PROCEEDINGS

Hearing on the Current State of the Economy And the Need for a "Growth Package"

Senate Republican Conference Task Force on Economic Growth and Job Creation

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Introduction and Executive Summary

by

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The National Center for Policy Analysis is a nonpartisan research institute, which is not affiliated with any political party. Nonetheless, we have decided to publish the proceedings of a Republican conference on economic growth as a public service because of the importance and timeliness of the issues discussed.

Both Republicans and Democrats in Congress have proposed ways of stimulating the economy and putting it on a higher growth path. The reasons for action are outlined by economist Lawrence Kudlow:

- The Office of Management and Budget is forecasting average real growth for the economy of only 2.6 percent through 1996.
- The Congressional Budget Office is forecasting an average growth rate of only 2.3 percent.
- Kudlow's own forecast for the next six quarters is 3 percent — about half of what is normal in the early stages of an economic recovery.

As both Kudlow and economist Gary Robbins point out, the forecasted sluggish growth rate is extremely costly relative to the past performance of the American economy.

- If the economy grows at only 2.5 percent over the next five years instead of at the 3.3 percent rate posted over the five year period 1985 to 1989, *the loss of output will equal $2.3 trillion.*
- The slower growth rate will mean *9 million fewer jobs created, 44 million man-years of lost labor and $875 billion in lost wages.*
- Government will also suffer as a result of *$520 billion less revenue for the federal government and $350 billion in less revenue for state and local governments.*

There is a consensus among the economists testifying that the reasons for slower growth are the same as the reasons for the current recession: higher taxes on labor and capital and an increase in costly regulations over the past three years. The current recession is a man-made event, not a natural one, and the price the American people have paid has been high.

- Because of the economic downturn we are experiencing *we have already lost 3 percent of GNP and 5.4 million jobs,* relative to the rate of job creation during the previous five years.
- *The average aftertax income of U.S. families has fallen by an amount equal to a 15 percent increase in federal taxes.*

The one sector of the economy that is most sensitive to the effects of taxes and regulations is the small business sector. As Kudlow explains:

- More than 90 percent of the 18 million jobs created in the 1982-1990 expansion were created by small and new businesses.

- Yet the rate of new business formation is down 12 percent and nonfarm proprietors' income — which measures the strength of self-employed business people — has been growing at a real rate of only 1.6 percent over the past year, compared with an 11 percent growth rate in 1983.

As Housing and Urban Development Secretary Jack Kemp observes, blacks, Hispanics and other minorities have the most to gain from economic expansion and have the most to lose from the depressing conditions in the small business sector:

- The economic expansion of the 1980s created 4.5 million new entrepreneurs.

- That included an 80 percent increase in Hispanic-owned businesses, a 50 percent increase in female-owned businesses, a 40 percent increase in black-owned businesses and probably a 60 percent increase in Asian-owned businesses.

What should be done? The consensus is that the economy cannot achieve a higher growth rate unless we create new incentives for people to work and save and invest.

In the discussion that follows, considerable attention is paid to two issues: (1) would pro-growth tax cuts increase the federal deficit? and (2) would pro-growth tax cuts be fair? Yet as Gary Robbins explains, both concerns are misplaced. Almost any tax cut on investment income will pay for itself many times over in terms of increased jobs, increased production and higher economic growth. A tax cut on investment income almost certainly will generate more government revenue, not less. And more than 90 percent of the increase in aftertax income will go to wage earners rather than owners of capital. Specifically:

- For every $1 billion cut in taxes on investment income, we can expect about $25 billion in increased production.

- Government will get about $12 billion in increased revenue — making an $11 billion "profit."

- Wage earners will receive about $12 billion in additional aftertax wages, whereas investors will receive only $1 billion in additional aftertax income.

Numerous proposals are discussed, including (1) a capital gains tax cut, (2) inflation indexing for capital gains, (3) inflation indexing of depreciation, (4) expanded rights to make IRA contributions, including the right to make aftertax deposits and tax free withdrawals, (5) enterprise zones, (6) home ownership incentives, (7) a payroll tax cut and (8) a reduction in the penalty on work imposed by the Social Security earnings test.

Each of these measures would stimulate the economy and lead to a higher rate of economic growth.

Statement by Senator Bob Kasten

This is a hearing of the Senate Task Force on Economic Growth and Job Creation, and frankly it's coming at a historic time. In the past 48 hours, seven or eight different members of the House or the Senate have come forward talking about the need for economic growth and for economic stimulus, and in this hearing and in the work that we do over the next week or two, we may have the ingredients to bring all of these ideas together.

The Task Force on Economic Growth and Job Creation will examine the overall state of the U.S. economy and review legislative initiatives to get our economy moving again.

We will hear from several experts on economic growth including Representative Newt Gingrich, Senator Phil Gramm, Housing and Urban Development (HUD) Secretary Jack Kemp, former Office of Management and Budget (OMB) economist Larry Kudlow and former Treasury economist Gary Robbins.

"Antigrowth policies have pushed the economy into recession."

Before we begin, I want to make a few brief observations about the economy. During the 1980s, our pro-growth policies of tax reduction and regulatory reform generated nearly 20 million new jobs, slashed the so-called misery index in half and raised real incomes for all American families.

Over the past few years, however, the federal government has almost completely reversed the incentive-based policies that brought this prosperity. Taxes were raised. Federal spending growth accelerated. And the bureaucracy went on a new regulatory binge.

These antigrowth policies have pushed the economy into recession. This year, unemployment hit a high of 7 percent, the poverty rate increased for the first time since 1982 and household net worth declined for the first time in two generations.

Many economists believe that the recession is over. But without renewed incentives for saving, investing and producing — and without a renewed commitment to entrepreneurial capitalism — I am concerned that the economy may not rebound as strongly as it has in the past.

