. However, examination of the details released so far shows that spending cuts are lower than advertised and tax increases are higher.

"Almost a fifth of so-called spending cuts are actually tax increases."

Spending Cuts. Table I summarizes the proposed spending cuts. Despite the Clinton administration's claim that there will be $331.7 billion in spending reductions over the next five years, the actual figure is only $273.6 billion. Clinton's proposals for $58 billion in higher taxes on Social Security benefits, increased user fees and higher Medicare premiums clearly are tax increases, not spending reductions. And these measures account for 19.4 percent of the so-called spending cuts in fiscal year 1994 and 17.5 percent over the next five years.

Of the $273.6 billion in actual spending cuts, 41 percent will come from the defense budget. Another one-third will come from entitlement programs, largely from Medicare. However, Medicare cost reductions are achieved almost entirely by reducing payments to hospitals, doctors and other providers, rather than by reducing benefits. The remaining one-quarter of spending cuts will come from domestic discretionary programs.

Spending Increases. Almost one-half of the spending cuts will be offset by higher spending for new or expanded government programs. President Clinton proposes $117 billion in new spending over the next five years for infrastructure, education programs and health care. Net spending reductions, therefore, amount to only $157 billion through 1998. [See Table III.]

Tax Increases. The Clinton program calls for $328 billion in higher taxes over the next five years. Most of the tax increases come from higher personal income tax rates and a new energy tax. Specifically, the plan will (1) add a fourth income tax bracket of 36 percent for single returns with adjusted gross income over $115,000 and for joint returns over $140,000, (2) apply a 10 percent surtax to income over $250,000,[2] (3) remove the wage ceiling (currently $135,000) on the 2.9 percent Medicare Hospital Insurance payroll tax rate, (4) increase the taxation of Social Security benefits from 50 percent to 85 percent, (5) impose a tax on the energy content of fuels as measured by British thermal units (BTUs)[3] and (6) increase the corporate tax rate from 34 percent to 36 percent.

Tax Cuts. The President also proposes tax cuts, including enterprise zones, job credits and an expanded earned income tax credit (EITC). The largest is a targeted investment tax credit. Small businesses will have a 7 percent credit on equipment for 1993 and 1994 and a 5 percent credit after that. Larger business will have a temporary 7 percent credit on equipment during 1993 and 1994 on incremental investment over a historic base amount. Accounting for the misclassified tax increases discussed above, the Clinton plan proposes to raise taxes on net by $303 billion over five years. [See Table II.]

"The minor incentives created for private investment are more than offset by higher taxes on investment income."

The Ratio of Tax Increases to Spending Cuts. Prior to Clinton's speech to Congress, Budget Director Leon Panetta predicted that spending cuts would outweigh tax increases by two to one. In the actual plan, the ratio is reversed. Moreover, as Figure I shows, heavy reliance on tax increases begins immediately and continues throughout the next five years. Spending cuts are concentrated in the third, fourth and fifth years — raising the question of whether they will ever be realized. Overall:

TABLE I

Clinton's Proposed Spending Cuts[1]

($ billions)

	1994	1995	1996	1997	1998	1994-98
Defense (over Bush's cuts)	6.7	11.7	19.7	37.4	36.3	111.8
Domestic discretionary[2]						
Programs not needed	0.3	1.1	2.2	2.9	3.2	9.7
Reduced subsidies & higher user fees	0.7	1.2	1.6	1.8	1.8	7.0
Gov't management	4.0	7.5	10.3	13.2	14.8	49.8
Streamlining gov't	0.6	1.6	2.5	3.3	4.2	12.1
Total	4.5	10.2	15.4	20.2	23.0	73.3
Entitlement programs						
Eliminating subsidies & charging user fees	0.8	1.8	5.3	7.0	5.0	19.9
Managing government for cost-effectiveness	1.9	3.4	4.9	6.8	8.9	26.0
Controlling health care costs	3.1	6.5	11.6	17.2	21.9	60.3
Medicaid	0.0	1.3	1.5	1.7	2.0	6.5
Medicare	3.0	5.2	10.1	15.5	19.9	53.7
Shared contributions	2.9	6.2	8.9	10.6	11.7	40.4
Medicaid matching rates	0.2	0.4	0.4	0.5	0.5	2.0
Income security	0.1	0.2	2.3	3.2	3.5	9.2
Tax Social Security benefits	2.7	5.6	6.2	6.9	7.7	29.1
Total	8.7	17.9	30.8	41.7	47.5	146.6
TOTAL CUTS CLAIMED	19.8	39.8	65.9	99.3	106.8	331.7
TAX HIKES DISGUISED AS SPENDING CUTS						
Tax Social Security benefits	2.7	5.6	6.2	6.9	7.7	29.1
Reduced subsidies & higher user fees[3]	1.1	1.7	3.9	5.3	5.3	17.3
Medicare premiums	0.0	0.0	1.1	3.9	6.6	11.6
Total	3.8	7.3	11.3	16.0	19.5	58.0
ACTUAL SPENDING CUTS						
Defense	6.7	11.7	19.7	37.4	36.3	111.8
Domestic discretionary	4.1	9.7	14.8	19.5	22.3	70.4
Entitlements	5.2	11.1	20.1	26.3	28.7	91.4
Total	16.0	32.5	54.6	83.2	87.3	273.6

Source: "A Vision of Change for America," report accompanying President Clinton's State of the Union address, February 18, 1993.

[1] Years are fiscal years.

[2] Includes $5.4 billion in higher spending over five years due to technical adjustments.

[3] Includes excise taxes, user fees and reduced subsidies that will raise production costs directly. Excludes the elimination of grants or reduced government spending on projects.

