A PRO-GROWTH BUDGET STRATEGY: VISION FOR THE 1990s

by

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NCPA Policy Report No. 154

October 1990

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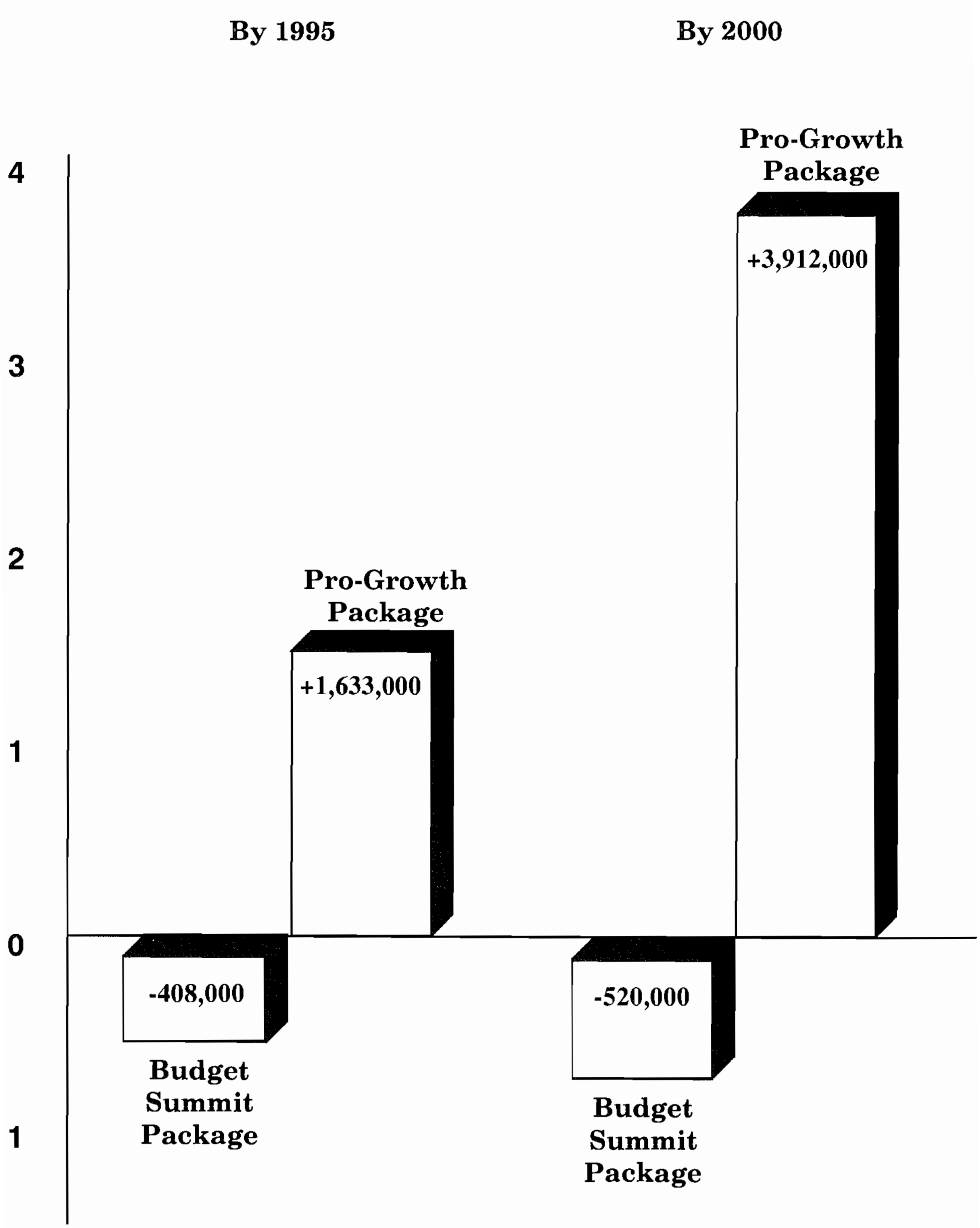
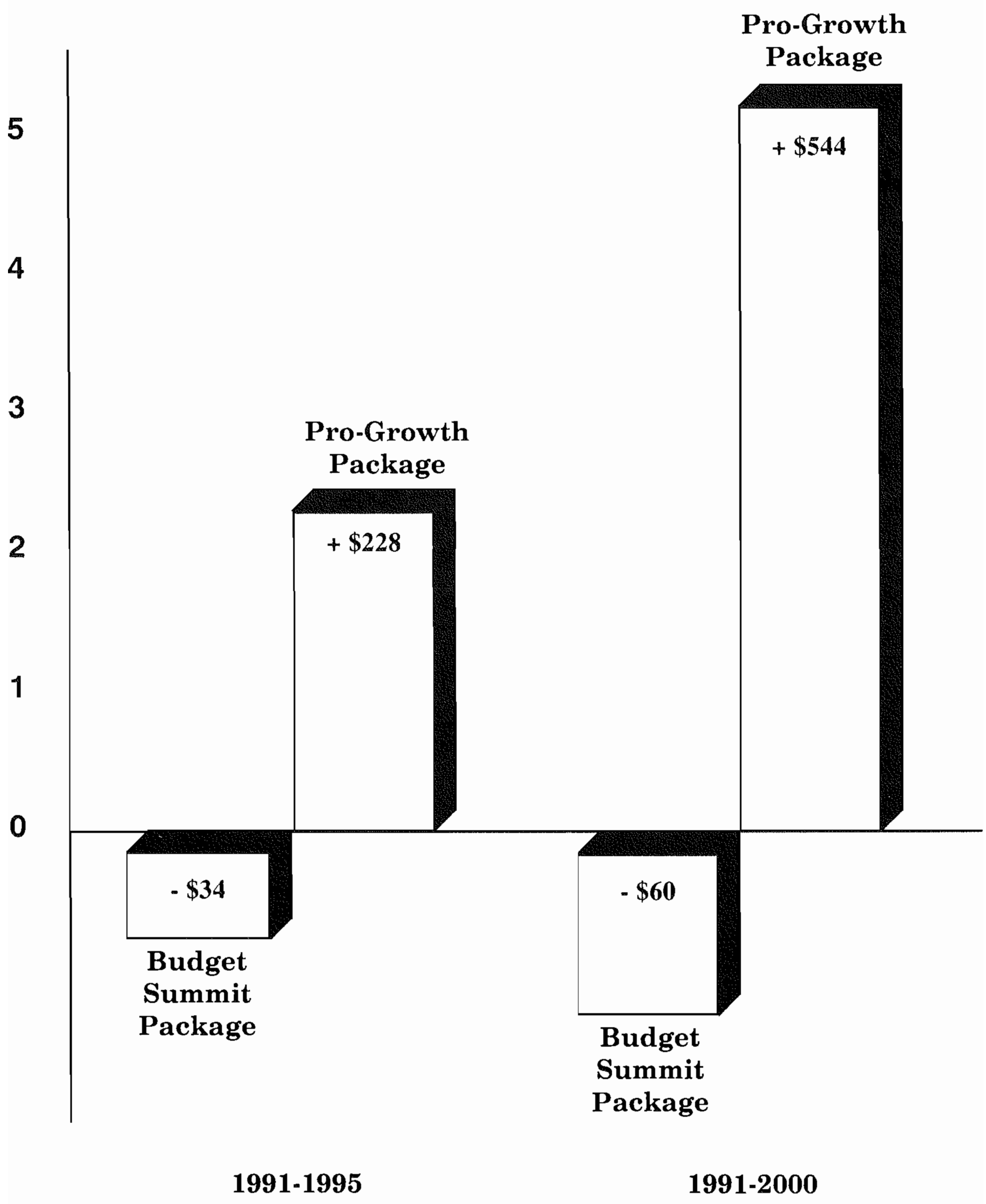
CHANGE IN JOBS[1]