We have an agenda to jump-start the economy and create jobs — to restore confidence in the future. The president is now prepared to advance a growth package of incentives to revive the economy —including a capital gains tax cut to boost small businesses, enterprise zones to create jobs for the urban and rural poor and expanded savings and home ownership incentives for young, middle-income families.

Our growth package will create 1.1 million new jobs by the year 2000.[1] [See Figure I.] In contrast, tax redistribution schemes proposed by some in the majority party will not open a single new plant or small business in America — or create a single new job for American workers.

The fairest tax policy is one that expands the economic pie and creates jobs. The American people understand that growth is not a zero-sum game. That's why I think we will see a rising tide of grass-roots support for our growth initiatives.

Statement by Senator Phil Gramm

Mr. Chairman, let me first thank you for holding this hearing. I think we all agree that if the economy has turned the corner, it sure didn't leave any skidmarks when it turned, and that we have a problem that needs a proactive approach. The *Washington Post* noted this morning in their lead editorial about Senator Bentsen's proposal[2] that the Democrats have as their primary agenda increasing government spending. We have as our primary agenda creating jobs and opportunity in the private sector, and that is the agenda we are here to talk about today. It is an agenda that I take very seriously because I think (a) it is what the American people elected us to do — it is certainly what the people of Texas elected me to do, and (b) I think the economy needs our help and needs it now.

"We are really debating not one but two tax issues — what to do with defense savings and how to create economic growth."

Let me state it in very clear terms. We are about to decide in the next couple of months whether we're going to build on the progress that started on January 1, 1982, when the Reagan tax cuts went into effect and when we began creating 21 million new jobs, and build on the success that we have achieved since January 1, 1982, by going back to creating basic incentives for people to work, save and invest. Or whether we are going to sit by and allow the economy to fall back into the stagnation of the 1970s. That's the choice we face, and I think it's very important that we understand it.

Mr. Chairman, I want to talk briefly about two debates that are going on in America today under the title of growth incentives. If you look at what is being debated, we are really debating not one but two tax issues.

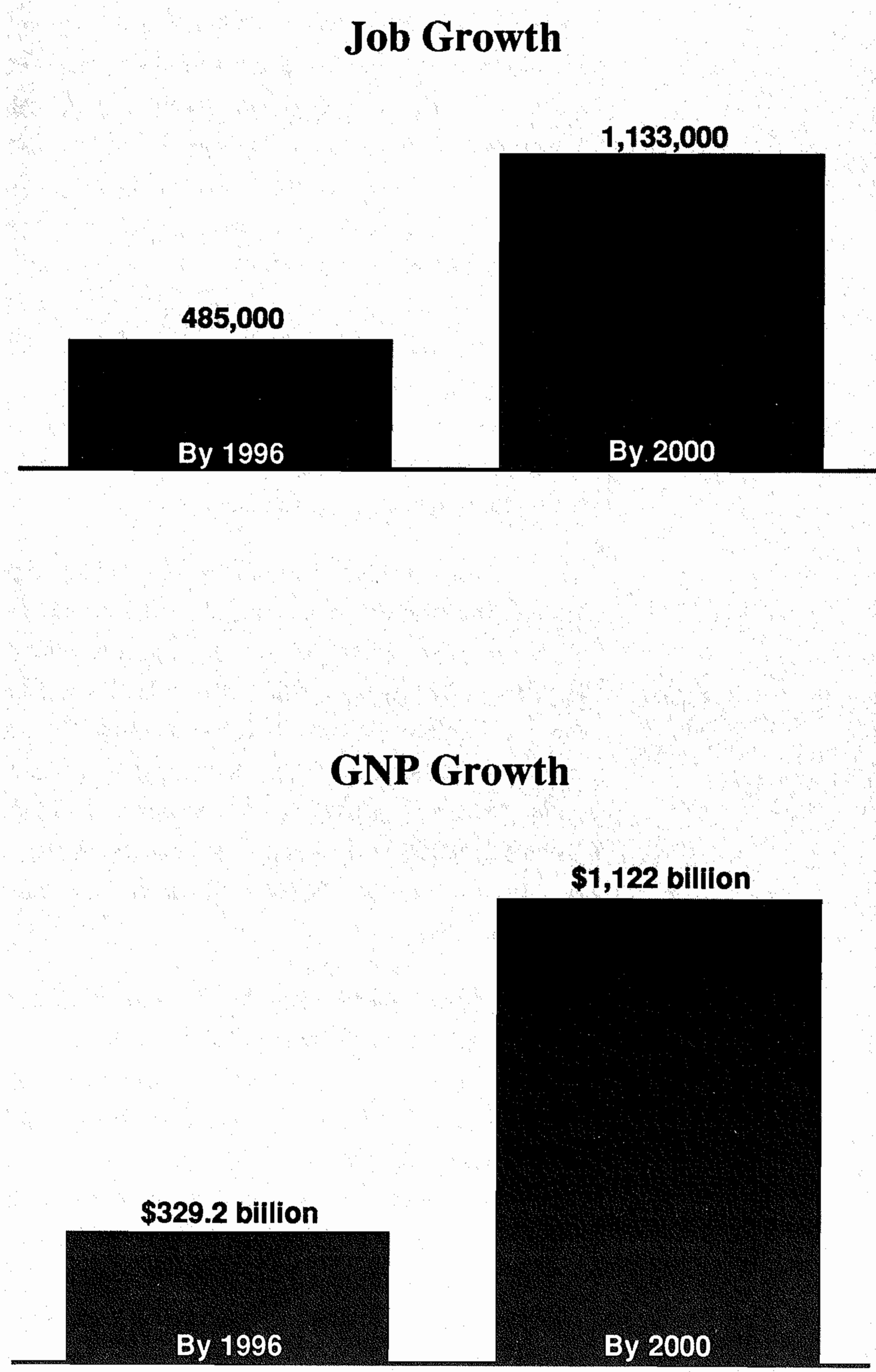
One, which was addressed the day before yesterday by Senator Bentsen, is the issue of what do we do with defense savings if and when they

"This growth package will create 1.1 million new jobs by the year 2000."