TABLE II

Clinton's Proposed Tax Changes[1]

($ billions)

	1993	1994	1995	1996	1997	1998	1993-98
Individual taxes:							
Higher rates	1.8	27.7	19.9	22.9	26.3	27.7	126.3
85% Social Security	0.0	2.7	5.6	6.2	6.9	7.7	29.1
Repeal health ins. cap	0.0	2.8	6.0	6.4	6.8	7.2	29.2
Expanded EITC	0.0	-0.5	-6.2	-6.4	-6.7	-6.9	-26.8
Business provisions:							
36% corporate rate	0.4	7.7	5.4	5.5	5.7	5.8	30.6
Targeted ITC	-4.6	-9.2	-6.7	-3.1	-2.3	-2.9	-28.9
Other incentives[2]	-1.0	-1.4	-1.9	-2.3	-2.6	-2.8	-12.1
Training & educ.	-0.5	-0.6	-0.8	-0.9	-1.0	-1.2	-5.0
Enterprise zones	0.0	-0.1	-0.3	-0.8	-1.2	-1.7	-4.1
Investment in real estate	-0.1	-0.6	-1.0	-1.1	-1.3	-1.8	-5.8
Excise taxes:							
BTU tax	0.0	1.5	8.9	16.4	22.3	22.4	71.4
Extended gas tax	0.0	0.0	0.0	2.6	2.6	2.6	7.9
Estate tax rates	0.0	0.5	0.5	0.6	0.6	0.6	2.8
Miscellaneous	0.5	5.7	9.8	11.4	17.3	14.6	59.3
NET TAXES CLAIMED	-3.6	36.1	39.1	57.3	73.4	71.5	273.8
DISGUISED TAXES[3]	0.0	1.1	1.7	5.1	9.1	11.8	28.9
TOTAL TAXES[4]	-2.4	37.8	44.2	66.5	85.2	100.4	302.7

[1] Years are fiscal years.

[2] Includes a minor lowering of capital gains taxes on investments in small businesses held more than five years. The revenue cost is $714 million over five years.

[3] Includes excise taxes, user fees, reduced subsidies and Medicare Part B premiums that are counted in the Clinton plan as spending cuts.

[4] May not agree exactly with totals in other tables due to rounding.

TABLE III

Summary of the Clinton Plan[1]

($ billions)

	1994	1995	1996	1997	1998	1994-98
Spending cuts	-16	-33	- 55	- 83	- 87	-274
Spending increases	8	15	22	33	39	117
Net spending	- 8	-18	- 33	- 50	- 48	-157
Higher taxes	46	51	66	83	82	328
Disguised taxes	4	7	11	16	20	58
Total new taxes	50	58	77	99	102	386
Tax cuts	-13	-17	-15	-15	-17	-77
Net taxes	37	41	62	84	85	309[2]
Spending cuts per $1 of new taxes	$0.22	$0.42	$0.52	$0.60	$0.57	$0.51

Source: "A Vision of Change for America," report accompanying President Clinton's State of the Union address, February 18, 1993.

[1] Fiscal years.

[2] May not agree exactly with totals in other tables due to rounding.

- Taxes will increase an average of $2 for every $1 spending is reduced over the next five years.

- In 1994 — the first full year of the plan — taxes will increase by about $5 for every $1 spending goes down.

Congress passes a new budget every year, so there is no guarantee that any spending or tax changes beyond the first year will ever take place.

Changes in Incentives to Work, Save and Invest

Although the Clinton administration claims its plan will stimulate the economy, we find that the reverse is true. The minor incentives created for private investment will be more than offset by higher taxes on investment income.

A Very Weak Stimulus Package. The proposed investment tax credit (ITC) is generally intended to apply only to investments that would not otherwise be made.[4] As a practical matter, this means that the tax break is available only to those firms that increase their investment spending over prior years. Industries that are contracting or restructuring and are most in need of help will not be eligible to receive the credit. Overall, the positive stimulus created by this tax credit is only one-sixth the size of the negative impact of the higher corporate income tax rate.

"Public 'investment' has virtually no effect on the economy."

The plan excludes from taxation 50 percent of the capital gains on the sale of small businesses held for more than five years. Yet because the provision is so limited, its impact on the economy will be small.[5] The plan makes permanent the current 20 percent tax credit for research and experimentation. It also includes a tax credit for worker training. Yet experience with labor-based tax credits has been disappointing. Given the lack of tangible evidence of success, we might expect the training tax credit to be widely abused and to do little economic good.

What about the increased public spending on infrastructure? The Clinton administration argues that public sector investment operates much like private sector investment, creating jobs and increasing wages.[6] While some older economic studies supported that contention, recent research refutes it. The latest finding is that public capital spending increases have no effect on private sector output, productivity or capital formation.[7]

Higher Taxes for Investors and Entrepreneurs. Table IV shows the various effects of the increase in the top income tax rate to 36 percent and of the surtax on those taxpayers with incomes in excess of $250,000. Although the Clinton plan may be good politics in that it punishes a very small percent of voters, it is bad economics in that it targets investment and entrepreneurial income. Specifically:

- Although 82.7 percent of taxpayers who receive dividend income will not be affected, 53 percent of the income from dividends will be subject to higher taxes.

- Although 91.1 percent of taxpayers who receive interest income will not be affected, 34.4 percent of interest income will be taxed at higher rates.

- Higher tax rates will also apply to 42.4 percent of business and professional income, 50.6 percent of rent and royalty income and 84.1 percent of income from partnerships and Subchapter S corporations.

Higher Marginal Tax Rates. The tax changes contained in the Clinton plan will, on net, raise the cost of labor and capital. The average marginal tax rate on labor will increase by 4.6 percent by 1998, primarily

TABLE IV

Impact of Higher Tax Rates[1]

Type of Income	No Rate Change[2]	36% Rate Only[3]	36% Rate And 10% Surtax[4]
Adjusted gross income:			
Number of returns	94.3%	4.9%	0.7%
Amount	70.2%	17.1%	12.8%
Salaries and wages:			
Number of returns	94.1%	5.2%	0.7%
Amount	76.1%	16.3%	7.5%
Taxable interest:			
Number of returns	91.1%	7.7%	1.2%
Amount	65.4%	16.9%	17.7%
Dividends:			
Number of returns	82.7%	14.4%	2.9%
Amount	47.0%	21.2%	31.8%
Business or professional income:			
Number of returns	88.9%	9.3%	1.7%
Amount	57.6%	26.2%	16.2%
Net capital gains (Schedule D):[5]			
Number of returns	100.0%	0.0%	0.0%
Amount	100.0%	0.0%	0.0%
Rent and royalty income:			
Number of returns	82.7%	13.0%	4.3%
Amount	49.4%	23.2%	27.4%
Partnership and S Corporation:			
Number of returns	66.3%	22.8%	10.8%
Amount	15.9%	19.0%	65.1%
Estate and trust income:			
Number of returns	72.6%	18.7%	8.7%
Amount	28.1%	17.8%	54.2%
Farm income:			
Number of returns	92.7%	6.1%	1.3%
Amount	75.2%	16.2%	8.5%

[1] Based on 1990 distribution of tax return information.