[1]Relative to the federal government's baseline forecast.

AVERAGE ANNUAL CHANGE IN GNP[1]
($ Billions)



[1] Relative to the federal government's baseline forecast.

EXECUTIVE SUMMARY

As the U.S. economy falters on the eve of a serious recession, leaders in both political parties are proposing new taxes as a way to reduce the federal deficit. This strategy is self-defeating. The new taxes will make the recession deeper and longer and will lower our economic growth rate throughout the 1990s.

Fortunately, there is a better way. By selectively *reducing* taxes on capital and labor, we can stimulate the economy and reduce the deficit *at the same time.* This pro-growth strategy focuses on three types of tax measures.

Inflation Indexing. Although the tax code is indexed to prevent wage earners from being pushed into higher tax brackets by the effects of inflation alone, there is no similar protection for owners of capital. Currently, higher rates of inflation reduce the aftertax return on almost every type of investment. Change is needed especially with respect to capital gains and depreciation of investment in plants and equipment.

Lowering the Tax on Capital. Tax rate reductions in the 1980s provided an important stimulus to the economy and led to the longest peacetime economic expansion in our history. Yet recent increases in taxes on capital have had a depressing effect and are responsible for the current economic slowdown. In particular, the 1986 Tax Reform Act raised the tax rate on capital gains by 40 percent and limited the ability of people to save through IRAs and 401(k) plans. The Social Security benefit tax has eroded the value of all tax-deferred savings for a majority of American workers. These policies need to be changed.

Lowering the Tax on Labor. The economic expansion of the past decade was primarily due to an increased supply of labor induced by lower marginal tax rates. For millions of American workers, however, increases in the Social Security (FICA) payroll tax rate have more than offset reductions in the income tax rate — despite the fact that higher payroll taxes are not needed to pay Social Security benefits. Moreover, a punitive retirement earnings penalty of elderly workers is encouraging unnecessary retirement at a time when American industry desperately needs their skills. These policies also need to be changed.