"In nominal terms, more than $1 trillion of additional GNP will be created."

FIGURE I

Results of the Emergency Economic Growth Act



Source: Produced for the Institute for Policy Innovation by Gary and Aldona Robbins.

occur. I happen be one of those people who believes that even in a world where the lion and the lamb are about to lie down together, we'd better be the lion — because only then can we be sure that the lamb is going to be safe. But since defense spending in all probability will be reduced in the future, there is a very real question about what is going to happen to that money. I applaud Senator Bentsen's proposal to return the money to the working men and women of America. I think Republicans should take a strong stand in favor of a proposal that Congressman Gingrich and I, along with others, have made — the Peace Dividend Investment Act. What we are proposing is that if defense is cut in the future, half of the money that is saved will automatically go to deficit reduction — with a commensurate reduction in our deficit targets to assure that it is not spent — and that the other half will go back to working families through tax cuts. I would prefer raising the standard deduction. The Bentsen proposal is slightly different. It would give the money only to families with children. I don't think senior citizens ought to be excluded; I don't think married people or singles without children should be excluded. I think we ought to raise the standard deduction.

That is a distinction of relatively minor importance. Of great importance is that we have a solid policy that any reduction in defense will not be spent by Congress, but will go to reduce the deficit and go back to working families so that families can invest in housing and education and nutrition. I know Congress. Congress bounces checks. Congress doesn't pay its tab at the restaurant. Congress spends money that it doesn't have on programs it doesn't need. I also know American families and I have absolute confidence in American families. I have no confidence in Congress. So I think it is important to look at Senator Bentsen's proposal in terms of the debate about the peace dividend.

"If we cut defense spending and give the money back to the taxpayer, that is a sound policy; but it is not an economic growth policy."

Let me make it clear that if we decide for strategic and defense reasons to cut defense, giving money back to the taxpayer, that is a sound long-term policy. But it is not an economic growth policy. In fact, there aren't 12 economists in the world who would argue that cutting defense and giving the money back to taxpayers — especially when you are encouraging people to save it and not spend it — will have other than a slightly depressing economic impact in the short term. So, in addition to reducing the deficit and returning half of the peace dividend to taxpayers, we need a strong economic growth package today. We need a program that encourages people to invest tens of billions of dollars today — not next week, not next year, but now.

An ingredient in any economic growth package has to be a reduction in the capital gains tax rate. Why? First of all, it is a proven policy. We have never reduced the capital gains tax rate in the postwar period without seeing the economy move forward at a rapid rate. We have never reduced the capital gains tax rate without seeing a surge in investment and transactions. And equally important in a time of tight budgets, we have never reduced the capital gains tax rate without collecting *more* revenue at the lower rate.

"You cannot make capitalism work unless you reward people who take risks and create jobs."

Many of our Democratic colleagues are going to say, "But rich people will benefit." Well, I ask you, Mr. Chairman and members of the conference, how are we going to get people to invest tens of billions of dollars if they don't have it? I submit that if America is going to be saved, it's going to be saved at a profit. You cannot make capitalism work unless you are going to provide rewards for the people who get out and take the risk, make the investment, create the jobs. I think it is time that we employ the basic system that made America rich and powerful and free, and unleash the forces of investment and competition.

Finally, I think, in addition to capital gains tax rate reduction, we need more targeted proposals like providing a tax credit to moderate-income families to build new homes. The National Home Builders Association has endorsed the proposal that Congressman Gingrich and I put forward.[3] They believe that this proposal would — over a two-year period — create some 500,000 new jobs as people built and bought homes, and that is exactly the kind of immediate stimulus we need to create new jobs and new opportunity in the economy.

Statement by Representative Newt Gingrich

Senator Malcolm Wallop and Representative Tom DeLay have been working for over a year now to get the gospel out that this recession is not over.[4] Certainly, if it is showing any signs of turning the corner, as Phil Gramm says, it's not turning in a way that makes you very excited. I also just want to take a second to praise Senator Bentsen's general direction. I agree with Senator Wallop that the president has to look at defense in terms of national requirements, not economics. But I do think it is very, very important to establish the principle that, if defense can be cut, the money should go back to the taxpayer. Ironically, I think that will make some of our more liberal friends less eager to cut defense. If the money is just going to go back to the taxpayer and not go to their pet bureaucracy, you'll see a lot less pressure to cut defense spending.

I think the underlying premise that your money belongs to you — it's not a grant to the government to be redistributed within the government — is a very important principle. I think in that sense, Senator Bentsen has helped the cause. I also want to emphasize that if we approach this correctly, there is no conflict between growth and fairness. Our good friends on the left have gotten us down a track that I think is nonsense. Growth is fairness in a free society. Jobs are fairness. It is impossible in a free society to say to people who do not have access to jobs and the benefits of economic growth and who can't get more take-home pay for their families, "Now we are going to be fair with you."

I think our side should say we are *very* prepared to argue about fairness. We think having a job is more fair than being unemployed. Having a chance to found your own business is more fair than being unable to do so. We believe that having higher take-home pay is more fair than having less. Let our friends on the left come and debate that.

"If we approach this correctly there is no conflict between growth and fairness."

I also would like to suggest that growth is the absolute key to a healthy, sound America. If we had the Japanese growth rates for a decade, assuming we controlled government spending without any dramatic cuts, we would within a decade have a balanced budget and dramatically higher family income, and poor people would have a substantial increase in their real income.