[2] Assumes that 1990 taxpayers with incomes below $75,000 would not be subject to either rate increase.

[3] Assumes that 1990 taxpayers between $75,000 and $200,000 would be subject to the new 36% rate.

[4] Assumes that 1990 taxpayers with income over $200,000 would be subject to the 10% surcharge.

[5] There is a maximum capital gains rate of 28% by statute.

because of higher income tax rates on wages and salaries and the application of the Medicare payroll tax to all wages.[8] The marginal tax on capital will increase by 5 percent by 1998, mainly due to the rate changes that affect dividends, interest and other investment income. As Figure II shows, overall:

- By 1998, the next dollar of wages and salaries earned will pay 46.3 cents in taxes, compared to 44.2 cents in 1992 and 41.9 cents in 1988.
- The next dollar of income earned on capital will pay 58.5 cents in taxes in 1998, compared to 55.7 cents in 1992 and 54.8 cents in 1988.

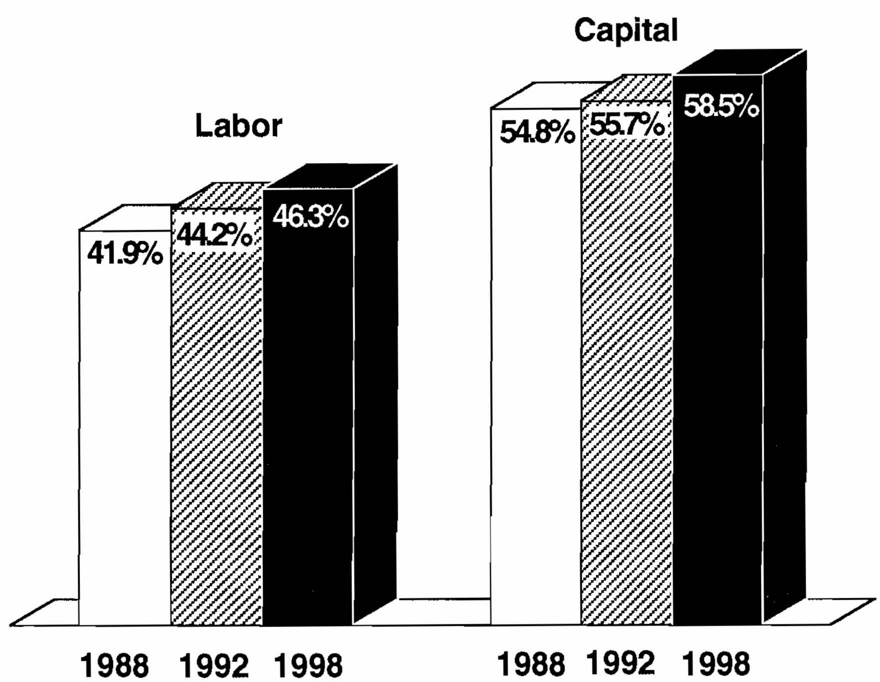
Because of these changes, workers will be less willing to supply labor, investors less willing to supply capital and businesses less willing to employ either labor or capital.

Higher Tax Rates for the Elderly. A major component of the Clinton plan is its attempt to raise $29 billion over five years by taxing 85 percent of Social Security benefits. This tax will have a major negative impact on work and saving by the elderly, and in the long run it will make the deficit larger.[9]

"Because of higher marginal tax rates, the economy will have less labor and capital."

FIGURE II

Marginal Tax Rates[1]



[1] Economy-wide average marginal rates computed from the Fiscal Associates tax model.

"When the elderly earn $1, they will pay taxes on $1.85."

TABLE V

Marginal Tax Rates for the Elderly On Income from Savings

Income Tax Bracket	Clinton's Proposed Social Security Benefit Tax	Total Tax Rate
15%	14.7%	27.8%
28%	23.8%	51.8%

Under current law, the elderly pay income taxes on up to one-half of their Social Security benefits. If their income exceeds $25,000 (individuals) or $32,000 (couples),[10] they pay taxes on 50 cents of benefits for each $1 of income above these thresholds. The Social Security benefit tax usually is described as a tax on *benefits*. In fact, it is a tax on other *income*. No tax is paid unless a taxpayer's income reaches a certain level. Beyond that point, the tax rises as income rises. Under the Clinton plan, 85 cents of benefits will be taxed for each additional $1 of income.[11] *Thus when elderly taxpayers earn an extra $1, they will pay taxes on $1.85.*

About 60 percent of the income of elderly taxpayers comes from investments (including pensions).[12] For most younger people, the tax rates on investment income are 15 percent and 28 percent. Under President Clinton's proposal, the rates for the elderly on income from savings will be up to 85 percent higher. As Table V shows:[13]

- Elderly taxpayers in the 15 percent income tax bracket could pay an effective rate of 27.8 percent (15% x 1.85).

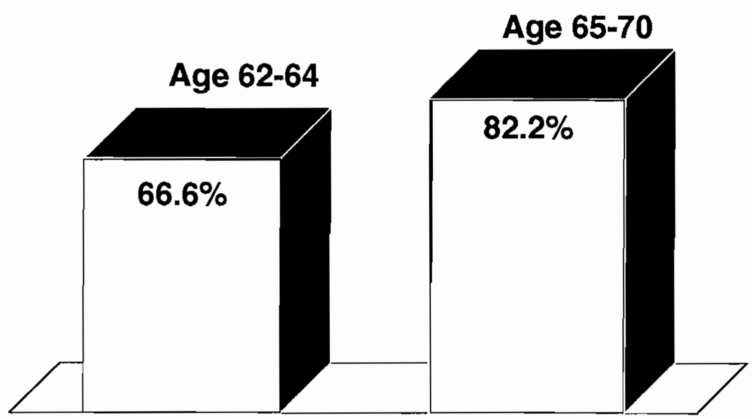
- Elderly taxpayers in the 28 percent tax bracket could pay an effective rate of 51.8 percent (28% x 1.85).