The pro-growth strategy in this report are based on policies that have been endorsed by Republicans and Democrats in Congress. If adopted, the proposals' economic benefits would be substantial:

- The pro-growth strategy would increase the U.S. economic growth rate by about 1 percentage point over the decade of the 1990s.
- Gross national product (GNP) would increase by about $544 billion per year.
- By the end of the decade, there would be almost 4 million additional jobs.

This pro-growth package would be phased in in a way consistent with the budget-balancing objectives of the budget summit. In Phase I, selected tax cuts would produce $109 billion in new revenue by 1995. When combined with expected cuts in federal spending, the five-year deficit of the federal government would be reduced by $500 billion, producing an $81 billion surplus in 1995. To eliminate this surplus and provide a further stimulus, additional Phase II pro-growth measures would be adopted at mid-decade.

INTRODUCTION

The United States has experienced the longest peacetime economic expansion in its history, due to tax reductions enacted during the 1980s. The growth of output and income over the past decade cannot be explained by any other factor. Harvard economist Lawrence Lindsey has called the tax cuts of the early 1980s "The Growth Experiment" and noted the overwhelming evidence from that experiment:

> Some of the more extreme supply-side hypotheses were proven false. But the core supply-side tenet — that tax rates powerfully affect the willingness of taxpayers to work, save, and invest and thereby also affect the health of the economy — won as stunning a vindication as has been seen in at least a half century of economics.[1]

WHERE WE ARE NOW

According to the latest government economic forecast, the federal budget will run a $293.7 billion deficit in fiscal year 1991. Under current law, expenditures are projected to grow at 2 percent annually while tax revenues are projected to grow at 6.5 percent a year. As Table I shows, by 1995 the deficit is expected to be close to $84.6 billion.

This forecast assumes that the United States will not experience a recession. It is being questioned, however, by increasing numbers of economists who believe we are entering or have entered a recession — and that the true economic picture is much worse than federal forecasters are willing to admit.

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

- In the President's January budget, the five-year deficit was projected to be $212.3 billion.
- Yet because of deteriorating economic conditions, the projected five-year deficit jumped by almost $500 billion in July and another $200 billion by September.

In other words, the size of the projected federal deficit has more than quadrupled in the past nine months because of the deteriorating economy. If economic conditions deteriorate as much between now and next March as

TABLE 1
CURRENT LAW FEDERAL BUDGET DEFICIT

Fiscal Year	Expenditures[1] (bil.)	Revenues (bil.)	Increase in Deficit Under Revised Economic Assumptions[2] (bil.)	Total Deficit (bil.)	Deficit without Soc. Sec. & RTC[3] (bil.)
1991	$1,384.7	$1,121.4	$30.4	$293.7	$243.0
1992	1,441.8	1,194.2	58.4	306.0	271.7
1993	1,451.6	1,278.6	54.4	227.4	264.2
1994	1,443.1	1,363.0	35.8	115.9	241.7
1995	1,506.4	1,441.1	19.3	84.6	213.6

[1]Based on Mid Session Review.

[2]Based on the forecast in the "Budget Summit Agreement," September 30, 1990.

[3]The Gramm-Rudman-Hollings deficit targets used in the budget summit agreement excluded the Resolution Trust Corporation expenditures and Social Security surpluses.

they have since July, the five-year deficit will grow by another $195 billion.

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

THE BUDGET SUMMIT AGREEMENT

The budget summit agreement which was rejected by the House of Representatives consisted of the following major elements:

- A $500 billion reduction in the federal budget deficit over fiscal years 1991 through 1995.
- About $134 billion in additional tax revenues over fiscal years 1991 through 1995.
- About $182.4 billion in reduced discretionary spending over fiscal years 1991 through 1995, with the majority coming from defense spending.
- About $119 billion in reduced entitlements and subsidies and increased user fees over fiscal years 1991 through 1995.[2]

Of the $134 billion in tax increases, about 70 percent would have been in the form of excise taxes — primarily on gasoline, petroleum, cigarettes and alcohol. The remainder would have consisted of a payroll tax increase of 2.9 percentage points for upper-middle income families[3] and an income tax increase of 0.84 to 0.99 percentage points for higher-income families.[4]

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

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

For example, government revenue estimates assume that U.S. businesses and consumers will continue to spend the same amount on energy, after the imposition of energy taxes. Energy taxes, however, will raise the cost of energy, reduce the demand and generate less revenue than anticipated. Furthermore, to the extent that the taxes slow the economy in general, other government receipts such as income and payroll taxes will also be lower.

The estimated deficit reductions of the summit agreement will not come to pass. As experience shows, estimates of increased revenues will be too high and estimates of spending cuts will be too low. According to a recent Tax Foundation study, not only did the five previous budget summit agreements of the 1980s fail to achieve their deficit reduction goals, but each one increased the federal deficit.[5]

Actual Economic Effects of the Agreement. Incorporating dynamic economic effects, we estimate that the budget summit agreement would depress the economy throughout the 1990s. Specifically:

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

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

- Because tax payments would be lower in a depressed economy, the federal government would receive only 67 cents of each dollar of new taxes it tried to collect over the next five years.
- For every $1 of new revenue, the private sector would lose $1.87 in reduced output of goods and services.
- Over the next five years the loss of output would equal about $675 per person, or $2,700 for a family of four.