The fact is that we know how to create growth, we know what patterns work, but we have a disagreement politically in Washington with the left on three grounds.

The first is what works in reality. In some grand irony, everybody in Eastern Europe and the Soviet Union is now saying, yes, we understand that command bureaucracies don't work; yes, we understand that government ownership doesn't work; yes, we know you can't control a free society in the information age from a central capital. And almost none of the message penetrates Capitol Hill. Some of our colleagues go to Moscow to make speeches they won't make on the Senate floor. Look at what works in reality — what worked with Ronald Reagan in the '80s, what worked on other occasions in American history, what they're preaching in Eastern Europe, what they are beginning to preach in Africa. The fact is free enterprise tends to work, and socialism doesn't work.

Second is what works in theory. As a former college teacher, the thing I have found the most frustrating in this city is trying to deal with the Joint Committee on Taxation and the Congressional Budget Office and others who look at the economy with a formula so crude that the equivalent in aerodynamics would be an argument that no airplanes can fly, therefore we ought to close Washington National Airport.[5] The objective fact is that any economic model that does not take into account how human beings function is inherently wrong. And I am perfectly prepared next year to move to eliminate the Joint Committee on Taxation when the legislative appropriation comes up on the grounds that they are so destructive of common sense that it is harmful to the country to have that kind of intellectual nonsense being perpetrated on Capitol Hill. The fact is that the model used by our friends in the bureaucracy is plainly wrong. Instead of debating within that model, we ought to abolish the model and argue for what we know works in reality.

Finally, people need to understand — and we need to say more clearly — that there is a very real difference in this city about what kind of America we want. Our friends on the left talk about class warfare with great enthusiasm. Class warfare may have had some meaning in a 19th-century European context, but in America it is nonsense. This is the most mobile society on the planet. People have a chance to get rich; rich people have a chance to get poor. Our friends on the left believe in class warfare, but it is antithetical to the American cultural style. It's the reason the McGovern "demogrant" didn't work, because it would have required everybody above a certain income level to pay more to give the money to everybody below that level.[6] Even most of the people below that level thought that they or their children could do better.

"Class warfare is antithetical to the American cultural style."

Capitol Hill today is dominated by people who claim that they like jobs but hate and are envious of job creators. How does the public rate the condition of the national economy these days? Very good: 1 percent; fairly good: 31 percent; fairly bad: 46 percent; very bad: 20 percent. Now, those folks are telling us that they would like Capitol Hill to spend less time arguing and more time acting, and I hope that the Democratic leadership will get the message.

I think we have an obligation to go out and do everything we can to pass a bill that will create economic growth, create real jobs and increase take-home pay.

Discussion

SENATOR KASTEN: Since most of us in this room agree with the 66 percent of the people in the two last categories — the state of the economy is either bad or very bad — we also agree that we need to act. Senator

Gramm, you said there were two basic issues or two debates here, one on the so-called peace or democracy dividend and the other on the tax package. I suggest that within that tax package question, we've got a major difference as we see some of the Democrats, rallying around the so-called Gore-Downey tax bill.[7] In my view that tax bill simply redistributes the taxes. It doesn't solve the basic problem of getting this economic engine going again. It's not the kind of growth-oriented tax reform we need in my view to create jobs.

SENATOR GRAMM: Mr. Chairman, let me first say that the top 1 percent, the top 5 percent and the top 25 percent of all income earners in America pay a larger share of the total tax bill today than they did in 1980 when Ronald Reagan was elected president.[8] [See Figure II.] Any proposal that makes the tax system more progressive is going to be anti-job, anti-economic growth and I don't think you are going to find many knowledgeable people in the private sector of the economy or any enlightened people in government who believe that move would be in the right direction. The Democrats are absolutely obsessed with spreading the misery solving the problem. When the American people talk about fairness, they are not talking about spreading the misery. They are talking about eliminating the misery. And that's why I am determined to help eliminate it.

"When the American people talk about fairness, they are not talking about spreading the misery, they're talking about eliminating the misery."