Marginal tax rates on wage income could go higher. For every dollar in wages earned over the Social Security earnings limit, a beneficiary between the ages of 65 and 70 loses 33 cents in benefits; a beneficiary under age 65 loses 50 cents.[14] Add in the Social Security (FICA) tax, the income tax and the Social Security benefit tax and under current law the marginal tax rate on wage income can reach 62.23 percent for someone between the ages of 65 and 70 and 78.28 percent for someone under age 65.[15] Increasing the taxation of Social Security benefits to 85 percent would increase those marginal rates to 66.61 percent and 82.21 percent, respectively. [See Figure III.]

"Some elderly workers will face a marginal tax rate of 82 percent."

FIGURE III

Highest Marginal Tax Rates For Middle-Income Elderly Workers Under the Clinton Plan

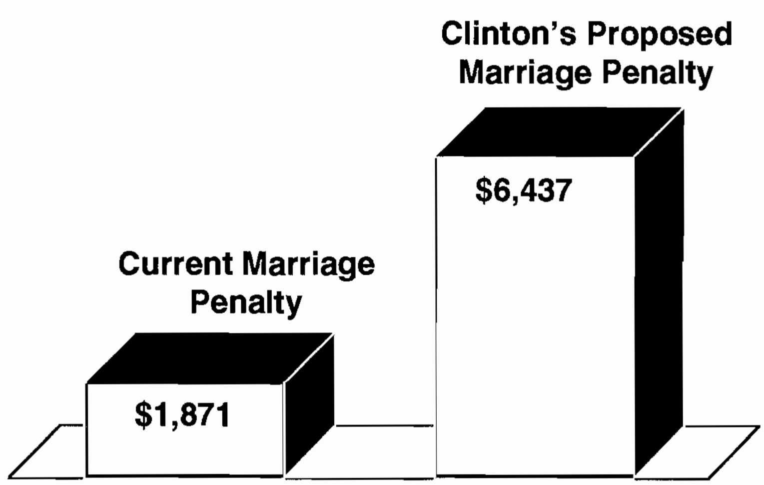


"The Clinton plan will substantially increase penalties for marriage."

FIGURE IV

The Marriage Tax

(Husband and wife each earn $140,000)



"The Social Security benefit tax is a tax on the retirement savings of all young workers."

Future Taxes on the Savings of Workers. The Social Security benefit tax is not just a tax on the elderly. It also affects the vast majority of young workers. The Clinton administration proposal to increase the Social Security benefit tax is a proposal to raise future taxes on the retirement savings of today's workers. And because the income thresholds are not indexed, in the future the tax will reach more retirees and a greater portion of retirement income.[16] Raising taxes on this important component of U.S. saving can only harm long-term economic growth.[17]

The Marriage Penalty. Current law contains a marriage penalty because a husband and wife with roughly equal incomes may pay more in tax than two single individuals earning the same incomes. For taxpayers in the 31 percent bracket, the maximum marriage penalty currently is $1,871. The addition of a 36 percent tax rate would increase the marriage penalty to $6,433. [See Figure IV.] An additional penalty in the form of the 10 percent surtax would hit couples with combined incomes of over $500,000. For example, a couple earning $612,000 could pay an additional $8,367 to be married. Their total marriage penalty would be $14,800 ($1,867 under current law plus $4,562 for the higher 36 percent rate plus $8,367 for the surtax). The penalty due to the surtax increases with income.

Economic Effects of the Clinton Plan

We have used the Fiscal Associates general equilibrium model of the U.S. economy to estimate the economic effects of the Clinton plan.[18] The model explicitly incorporates detailed information on tax policy and how it affects capital, investment, output and jobs.[19] The results of our forecast are shown in Table VI.

Effects on the Economy. Because the Clinton plan will reduce private investment, it will depress the U.S. economy. By 1998, reduced investment will lower capital formation by $1.8 trillion. This slowdown in economic activity will mean about a 0.4 percentage point reduction in the long-run rate of economic growth. As a result:

- The total annual output of goods and services will be $261 billion lower than it otherwise would be by 1998 and $348 billion lower by the end of the decade.

- The economy will produce 1.4 million fewer jobs over the next five years and 1.7 million fewer jobs by the end of the decade.

Effect on the Federal Deficit. For all of the tax and spending changes, the Clinton economic plan will have very little effect on the federal deficit. Part of the reason is that the tax hikes will generate much less revenue

"By the end of the decade, 1.7 million fewer jobs will have been created."

than the administration predicts. [See Table VII.] But even according to the administration figures, the deficit will fall through 1997 and then rise again. The Clinton administration shows a cumulative change in the federal deficit of only $464 billion by the year 1998.[20] Accounting for the program's negative economic effects on tax revenue, our estimates suggest a cumulative reduction of only $108 billion.

Effect on the National Debt. The national debt will continue to grow faster than the economy.[21] Even under the Clinton administration's estimates, the debt will increase from $4 trillion today to over $5.4 trillion by 1998. When economic effects are taken into account, the debt will stand at $5.7 trillion in five years.