Forecasting Method. We have used a neoclassical, general equilibrium model of the U.S. economy to assess the impact of alternative tax and spending measures. This method is dynamic in that it takes into account the effect of government policy changes on the behavior of businesses, workers and consumers. The estimates presented here compare economic and budget effects of the proposed package against the baseline of the government's economic forecast which was updated for the budget summit agreement.

PRO-GROWTH TAX MEASURES

In order to avoid a recession and stimulate economic growth the United States needs pro-growth tax cuts designed to reduce taxes on capital and labor and increase economic activity. The proposed tax measures are as follows:

Reduction in the Maximum Capital Gains Tax Rate. Because the tax brackets are indexed, wage earners cannot be pushed into a higher tax bracket by the effects of inflation alone. There is no similar protection for savers, however. People who sell assets are forced to pay taxes on inflation-created profits even if there has been no real profit.

Historical experience and most academic studies confirm that a reduction in capital gains tax *rates* will produce more revenue in the form of *total* capital gains taxes.[6] Lawrence Lindsey, for example, estimates that government would collect maximum revenue at a rate of about 15 percent.[7] Capital gains tax reform would also:

- Help reduce the federal government's liability in the savings and loan crisis, because it would immediately make the assets of defunct S&Ls more valuable to investors.[8]
- Make the middle-income elderly less dependent on the younger population. About one of every three elderly taxpayers has a capital gain each year, and among the middle-income elderly that figure rises to one out of two.[9]
- Increase federal revenue, in a highly *progressive* way. Taxpayers earning $75,000 or more would pay most of the increased tax payments.[10]

Senators Robert Kasten (R-WI), Connie Mack (R-FL) and Richard Shelby (D-AL) have proposed the Economic Growth and Venture Capital Act of 1990. This legislation would reduce the tax rate on long-term capital gains from the sale of all capital assets. The plan couples indexing of capital gains — a major feature of the bill passed last year by the House of Representatives — with a reduction in the capital gains tax rate to a maximum of 15 percent — the rate proposed by President Bush during his 1988 presidential campaign. Specifically, the proposal would:

- Lower the maximum capital gains tax rate from the current 28 percent to 15 percent on all capital assets.

- Establish a 7.5 percent rate for those taxed at the 15 percent federal personal income tax rate.

- Eliminate from taxation that part of capital gains which is due to inflation and adjust the limit on capital losses for changes in the price level (as currently is done for income tax rate brackets).

- Establish a single one-year holding period for assets to qualify for favorable tax treatment.

- Extend the favorable capital gains treatment to corporations.

We estimate that this plan would reduce the tax on capital by 8.6 percent in 1995 and by 10 percent in the year 2000. The economic effects grow over time as the indexing provision removes from taxation an increasingly larger portion of capital gains due solely to inflation. This lower tax on capital would reduce the cost of capital for the economy as a whole by about 5 percent, which would lead to more investment, more jobs and more growth.

Indexing for Depreciation of Equipment Investments. The tax code also fails to index the depreciation of productive assets in order to allow for their replacement. In a period of no inflation, the tax law is reasonably fair. But if inflation averages 5 percent per year, a company must spend 50 percent more to replace a machine after eight years. This means the company must earn additional income and pay additional taxes equal to about one-fourth the replacement cost.

Current tax treatment of depreciation also spreads out the recovery of the original cost of the investment. The total amount allowed to be depreciated over time equals the original purchase price only. However, because of the time value of money, amounts written off after the first year have a lower present value and, therefore, represent only partial tax offsets for depreciation.

To deal with this problem, the 1981 tax law incorporated new investment incentives, of which the Accelerated Cost Recovery System (ACRS) was the most important. The results were dramatic:[11]

- The economic recovery of the early 1980s was the most investment-oriented recovery on record, despite high real interest rates.

- Whereas in a normal recovery, investment expands 8 to 9 percent in the first two years, in the Reagan recovery, investment expanded at twice that rate.

ACRS was eliminated by tax reform in 1986. In order to repeat the experience of the early 1980s, we need to remove inflation-created disincentives to invest in plants and equipment. Inflation indexing is a reasonable way, and it can also be revenue neutral. As a member of Congress, Jack Kemp proposed the Neutral Cost Recovery System which would index depreciation and *increase* federal revenue in every future year. The proposal would adjust current tax depreciation schedules each year so that depreciation after the first year is equivalent to its first-year value. A further adjustment would reflect the increase in recovery costs due to inflation. The neutral cost recovery proposal holds the investor harmless for the time value of money and protects tax depreciation write-offs against inflation. It provides an immediate incentive, an effect similar to giving an $90 billion tax cut on new investment without any loss of federal revenue.

Creation of "IRA-Plus" Accounts. The IRA program was one of the most successful ever adopted. By 1984, 15.4 million taxpayers were depositing $35.8 billion per year in IRA accounts. Fully 80 percent of these deposits represented new savings.[12] If we assume that the average depositor was in the 35 percent income tax bracket, for each $1 increase in the federal deficit more than $2 of new savings was added to the credit market. Thus IRAs financed an increase in private investment which led to increased tax revenues that offset government deficits.