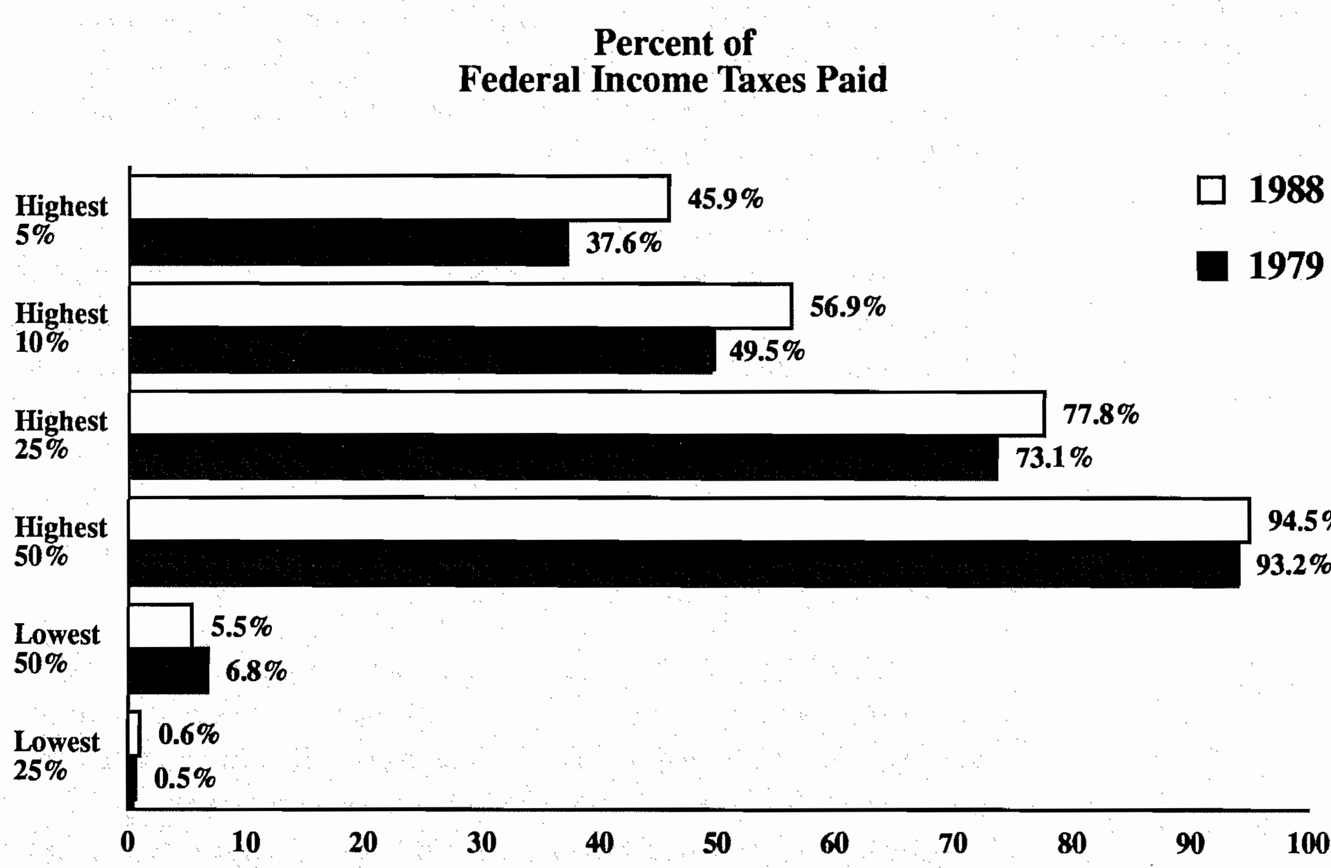
I know that the Democrats will try to create the class warfare concept that was rejected in Eastern Europe and the Soviet Union and has been rejected by almost everybody except the Democrats. I think it is worth taking them on on this issue because I think we are talking about something fundamentally important.

REPRESENTATIVE GINGRICH: I think the problem that left-wing Democrats have is very simple: in a free society, their economic model kills jobs. Any time you raise taxes on people who invest and create jobs, you kill jobs. Now, I don't think it helps a middle-class family to be told, "Gee, we will give you a tax cut — except, by the way, you are going to be unemployed." I think to the millions of people who are currently unemployed, it doesn't do any good to tell them, "We would like to be more fair to you, but by the way, we just slowed down the economy some more." I have been fascinated by what has now been a five-year dance on the left, in which they keep trying to find some new way to conduct class warfare in the William Jennings Bryan mode without killing jobs. You just can't do it.

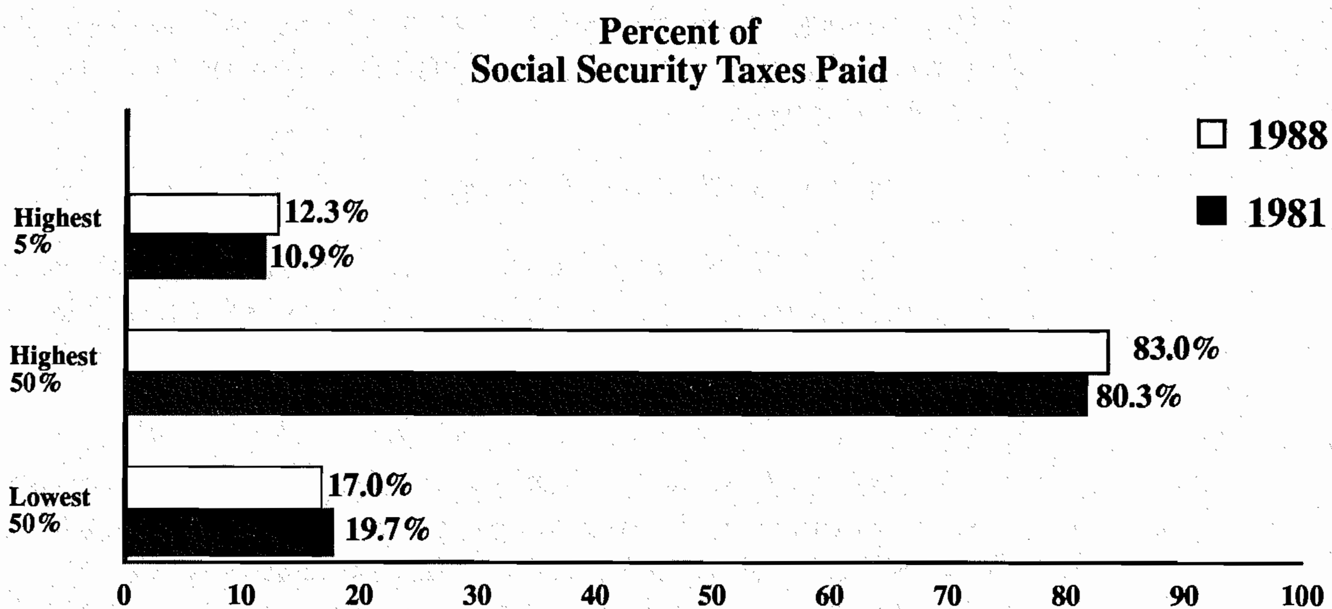
Let me say, second, I believe that it is totally hypocritical to talk about very high marginal rates for the rich. When John F. Kennedy became president, he said to the IRS, "We have a 90 percent tax rate for the very rich. How

FIGURE II

Increasing Progressivity of U.S. Taxes



Source: Tax Foundation.