TABLE VI

Economic Effects of the Clinton Plan

(Changes relative to baseline)[1]

	Output ($ bil)	Capital Stock ($ bil)	Jobs (thous)	Wage Bill ($ bil)	Real Growth Rate[2]
1993	**-14.6**	**-55.0**	**-164**	**-8.2**	**- 0.1%**
1994	**-45.8**	**-262.9**	**-398**	**-28.0**	**-0.2%**
1995	**-96.0**	**-611.0**	**-719**	**-60.2**	**-0.3%**
1996	**-155.4**	**-1,011.1**	**-1,040**	**-98.2**	**-0.4%**
1997	**-209.1**	**-1,406.2**	**-1,230**	**-128.4**	**-0.4%**
1998	**-260.6**	**-1,761.6**	**-1,409**	**-159.7**	**-0.4%**
1999	**-306.0**	**-2,054.4**	**-1,557**	**-186.9**	**-0.4%**
2000	**-348.0**	**-2,315.4**	**-1,672**	**-211.9**	**-0.4%**

[1] Changes for output and wages are annual. Changes for the capital stock and jobs are cumulative.The baseline economic assumptions are those the Congressional Budget Office (CBO) published in January 1993. CBO assumes the annual growth in real GDP to be 2 percent in 1992, 2.8 percent in 1993, 3 percent in 1994, 2.9 percent in 1995, 2.7 percent in 1996, 2.4 percent in 1997 and 2 percent in 1998. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998*, Washington, DC, January 1993, Table 1-3.

[2] Percentage point change.

Effect on Interest Rates. The Clinton administration argues that the adoption of its deficit reduction program will cause real interest rates to fall and that this will be good for the economy. Some have even pointed to the recent decline in long-term rates as a sign that the anticipation of the Clinton plan is already producing this effect. However, there is little convincing evidence that budget deficits affect market rates of interest and even less evidence that low real interest rates are good for the economy and high interest rates are bad. Numerous empirical studies have shown virtually no relationship between the size of the federal deficit and interest rates in the past. These findings are not surprising, given that the U.S. federal deficit is quite small in relation to the total market for credit. By the end of September 1992, the size of the U.S. credit market was $14.7 trillion and growing by about $700 billion annually.[22] By 1998, Clinton's own estimated deficit reduction will amount to only 4.1 percent of the U.S. credit market. By our estimate, Clinton's deficit reduction will amount to only 0.6 percent. Furthermore, the relevant credit market — that of the world — is many times that of the U.S.

"Even under Clinton's own estimates, the national debt will grow faster than the economy."

TABLE VII

Change in Government Revenue

(Amounts in $ billions)

Fiscal Year	Clinton Estimate[1]	NCPA Estimate[2]	Difference
1993	3.5	3.4	-0.1
1994	33.3	14.0	-19.3
1995	33.5	13.3	-20.2
1996	51.1	17.9	-33.2
1997	66.5	20.8	-45.7
1998	64.1	8.6	-55.5
1999	65.4	1.2	-64.2
2000	66.9	-5.4	-72.3
1993-1996	121.4	48.7	-72.7
1993-1998	252.0	78.2	-173.8
1993-2000	384.3	73.9	-310.3

[1] Includes only those provisions categorized as tax changes by the Clinton administration.

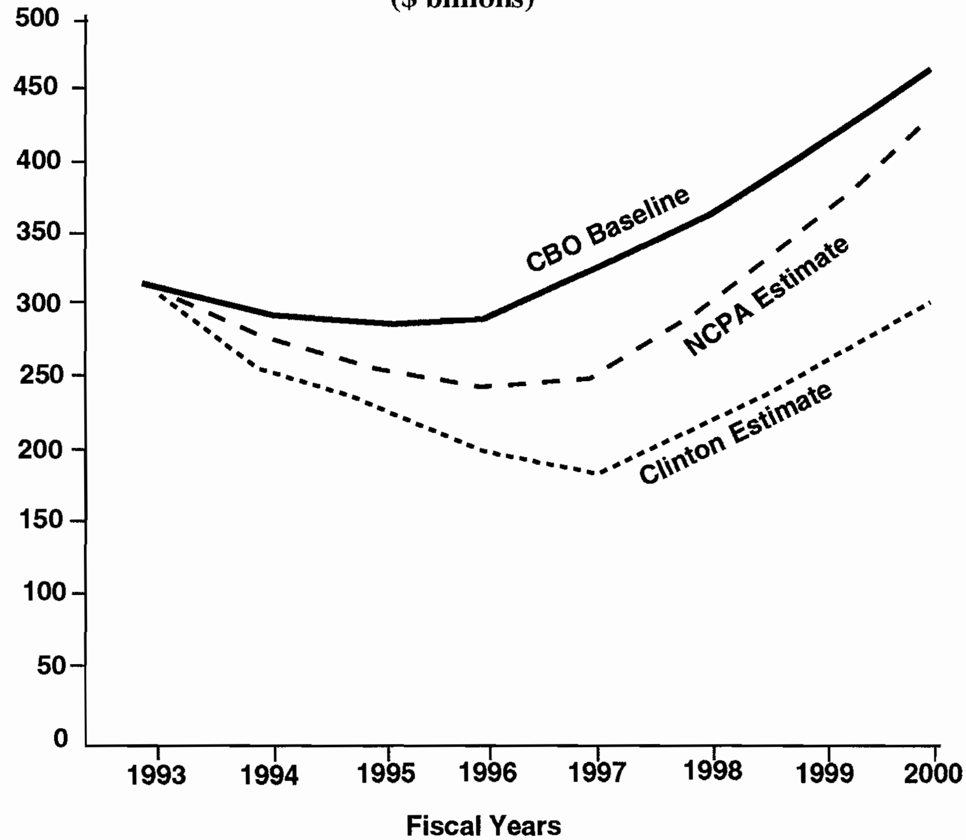
[2] Includes the economic effects of all tax and spending provisions.

"By the end of the decade, the Clinton plan will have reduced the deficit by only 7 percent — even if all spending cuts are made."

FIGURE V

The Federal Deficit Under the Clinton Plan

($ billions)



Is the Clinton Plan Fair?

A major goal of the Clinton plan is to redistribute income from the rich to the poor by increasing taxes on the wealthy more than on lower- and middle-income people. Not only will this objective not be met, but middle-income wage earners will bear the greatest burden. Since wealthier taxpayers tend to receive most of their income from investments, Clinton's higher tax rates are aimed mainly at investment income. And when investment contracts, the wage income of workers contracts as well.