When IRAs were introduced, most American workers could expect to be in a lower tax bracket after they retired. Hence, it made sense to avoid taxes during the working years and defer them until retirement.

With the passage of the Social Security benefit tax in 1983 and the reduction in marginal tax rates passed in 1981 and 1986, the traditional assumption is not necessarily true. Many workers who today are in the 15 percent income tax bracket will be in the 28 percent bracket by the time they retire. The Social Security benefit tax can further increase their marginal tax rate to 42 percent.[13]

In recognition of these important changes in the tax law, Senator William Roth (R-DE) has proposed IRA-Plus Accounts. A similar proposal has been made by the Bush Administration. The Roth proposal would allow people to make deposits with aftertax funds and to make withdrawals tax free. Specifically, the bill would:

- Allow annual aftertax, nondeductible contributions of up to $2,000 per working taxpayer.

- Increase the $2,000 contribution to $3,000 after five years and allow non-working spouses to contribute up to $2,000 annually.

- Allow the interest earned to be withdrawn tax-free after the age of 59-1/2.

- Allow tax-free withdrawals for the first-time purchase of a home, for a college education for a family member or for catastrophic medical expenses.

The IRA Plus account would lower the tax on capital by 0.7 percent by 1995 and by 1.5 percent by the year 2000. Its impact would grow over time as more and more of the capital stock was financed by IRA Plus funds. The lower tax on capital would reduce the cost of capital for the economy as a whole by 0.4 percent in 1995 and 0.8 percent in the year 2000. This reduction would lead to more investment, more jobs and more growth.

Restoration of Saving Incentives for 401(k) Plans. Employer-sponsored 401(k) plans are another important saving incentive. These plans allow workers to save for their retirement through tax-deferred contributions. They are the fastest-growing segment of the nation's private retirement system.

Prior to 1986, workers could set aside up to $7,000 in 401(k)s. The Tax Reform Act of 1986 reduced that figure by the amount the taxpayer contributes to an IRA or other tax-deferred savings account. This year, employees can set aside a *total* of $7,979 ($7,000 adjusted for inflation) for 401(k)s and IRAs. For example, an employee with a $2,000 IRA contribution could contribute only $5,979 tax-free to a 401(k) plan.

To restore the pre-1986 retirement saving incentives, workers should be allowed to make aftertax contributions equal to the amount of the IRA offset. For example, an employee with a $2,000 IRA contribution could make a $2,000 aftertax contribution to a 401(k). Withdrawals of these funds would be tax free, and the rules for tax-paid 401(k) plans would be the same as for the IRA Plus account.

Elimination of the Earnings Test for Social Security Recipients. Since 1980, the American economy has expanded by a third in real terms. Evidence suggests that the most important reason for this growth was the expansion of the labor supply. Because people were allowed to keep a greater share of their earnings, more people went to work and they worked longer hours.[14]

Unfortunately, the supply-side revolution ignored the role of the elderly worker. Above an annual income of $9,360, elderly workers lose $1 of Social Security benefits for each $3 of wages — a 33 percent tax. When the Social Security earnings penalty is combined with the income tax, the FICA tax and the Social Security benefit tax, the marginal tax rate on earnings can reach as high as 80 percent.[15] Raising the earnings limit (the amount that can be earned without loss of benefits) undoubtedly would expand the supply of elderly workers, help employers meet their demands for skilled labor over the next decade, and increase federal revenue:[16]

- If the earnings limit were raised from $9,360 to $39,360, the federal government would receive more than $3 billion in work-related taxes over and above the payment of additional Social Security benefits.

- If the earnings limit were completely abolished, the federal government would still make a small profit (about $140 million) as additional work-related taxes more than offset increased benefit payments.

In the pro-growth package proposed here, we include the complete elimination of the Social Security earnings penalty.

Elimination of the Social Security Benefits Tax. The elderly pay income taxes on up to one-half of their Social Security benefits if their total income (including benefits) exceeds $25,000 for individuals or $30,000 for couples. They pay taxes on 50 cents of benefits for each $1 of income above these thresholds. As a result, when the elderly receive $1 of income they pay taxes on $1.50 — causing their tax rate to be 50 percent higher than the rate paid by younger people with the same income. Because of the Social Security benefit tax:[17]

- Elderly taxpayers in the 15 percent income tax bracket automatically face an effective income tax rate of 22.5 percent.

- Elderly taxpayers in the 28 percent income tax bracket automatically face an effective income tax rate of 42 percent.

The Social Security benefit tax is *nominally* a tax on benefits. But it is *actually* a tax on income. Since about 60 percent of the income of the elderly is income from investments (including pensions), the tax is mainly a tax on income from savings. Moreover, although the tax is currently paid by the elderly, its existence automatically reduces the value of pensions, IRAs and all other tax-deferred savings of young people:[18]

- Since the average worker today is in the 15 percent income tax bracket, funds placed in tax-deferred savings avoid a 15 percent tax.