Source: Estimated from IRS *Statistics of Income*, wage and salary data from 1981 and 1988. Reprinted from Aldona Robbins and Gary Robbins, "Tax Fairness: Myths and Reality," National Center for Policy Analysis, NCPA Policy Report No. 90, March 1991.

"All a high tax does is lead the wealthy to hire more tax lawyers and accountants."

many people pay it?" The answer was zero. Not a single person was paying the top rate because all that high rate does is lead the wealthy to hire more tax lawyers and accountants and divert the money out of the treasury. So I would simply argue that unless you are in favor of forcing people back to tax lawyers and accountants and away from paying their taxes, unless you are in favor of killing jobs, the Downey-Gore approach is nonsense. Ask any European government right now what they would think of the Downey-Gore proposal and they will tell you that it is a joke.

SENATOR GRAMM: Mr. Chairman, I want to add something to that. I have a quote here from Senator Paul Tsongas, who is now a candidate for president in the other party, and I think it's a pretty profound quote on this subject, and I want to read it. "I voted against the 1978 Steiger capital gains tax reduction. Do you know why I voted against it? Because I was a Democrat. The ethic in the House among my fellow colleagues was that this was pro-business and therefore, since it was pro-business we were against it. So I voted against it. That bill which I did not support did more for the economy of my state than anything I did as a congressman."[9]

SENATOR TRENT LOTT: Just a couple of questions, since I know we have other witnesses. Your plan includes benefits that would help middle-income people and the elderly. You include the so-called Individual Retirement Account Plus plan.[10] You have incentives for home ownership and you have work incentives which reduce the Social Security earnings penalty. In addition, you have the capital gains tax cut and enterprise zones. I don't think the most important consideration here, now, is the budget agreement. The important thing is to get the economy going. But having said that, I think we can do it and live within the budget agreement. Your package is deficit-neutral, is that correct?

SENATOR GRAMM: That's right.

SENATOR LOTT: But that is accomplished by, among other things, the assumption that on a five-year revenue impact basis, your capital gains provisions would produce $9.5 billion in additional revenue. How do you get that number?

SENATOR GRAMM: That's a Treasury number, but so far as I am aware, every major outside economic group in the country estimates that, under current conditions, reducing the capital gains tax rate will mean the collection of more revenues because of more transactions and intensified economic activity.

REPRESENTATIVE GINGRICH: Let me comment on that because I think you've put your finger on a very important issue here. This is why I say the intellectual fight is a very important part of this. Three things happen if you lower the capital gains tax. First, you encourage people to engage in more transactions. By definition, if you buy more houses, sell more stock, sell more timber or create more factories, just the churning effect increases revenue.

"A capital gains tax cut will increase the value of RTC real estate holdings by $6 billion to $12 billion."

Second, there is universal agreement — universal except for a tiny corps on the left — that a capital gains cut is good for the economy.[11] Even the House Ways and Means Committee Democrats issued a report saying that. Therefore, you have more people at work; they are earning higher take-home pay; and that increases tax revenues.

There is a third factor which nobody has yet been able to quantify — although the home builders gave us an estimate that it's somewhere between $6 and $12 billion, which is not counted in this particular projection — that is the cost of the Resolution Trust Corporation. The largest single holder of property for sale in America today is the U.S. government. If you have a capital gains tax cut which makes it more desirable to buy property, and you increase the value of the government's current holdings at the Resolution Trust, the best estimate — and this is purely an estimate — is that in addition to the amount that we list, the government will get back another $6 billion to $12 billion that it will not get back in the current depressed real estate market.

Adding these pieces together, I think we can make a very good argument that would convince virtually anyone other than the Joint Tax Committee.[12] We can make a very good argument that this bill will in fact generate substantial additional revenue.

"With the luxury tax on airplanes, we killed one job for every $64 raised in taxes."

Let me make one other point. With the luxury tax increase on airplanes, based on what Beechcraft has reported, we killed one job for every $64 raised in taxes.[13] Now that's madness. Yet if you asked some of the bureaucrats on Capitol Hill whether they have studied the Beechcraft example in Kansas, the answer would be, "No, that doesn't count." That is an example of why we have to take on the people on Capitol Hill who are out of touch with economic reality.

SENATOR LOTT: One other question. I think we need a spur to the economy as quickly as possible. If we passed your package in the next 30 days, how quick an impact would it have on the economy?

"People would begin changing their behavior before the president even signed a capital gains tax cut bill."

REPRESENTATIVE GINGRICH: Let me jump in first, then Phil can answer. The home builders point out that in 1974, when we passed a tax credit on a limited-time basis to encourage people to buy their first home, it had a tremendous immediate effect. People read the evening paper, they watch the evening news, their realtor calls the following Saturday — they pretty quickly hear the news and recognize it as a good deal. That's one reason why we built into the Gramm-Gingrich bill a tax credit of up to $1,000 for couples with less than $43,000 income so they can go out and buy that very first starter house and have money for a down payment.

Further, I believe that the impact of the capital gains change and the impact of allowing senior citizens to earn an additional $8,000 a year without penalty from Social Security[14] — those two things would have an almost instantaneous impact on behavior. Sophisticated investors and their advisors would know about the bill before it passed the Congress. Before the president signed it, people would begin to change their behavior based on an expectation of change in the real world.

SENATOR GRAMM: I think the genius of a free society is that when you change the rules of the game, people know it while it is occurring. They respond to it before it happens. You change expectations and create a new excitement, a new life within the economy. That is what we are really talking about here. Nothing is wrong with entrepreneurship in America. Nothing is wrong with our ability to generate ideas and products. What happened in the late 1980s and in 1990 and 1991 was that we added more burdens, more regulations, more taxes and stifled some of the incentive to create. What we are trying to do here is to unleash that incentive again. That incentive is not just locked up at General Motors. It is locked up in every major and minor corporation in the country and among literally millions of working Americans who have an idea and are waiting for an opportunity to go out and apply it.