Taxing Wealthy Investors. 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 investment and only 25 percent from wages.
- In contrast, middle-income families tend to receive about 75 percent of their income from wages and 25 percent from capital.

As noted above, higher taxes on investment income reduce investment and lower the rate of economic growth. But will the higher taxes produce the intended result — a redistribution of income from rich to middle- and lower-income taxpayers? The answer is no.

Capital Flight. High tax rates on upper income taxpayers and on corporations will encourage more of the capital flight that began with the 1986 Tax Reform Act and continued under President Bush. The Clinton program will accelerate business plans to locate plants overseas. Clinton's higher personal and corporate income tax rates will raise the cost of equity capital in the United States by 15 percent.[24] This will hurt the competitive position of U.S. firms.

"Middle-income workers will lose $8 for every $1 that wealthy investors lose."

Revenue from the new, higher taxes on capital will be much less than the administration claims. After a sufficient time to relocate operations, capital will pay virtually no additional tax. Instead, capital formation will slow until the pretax return to new investment is raised sufficiently to offset the new tax entirely. Because the rising pretax return will go to all capital, not just new capital, higher corporate taxes on existing capital will eventually be offset. In other words, the attempt to raise taxes on the rich will result in a cutback in the stock of U.S. capital.

Burdens for Middle-Income Workers. Labor will not escape the tax as easily as capital. While capital flows rather freely across international borders, labor migration is much more difficult. Less capital means a lower capital-to-labor-ratio. That means lower productivity and lower wages. A shrinking capital base lowers the return to labor at the same time it is raising the return to capital. We estimate that *the net effect of Clinton's new taxes will be to reduce the aftertax income of labor by $8 for each $1 reduction in aftertax capital income.*

How Clinton Has Already Increased the Deficit by More than He Promises to Reduce It

The most recent attempt to contain the deficit was the Omnibus Budget Reconciliation Act (OBRA) of 1990. This was the result of the infamous budget summit agreement under which George Bush broke his promise not to raise taxes. OBRA increased taxes ($167 billion over five years) and spending immediately and promised spending restraint beginning in 1993. In order for the spending restraint to be effective, however, OBRA required that the president affirm the enforcement (sequester) mechanism after the 1992 election.

"Clinton's failure to honor the OBRA agreement will increase the federal deficit by $251 billion over the next five years."

During his administration's first week in office, however, President Clinton exercised his option to suspend the enforcement mechanism for 1994 and 1995.[25] By implication, the suspension extends to subsequent years as well. Table VIII shows its effects.

- By refusing to abide by the OBRA agreement, Clinton automatically produced an increase in the cumulative federal deficit of $251 billion by 1998 and $461 billion by the year 2000.

- This action *increased* the cumulative deficit by $155 billion more than the Clinton economic plan will reduce it — even if the entire plan is adopted.

"By the end of the decade, Clinton's failure to honor OBRA will produce a $155 billion increase in net deficit spending — even if the Clinton economic plan is adopted in full."

TABLE VIII

How Clinton Has Already Increased the Deficit by Failing to Honor the 1990 Budget Agreement

(Amounts in $ billions)

Fiscal Year	NCPA Estimate of Deficit Reduction Due to Clinton Program	Deficit Increase Due to Clinton's Failure to Honor OBRA Limits[1]	Net Change in the Deficit
1993	6	0	+ 6
1994	- 17	+ 23	+ 6
1995	- 29	+ 43	- 14
1996	- 47	+ 50	+ 3
1997	- 76	+ 61	- 15
1998	- 64	+ 75	+ 11
1999	- 49	+ 94	+ 45
2000	- 31	+ 116	+ 85
		1993-1998	+ 25
		1993-2000	+ 155

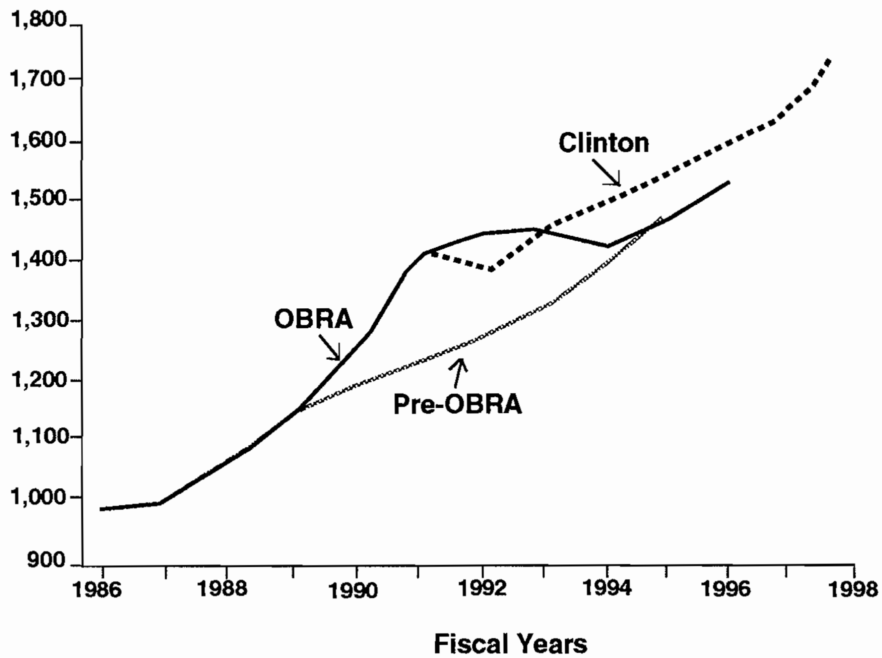
[1] Increases in excess of the maximum deficit amounts contained in the Omnibus Budget Reconciliation Act of 1990.

"The spending cuts Congress promised in return for George Bush's agreement to raise taxes will never materialize."