- Yet when many of these workers retire and withdraw their savings, they will face a 42 percent tax rate.

Unless repealed, the Social Security benefit tax will have a devastating effect on incentives to save. Its long-run effect will be to lower economic growth and make the federal deficit larger, not smaller:[19]

- Currently, the Social Security benefit tax adds about $4.6 billion per year to federal revenue.

- Because of its depressing effect on economic growth, however, the tax will cause federal revenue to be $10 billion lower than it otherwise would be in the year 2000.

Excise Tax Extensions and User Fees. In addition to the tax cuts listed above, we assume that there will be tax increases. Specifically, we assume the adoption of the proposals contained in President Bush's January budget that are commonly held to be part of any budget package.

ECONOMIC EFFECTS OF PRO-GROWTH TAX MEASURES

Table 2 summarizes the economic and budget effects of these tax measures taken as a whole. Although the excise taxes and user fees constitute a drag on the economy, overall the tax measures are very stimulative. Collectively, they would:

- Increase GNP by $1.1 trillion over the next five years and raise the economic growth rate by more than one full percentage point.
- Create 1.4 million jobs by 1995 and 2.3 million jobs by the year 2000.
- Spur investment that would increase the stock of U.S. capital by $3.6 trillion by 1995.
- Increase federal revenues by $109.1 billion over the next five years.

SPENDING MEASURES

Reductions in domestic and defense spending from the current baseline would also be necessary to eliminate the federal deficit by 1995. Our proposed reductions in spending from current law are as follows:

- Defense spending would be reduced by $179 billion over the next five years.

TABLE 2
EFFECTS OF PROPOSED TAX MEASURES[1]

Calendar Year	Jobs[2] (mil.)	Capital[2] Stock (bil.)	GNP Growth Rate (%)	Gross National Product (bil.)	Static Federal Revenue (bil.)	Dynamic Federal Revenue (bil.)
1991	0.153	$ 416.2	0.80%	$ 46.7	$ -0.9	$ 8.8
1992	0.405	1,182.3	1.04%	130.1	-6.9	15.1
1993	0.756	2,045.9	1.12%	225.6	-13.2	24.3
1994	1.087	2,847.2	1.07%	310.2	-25.3	26.7
1995	1.403	3,625.7	0.98%	381.7	-32.2	34.2
1996	1.664	4,191.1	0.91%	452.4	-40.7	37.4
1997	1.883	4,727.7	0.84%	519.8	-50.7	38.3
1998	2.049	5,231.5	0.77%	583.2	-56.7	42.8
1999	2.204	5,720.3	0.72%	646.2	-59.7	50.1
2000	2.322	6,198.6	0.66%	707.8	-62.9	56.9
1991-1995				1,094.3	-78.5	109.1
1991-2000				4,003.6	-349.3	334.6

[1] Changes from baseline, amounts in nominal dollars.
[2] Cumulative

TABLE 3
PROPOSED DOMESTIC SPENDING REDUCTIONS[1]

Fiscal Year	Flexible Freeze (bil.)	Fed. Emp. Benefits (bil.)	Reform Medicare (bil.)	Other Health (bil.)
1990	$ 0.0	$ 0.0	$ 0.0	$ 0.0
1991	3.2	3.3	8.9	2.5
1992	3.2	4.6	10.3	2.8
1993	2.9	4.9	11.4	3.1
1994	2.2	5.2	12.6	3.4
1995	1.8	5.5	13.9	3.7

[1]From current law baseline.

TABLE 4
DEFICIT REDUCTION

Fiscal Year	Spending Cuts (bil.)	Revenue (bil.)	Excise Tax Increases (bil.)	Net Interest Savings (bil.)	Deficit Reduction (bil.)
1990	$ 0.0	$ 0.0	$ 0.1	$ 0.0	$ 0.1
1991	26.9	6.6	14.8	2.0	50.4
1992	38.7	13.5	13.1	5.9	71.2
1993	51.1	22.0	9.2	9.9	92.2
1994	70.4	26.1	10.1	15.0	121.5
1995	101.5	32.3	10.6	21.6	166.0
Total	288.5	100.6	57.9	54.4	501.4

TABLE 5
FEDERAL BUDGET DEFICIT UNDER STAGE I
(With and Without Resolution Trust Corporation and Social Security)

Fiscal Year	Deficit w/RTC & Soc. Sec. (bil.)	Deficit wo/RTC & Soc. Sec. (bil.)
1991	$ 243.3	$ 192.6
1992	234.8	200.5
1993	135.4	172.2
1994	-5.6	120.2
1995	-81.4	47.6

- A flexible freeze would limit increases in discretionary non-defense spending to the rate of inflation.

- Total federal compensation, including pension and health benefits, would be reduced by 0.7 percent over the entire five-year budget baseline.

- Reform of Medicare and Medicaid would make the programs more sensitive to the true costs of health care.