SENATOR MALCOLM WALLOP: Mr. Chairman, just three observations and a question. I think, Newt, there is a fourth factor in favor of a capital gains tax cut. That is, mobile capital goes to the most promising growth whereas taxed capital tends to stay in the mossed places because it's unprofitable to move it. I agree with your observation that growth is fairness. I would carry that one step farther in terms of the new Nobel Prize-winning thesis that property is fairness.[15] The purpose of growth is the acquisition of property. And one of the reasons that you don't find those on the other side pressing for it is that if you cannot acquire property and government controls both the capital and the growth, then government controls the society. That's their goal. They don't want this free, ebullient, flowering society. They want something they have a handle on. This is a whole thesis behind regulation in this country.

Now I agree with both of you on the defense thesis, and this is my question. Clearly, if there are savings, they ought to go to deficit reduction or to the people who pay the taxes. But unlike your proposal, Senator Bentsen uses a defense cut to pay for his tax cut. Isn't that correct?

SENATOR GRAMM: Well, in addition to what now is set as the path for defense, he proposes an additional 5 percent reduction and proposes using that money to give a tax credit to families with children under 18 years of age.

SENATOR WALLOP: That's the basis of my complaint. Not only do I not think that is pro-growth, I think that adds to the economic woes of the country. If the reduction occurs, I agree with using the money to cut taxes. But I would far rather see something like the Gramm-Gingrich proposal or the Wallop-Delay proposal that pays for itself.[16]

REPRESENTATIVE GINGRICH: I think Senator Bentsen is moving in the the right direction. If there are defense cuts, the taxpayer has first claim on the money. I do not think that his particular proposal has any positive effect on the economy. You'd be cutting spending over here in order to cut taxes over there. Cutting taxes is a good general thing to do, and you can argue that over time it is better to have the money in private hands for investment's sake. But if you are trying to stimulate the economy in the near future to help people find jobs this year or next year, I don't think the Bentsen proposal addresses that underlying problem.

"If there are defense cuts, the taxpayer has first claim on the money."

SENATOR GRAMM: I think it just goes back to the fact that the Bentsen proposal should come under the heading of what to do with defense savings. And under that heading I think it is positive. I submit that it is going to be attacked very vigorously by liberal Democrats in the House and Senate who believe they have the right to spend that money and who don't want working people to have it back. I think defense spending should be determined by the need and the threat. But my fear, Senator Wallop, is that we are going to end up with defense cut by 15 percent, not 5 percent, and that every penny of that is going to be spent by the government. So I think setting out a program to guarantee that does not happen is vital. In the long run, it is just as important as an economic stimulus package. They are just two separate issues.

SENATOR CONNIE MACK: I see Senator Bentsen's proposal as positive in that he wants to stimulate the economy and he believes tax cuts will stimulate the economy. At this point, I think we ought to declare victory and then move on to what kind of tax cut package we can put together to get the economy moving again. Without getting into the debate about what caused real estate values to fall, I think it is fair to say that the collapse of real estate values has undermined the capital structure of our financial institutions and, therefore, we ought to look for ways to increase the value of real estate. I suggest that the plan you put forward this morning would do so, and I am interested in your reactions to that.

"The collapse of real estate values has undermined the capital structure of our financial institutions."

SENATOR GRAMM: Well, I think the proposal that we have put forward will not only help create jobs, but also it will help restore value in real estate. I think it will help the market for all of these properties that we are not such a proud owner of — because of S&L and bank collapses. And I think our estimated savings in terms of revenue generated are very low as compared to the reality because by adding to the value of real estate we enhance the ability of government to sell off this property that it holds, get the property back on local tax rolls, and put the real estate back in the hands of people who can use it productively. I think that reducing the capital gains tax rate not only stimulates the economy but more particularly it stimulates the growth in value in real estate, which is a fundamental source of weakness in the American economy today.[17]

SENATOR MACK: I would just add a comment based on a question I asked Chairman Alan Greenspan and Chairman William Seidman: if people are really concerned about the cost to the American taxpayer of the collapse in real estate values and RTC, what single thing could we do to enhance the value of real estate? Would it in fact be to lower the capital gains tax rate? Both said that, if you cut the capital gains tax rate you are going to increase the value of all assets, and both felt that was the direction in which we should go. It was interesting that chairman Greenspan said, "I don't think you really went far enough by proposing a cut in the capital gains rate of 15 percent." He said that he would eliminate it completely. But I think we are working on what might be do-able, so I think that if we could work towards 15 percent, that would be great.

SENATOR GRAMM: When we are on their 20 instead of our goal line, I propose that's when we debate a larger tax cut.

SENATOR KASTEN: Well, I think we are whole lot closer to getting this game going as a result of what has happened over the past 72 hours and the work a number of people had done before hand. Right now is the moment. We talked earlier about timing. If we could pass some kind of stimulus, some kind of tax reduction and growth legislation — pass it so it could be effective January 1, 1992 — we could make a tremendous difference with what now seems to be a coalescing around a number of these ideas. And Connie, I agree with you completely; we've got a chance. We've passed a capital gains tax reduction in the House of Representatives.[18] We've got the votes in the Senate. We can go forward with these ideas and I'd like to thank both of you very, very much for your testimonies.

REPRESENTATIVE GINGRICH: I would hope the Republicans in both the House and Senate — and the White House — would agree that we are not going to go home until we pass a growth package. If necessary, the president ought to call us back into a special session. The idea that we would leave here with the '92 economy in decay and do nothing to create jobs, I think, would be totally irresponsible. And I would hope with both sides of the Capitol and the President that we could reach a very strong agreement to stay here as long as it takes to create a growth package.