FIGURE VI

Government Spending

($ billions)

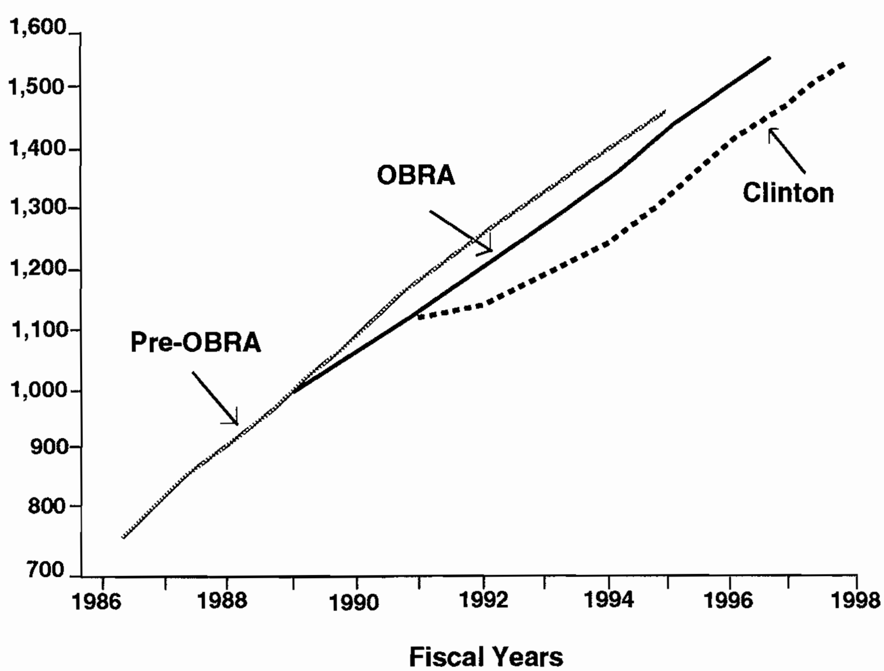


"Higher tax rates have caused actual revenues to be lower than they would have been."

FIGURE VII

Government Revenue

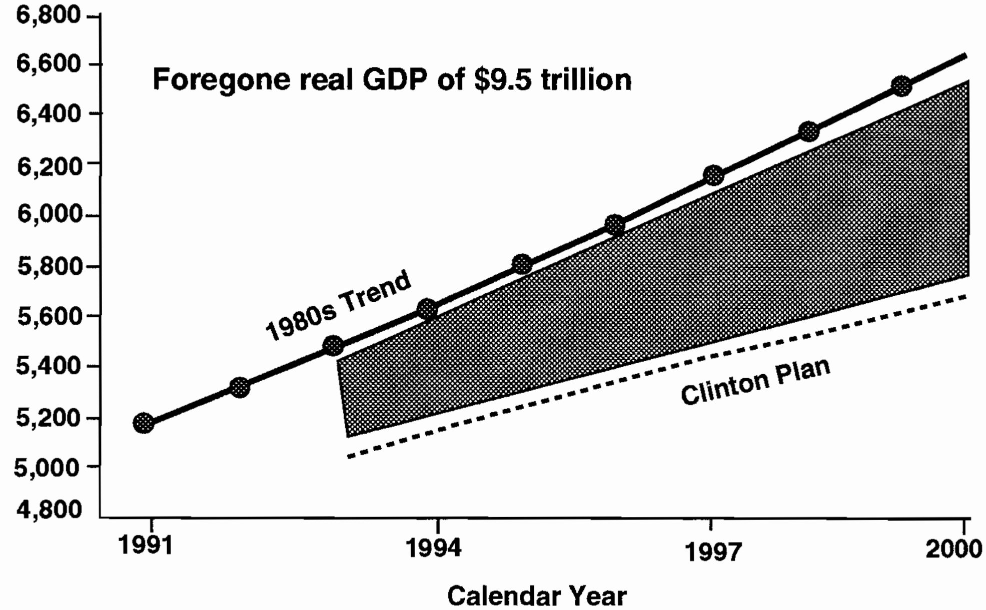
($ billions)



"The real problem we face is an economic growth deficit."

FIGURE VIII

Real GDP Growth
1980s Trend vs. Clinton Plan[1]
($ billions)



[1] Assumes 3% growth rate continued from 1988.

Figure VI shows the *projected* spending paths contained in the budget just before OBRA, the budget just after OBRA and the outlays implied by the Clinton plan.[26] OBRA boosted spending in its early years, with the promise of returning spending to its old path after 1994. By negating the return to the old path, the Clinton administration left federal spending at a permanently higher rate.[27]

On the tax side, the opposite pattern has emerged. Had the economy remained on its old growth path coming out of the 1980s, annual revenues would be considerably higher today. OBRA, which raised taxes at the start of the recession, lowered annual revenues by 9.6 percent compared with the old baseline. Even with an increase in net taxes of $85 billion a year, annual revenues will fall short of the old baseline by some $200 billion in 1994. [See Figure VII.]

CONCLUSION

The last ten years have seen six budget summit agreements under which the president and the Congress agreed to economic plans. Although the stated purpose of each budget summit was to reduce the federal deficit, under the agreements the national debt quadrupled. Under the last agreement (OBRA), a promised $500 billion reduction in the deficit over five years turned into a $1.4 trillion increase. These unfortunate experiences of our past yield important lessons for the future.

The real problem facing the United States today is not the federal deficit but a *growth deficit.* Our economy has not enjoyed a robust recovery, and most economists do not expect a return to the historic long-run real growth path of 3 to 3.5 percent. Slower growth automatically produces higher deficits. Since federal revenues claim about 19 percent of GDP, each $100 billion of lower output causes government to lose $19 billion in tax revenues. Furthermore, lower growth also causes government spending to rise,[28] increasing the deficit even more.

Returning to a 3 percent real growth rate would do far more to reduce the deficit than Clinton's complicated tax and spending proposal. As Figure VIII shows, the nation stands to lose $9.5 trillion in GDP between now and the end of the decade because we are not matching the growth rate of the 1980s. If the government got only its long-term average take in revenues, achieving a 3 percent growth rate would generate $1.8 trillion more in taxes. Simply stated, the economy has a much larger effect on the deficit than the deficit has on the economy. We cannot tax ourselves to prosperity.

Gary Robbin
Aldona 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.

Notes

[1] Includes $46 billion interest saving.