PRO-GROWTH STRATEGY: STAGE I

Table 4 summarizes the impact of the previous proposals on the federal budget deficit. It recaps the spending cuts, the dynamic revenue estimates which take into account the impact of the tax package on growth, the proposed excise tax increases and the interest savings from lower federal borrowing. Over the next five years, this pro-growth package would reduce the deficit by $501.4 billion. Table 5 shows the amount of expenditures, revenues and deficit with and without the cost of the savings and loan bailout from 1991 to 1995.

PRO-GROWTH PACKAGE: STAGE II ADDED GROWTH INCENTIVES

If the pro-growth proposals made above are adopted, the federal government will have a surplus of $81.4 billion in 1995. Although the general fund will have a deficit of $48 billion, the Social Security trust funds will take in $127 billion more than they will pay out to beneficiaries.

TABLE 6

PRO-GROWTH PACKAGE: STAGE II[1]

Calendar Year	Jobs[2] (mil.)	Capital[2] Stock (bil.)	GNP Growth Rate (%)	Gross National Product (bil.)	Static Federal Revenue (bil.)	Dynamic Federal Revenue (bil.)
1991	0.153	$ 416.2	0.80%	$ 46.7	$ -0.9	$ 8.8
1992	0.405	1,182.3	1.04%	130.1	-6.9	15.1
1993	0.756	2,045.9	1.12%	225.6	-13.2	24.3
1994	1.087	2,847.2	1.07%	310.2	-25.3	26.7
1995	1.633	4,010.9	1.10%	428.2	-84.0	-5.7
1996	2.193	5,258.3	1.15%	577.3	-96.0	6.3
1997	2.735	6,523.4	1.17%	729.5	-109.9	16.8
1998	3.202	7,662.3	1.14%	869.6	-120.3	29.6
1999	3.614	8,743.3	1.10%	1,005.0	-127.9	44.2
2000	3.912	9,596.8	1.03%	1,116.6	-136.2	54.7
1991-1995				1,140.8	-130.3	69.2
1991-2000				5,438.8	-720.6	220.9

[1]Changes from baseline, amounts in nominal dollars.
[2]Cumulative

This Social Security surplus is supposed to be used to reduce federal debt in the hands of the public. Experience teaches, however, that the surplus probably will be spent. Future tax increases can be enacted into law this year to take effect at a later date. Spending reductions cannot. There is no guarantee, therefore, that the $81.4 billion surplus will be used to retire the national debt.

Reduction in the Social Security Payroll Tax. An alternative is to use the surplus to reduce Social Security taxes and provide an added mid-decade boost to the economy. Senators Daniel Patrick Moynihan (D-NY) and Robert Kasten (R-WI) each have introduced bills to roll back the payroll tax increases that took effect in 1988 and 1990. The major objection to their proposals is that they would increase the federal deficit. However, a 1995 surplus of $81.4 billion would be twice what is needed to cover a 2.2 percentage point reduction in the Social Security payroll tax.

Today, most workers pay more in payroll taxes than in income taxes. Giving the budget surplus back to workers and their families in the form of a payroll tax reduction would reduce the tax burden on lower and middle income workers. Furthermore, the reduction in payroll taxes also would lower labor costs and increase employment.

New Depreciation Rules for Structures. Another pro-growth measure would be to extend neutral cost recovery to structures, beginning in 1995. As in the case of equipment, this proposal would lose almost no revenue and provide a large investment stimulus. Furthermore, neutral cost recovery of both equipment and structures would greatly reduce the double taxation of investment and savings that exists in the current U.S. tax system.

Economic Effects. Table 6 summarizes the economic and budget effects of these two tax measures in addition to those in Pro-Growth Package: Stage I. Lowering the Social Security payroll tax rate by 2.2 percentage points and extending neutral cost recovery to structures in 1995 would:

- Increase GNP by $5.4 trillion over the decade of the 1990s and raise the economic growth rate by over 1 percentage point.

TABLE 7
PHASE II
DEFICIT REDUCTION

Fiscal Year	Spending Cuts (bil.)	New Revenue (bil.)	User Fees & Excise Taxes (bil.)	Net Interest Savings (bil.)	Deficit Reduction (bil.)
1990	$ 0.0	$ 0.0	$ 0.1	$ 0.0	$ 0.1
1991	26.9	6.6	14.8	2.0	50.4
1992	38.7	13.5	13.1	5.9	71.2
1993	51.1	22.0	9.2	9.9	92.2
1994	70.4	26.1	10.1	15.0	121.5
1995	101.5	2.4	10.6	20.8	135.2
Total	$288.5	$70.6	$57.9	$53.6	$470.7

TABLE 8
PHASE II
IMPACT ON SOCIAL SECURITY BENEFICIARIES

Fiscal Year	Reform Medicare (bil.)	End Earnings Test (bil.)	End Taxing Benefits (bil.)	Net Impact (bil.)
1990	$ 0.0	$ 0.0	$ 0.0	$ 0.0
1991	-8.9	+2.4	+3.8	-2.8
1992	-10.0	+4.0	+5.4	-0.6
1993	-11.1	+5.2	+5.9	0.0
1994	-12.3	+5.6	+6.4	-0.3
1995	-13.6	+5.7	+6.8	-1.1
Total	- $55.9	+ $22.9	+ $28.2	- $4.8