[2] An increase in alternative minimum tax provisions and an extension of the phase-out of itemized deductions and personal exemptions for higher-income taxpayers, scheduled to expire by 1997, also are included.

[3] The proposal imposes an excise tax on fossil fuels at a basic rate of $0.257-per-million-BTUs plus a $0.342-per-million-BTUs supplemental tax on oil. The tax is also to be imposed on alcohol fuels and hydro- and nuclear-generated electricity. See U.S. Department of the Treasury, *Summary of the Administration's Revenue Proposals* (Washington, DC: February 1993), pp. 64-65.

[4] The credit will be triggered when investment in an industry exceeds a threshold level equal to a percentage of prior capital expenditures.

[5] The Clinton administration's estimated static cost of the capital gains provision is only $714 million over five years.

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

[7] 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.

[8] Raising the wage base has a disproportionate effect on marginal tax rates on labor. See 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.

[9] Increasing the tax on Social Security benefits will lead to less saving for retirement. See Aldona Robbins and Gary Robbins, "Taxing the Savings of Elderly Americans," National Center for Policy Analysis, NCPA Policy Report No. 141, September 1989.

[10] Income for purposes of determining the threshold is adjusted gross income plus tax-exempt income plus one-half of Social Security benefits.

[11] The tax would continue until 85 percent of benefits is taxed.

[12] See Aldona Robbins and Gary Robbins, "Elderly Taxpayers and the Capital Gains Debate," National Center for Policy Analysis, NCPA Policy Report No. 153, July 1990.

[13] Assumes taxpayer is below the maximum Social Security benefit tax.

[14] The earnings limit in 1993 is $10,560 for someone between the ages of 65 and 70 and $7,680 for someone under age 65.

[15] The marginal tax rate includes the earnings test penalty, the federal income tax rate, a 2.5 percent state income tax rate and the employee's 7.65 percent Old Age, Survivors and Disability Insurance (OASDI) and Hospital Insurance (HI) payroll tax rate. The earnings test that reduces Social Security benefits dampens the effect of taxing Social Security.

[16] Today about one-third of taxpayers age 65 and over who file income tax returns pay tax on some of their Social Security benefits. About 54 percent age 65 and over file tax returns. This percentage will continue to increase over time as the real incomes of retirees continue to grow.

[17] Pension funds, Individual Retirement Accounts and Keogh plans compose almost 30 percent of U.S. capital assets. See Robbins and Robbins, "Elderly Taxpayers and the Capital Gains Tax Debate."

[18] Simulating the economic effects of the Clinton plan is done in two stages. First, the model uses the latest government forecast of economic performance to produce a baseline. Then, it enables a dynamic simulation in which only tax and government spending parameters are allowed to change.

[19] Taxes figure directly into the cost of production and the returns to work, saving and investment. Labor taxes consist of personal income taxes, payroll taxes and labor's share of sales, excise and other indirect business taxes. Taxes on capital consist of those levied on assets directly, on the output produced by assets and on the return accruing to owners. Examples of taxes on assets are property or wealth taxes. Sales or value-added taxes are placed on the value of the output of assets. Taxes on the return accruing to the owners of capital are personal income taxes on dividends, net business income, rental income and interest, as well as corporate income taxes (usually income less tax depreciation). The tax treatment for the 20 capital classifications in the Fiscal Associates Tax Model is the average of 5,000 specific assets, weighted by their capital stocks. The Fiscal Associates Tax Model contains historical information on personal income, including its labor component, from the *Statistics of Income* for 72 income classes over the period 1954-89. The model separates individuals into groups that are homogeneous with

respect to the aftertax prices they face and computes effective average and marginal tax rates using the population weights of the groups. This method is qualitatively the same as that found in the Treasury Individual Tax Model, used by the U.S. Treasury and the Joint Committee on Taxation.

[20] Government revenue estimates typically are *static* in nature. That is, they assume that tax policy has no effect on the performance of the U.S. economy. Higher income tax rates and other changes will, however, reduce growth, which means smaller tax bases. These economic effects will reduce the Clinton administration's estimated revenue gain of $252 billion over the period 1993 to 1998 by $173.8 billion.

[21] Congressional Budget Office projections show the debt growing at an average annual rate of 6.45 percent between now and 1998. The rate of growth in the debt will average 5.01 percent under Clinton administration estimates and 5.76 percent when economic effects are taken into account. In contrast, the economy will grow at a nominal rate of 4.98 percent.

[22] *Federal Reserve Bulletin*, Vol. 79, No. 2, February 1993, Tables 1.58 and 1.60.

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

[24] This ignores the tax incentives in the package.

[25] OBRA called for a Gramm-Rudman-Hollings maximum deficit amount unless the President chose to override. The ceilings were supposed to return spending to its pre-OBRA path and produce some of the deficit reduction claimed for the entire package.

[26] The budget just before OBRA, for fiscal year 1991, was released in January 1990. The budget just after OBRA, for fiscal year 1992, was released in January 1991. We have adjusted the budget path put out by the CBO in January 1993 to reflect President Clinton's proposed spending and tax changes. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998*, Washington, DC, January 1993, Table 2-4.

[27] The drop in outlays during 1991 and 1992 relative to OBRA is primarily due to a different spending pattern for the savings and loan bailout.

[28] Spending on programs such as welfare and unemployment compensation tends to increase when growth is lower.

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The National Center for Policy Analysis

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

NCPA forecasts show that repeal of the Social Security earnings test would cause no loss of federal revenue, that a capital gains tax cut would increase federal revenue and that the federal government gets virtually all the money back from the current child care tax credit. These forecasts are an alternative to the forecasts of the Congressional Budget Office and the Joint Committee on Taxation and are frequently used by Republicans and Democrats in Congress. The NCPA also has produced a first-of-its-kind, pro-free enterprise health care task force report, written by 40 representatives of think tanks and research institutes, and a first-of-its-kind, pro-free enterprise environmental task force report, written by 76 representatives of think tanks and research institutes.

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

- Blacks and other minorities are severely disadvantaged under Social Security, Medicare and other age-based entitlement programs;

- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and

- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

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— TIME

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