TABLE 9
PHASE II
EFFECT ON SOCIAL SECURITY TRUST FUND[1]

Fiscal Year	Balance (bil.)	OASI Fund Outgo (bil.)	Phase I Elderly Tax Cuts (bil.)	Phase II Payroll Tax Cut (bil.)	New OASI Fund Balance (bil.)	Ratio of New Balance to Outgo (bil.)
1990	$206.7	$224.4	$0.0	$0.0	$206.7	$0.9
1991	281.0	238.6	-3.8	0.0	277.3	1.2
1992	367.3	252.9	-6.2	0.0	361.0	1.4
1993	466.5	267.8	0.8	0.0	467.2	1.7
1994	581.6	282.7	9.6	0.0	591.2	2.1
1995	709.0	297.4	19.6	-41.1	687.5	2.3

[1]Based upon Mid-Session Review estimates.

- Create 3.9 million jobs by the year 2000, about 1.6 million jobs in addition to Stage I proposals.

- Spur investment that would increase the stock of U.S. capital by $9.6 trillion by the year 2000.

- Increase federal revenues by $220.9 billion over the next ten years.

Effect on Federal Budget. Table 7 summarizes the impact of Pro-Growth Package: Stage II on the federal budget deficit. Over the next five years, it would reduce the deficit by $470.7 billion.

Effect on Social Security Beneficiaries. Elderly Social Security beneficiaries have been a central focus in budget summit negotiations. Entitlements have in the past been declared off-limits. This is no longer the case, in part because Social Security and Medicare comprise 39 percent of domestic spending and 30 percent of the entire federal budget.

Over the last several months, proposals have been put forward to increase the taxation of Social Security benefits, limit cost-of-living adjustments (COLAs), reduce Medicare benefits and institute an income surtax for Medicare Part B. At one point, proposed Medicare "cuts" would have amounted to over $100 billion, the lion's share of domestic program reductions.

Stage I and II proposals also would reduce Medicare outlays. These reductions would be accomplished by introducing greater price sensitivity through higher copayments. The package also contains two measures that would virtually offset the Medicare reductions: (1) the elimination of the Social Security earnings test for beneficiaries age 65 and over and (2) the elimination of the income taxation of Social Security benefits. Table 8 summarizes the provisions affecting Social Security beneficiaries. Their negative net impact would be $4.8 billion over five years.

Effect on the Social Security Trust Fund. Increased Social Security benefits would be paid out as a result of the elimination of the earnings test. However, the overall budget impact of this increase would be partially offset by increased income and payroll tax revenues from added labor force participation by the elderly. The trust funds also would be reduced by the 1995 payroll tax reduction. As Table 9 shows, however, the trust funds still would have more than adequate "reserves," generally defined as one-year's benefits. By 1995, the trust fund would hold government debt equal to 2.3 times annual outgo.

CONCLUSION

On the eve of a recession, the last thing the U.S. economy needs is another round of tax increases — destined to further depress the economy and make the recession deeper and longer than it otherwise would be. Fortunately, there is a better way. By selectively reducing tax rates on capital and labor we can create an economic stimulus that will sustain economic growth and meet the revenue needs of the federal government at the same time.

FOOTNOTES

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

[2]Under the strange accounting of the summiteers, user fees count as "spending reductions."

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

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

[5]See *Executive Alert*, National Center for Policy Analysis, Vol. 4, No. 5, Sept/Oct 1990, p. 8.

[6]For a summary of the historical experience, see Ronald Utt, "Capital Gains Taxation: The Evidence Calls for a Reduction in Rates," *Heritage Foundation Backgrounder*, No. 704, May 2, 1989; for a survey of the academic studies, see Lawrence Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," *National Tax Journal,* Vol. 40, No. 3, September 1987.

[7]Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986."

[8]See Aldona Robbins and Gary Robbins, "Adding to the S&L Solution: The Case for a Lower Capital Gains Tax," National Chamber Foundation, forthcoming.

[9]John 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.

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

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

[12]Steven F. Venti and David A. Wise, "The Determinants of IRA Contributions and the Effects of Limit Changes," in *Pensions and the U.S. Economy,* ed. Zvi Bodie, John Shoven and David Wise (Chicago: University of Chicago Press, 1988).

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

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

[15]John Goodman, "Should 85 Percent of Social Security Benefits Be Taxed?", National Center for Policy Analysis, NCPA Policy Backgrounder No. 101, July 20, 1990.

[16]Aldona Robbins and Gary Robbins, "Paying People Not to Work: The Economic Cost of the Social Security Earnings Limit," National Center for Policy Analysis, NCPA Policy Report No. 142, September 1989.

[17]These rates apply to people who are below the maximum tax, where one-half of benefits are fully taxed.

[18]Robbins and Robbins, "Taxing the Savings of Elderly Americans."

[19]Ibid.