Remarks by Secretary Jack Kemp

I think this is the most welcome debate that I have yet to hear. We are at what Newt Gingrich correctly called "an almost critical mass" with regard to the economy. The very bad news of economic decline is matched by what I hear from you and a lot of other men and women who understand that our whole entrepreneurial capitalistic system is at a defining moment, not only because of what it means to our own economy, Mr. Chairman, but what it means as a symbol and example to other countries who are trying to model their nations after ours.

"The real issue is what kind of economy we are going to have at the turn of the century."

I hope we don't make this too partisan. I liked watching Phil Gramm endorsing the Bentsen proposal for a cut in tax. I think Connie Mack made the point that the idea of cutting taxes to get the economy moving again is what is important. Now that that victory has been won intellectually, or at least is beginning to be won, politically the debate should center on which taxes have the greatest impact, which tax cuts would most incentivize the economy and the entrepreneur and create the greatest growth in the economy.

I am not going to talk about the budget. I'm not here on behalf of the administration. I'm not speaking officially, certainly not on behalf of the Republican party. I'm not here for rich people. I'm here on behalf of poor people who want to get rich. I was with the president recently in a very interesting circumstance. He was in St. Louis at Cochran Gardens, one of the notable low-income communities of America. One of the great ironies to me is that what we have in America's inner cities and in other pockets of poverty, rural or urban, are Third World-like or Eastern European-like socialist economies. There's no private property; only public housing. The reward for welfare is greater than the reward for work. The opportunity to start a business has been smothered by regulatory barriers and tax impediments that would frustrate any man or woman. It is particularly galling to me to see the level of poverty that exists in this country. It's unacceptable morally, unacceptable politically. We have an obligation to ourselves, to our young people, to the poor and certainly to the world — which looks to democratic capitalism as a way out of problems of underdevelopment and despair and grinding, abject poverty.

"The level of poverty in this country is unacceptable morally and politically."

So my testimony today, while not formal, Mr. Chairman, comes from my heart and comes from the empirical evidence that I have seen of what we are doing to our own country. At the moment that we have begun to triumph over the ideas of socialism, communism, fascism and apartheidism — all of those isms that are at odds with human nature and the historical antecedents of this country — it pains me to see what we are doing to our own nation.

I don't think frankly, Mr. Chairman, the question is what the budget is going to look like after Kasten-Mack or Wallop-DeLay or Gingrich-Gramm or some combination thereof should pass.[19] I think something is going to pass. But what a tragedy it would be to focus on only counting up beans or looking at budgets or whether or not the budget deficit is going to be this or that. The real issue is what kind of economy we are going to have for the American people at the turn of the century. The issue is not just jump-starting the economy. The issue is what kind of an American economy, what type of a democracy, are we going to have? What type of entrepreneurial-capitalistic system are we going to have? What a shame it would be if at the moment of the triumph over all those other isms, capitalism became nothing but another relic ism because there was not enough capital.

I saw this morning one of the most tragic headlines of recent days — and there have been some rotten headlines recently. From the *New York Times*, "Racial Gap Found on Mortgages" and "Loan Denial Rate Said to be Double for Black People and Minorities," and "Fed Study Finds Racism in the Approval of Home Loans." Now I know bankers will object perhaps to over-simplifying, and I don't mean to jump on anybody in an ad hominem way, but a *USA Today* headline reads "Blacks More Likely to Face Loan Rejection."

What's happening to low-income people and poor people in this country is they can't get access to credit — and they certainly can't get access to capital.

I saw a recent study which concluded that the capital gains tax on an asset held in this country for between 10 and 15 years is close to 75 percent effectively. The capital gains tax is a transaction tax. If you don't transact something, you don't pay it. The rich people are not hurt by the tax on capital gains. It's poor people who want to get rich who are hurt by capital gains taxes at that level.

"The capital gains tax on an asset held 10 to 15 years is close to 75 percent."

I mentioned that I didn't want to make this too partisan and I don't. I think Senator Bentsen's proposal is a healthy one. Daniel Moynihan wants to roll back the payroll tax as Malcolm Wallop and Tom DeLay would do. Joe Lieberman wants enterprise zones; he's cosponsor of the president's enterprise zone bill. Charlie Rangel is another cosponsor of the president's enterprise zone bill. Incidentally, that bill eliminates the tax on capital gains in pockets of poverty. Capitalism without capital is nothing but an abstract ideal. What people can see in our nation's inner cities and what is happening to our economy is that we are running up the cost of capital, and we are shrinking the seed corn that is necessary to start the next generation of businesses. And I want to suggest that we are going to need a lot of Democrats to come on board, so let's make this a bipartisan effort. George Mitchell, who I've been very critical of for failing to get President Bush a cut in the capital gains tax — I mean he almost laid down in the railroad tracks recently to keep the Gingrich-Gramm bill from passing the U.S. Senate — wants a low-income housing tax credit, and so do I. I mentioned Rangel and Lieberman, Moynihan and Bentsen, Downey and others, so I think the climate should be right. It shouldn't be too partisan.

Let's not spend so much time on the the budget and the deficit and federal spending, whether it's defense or otherwise, because those are numerators. The denominator, as Larry Kudlow has pointed out, is the GNP. If we make the size of the economy by the end of this decade, say 8 trillion instead of 5 trillion, the revenues from 8 trillion dollars are enough not only to get past the zero sum debate over defense but to help bring down the deficit in a much more positive way. There would be more money for infrastructure development, more for education, more for things that this government has an obligation to do to help defend our shores and make sure we've got a strong economy.

I mentioned earlier that President Bush was at Cochran Gardens. The audience was all black, some Puerto Rican, all public housing, all living in

"You are not going to get people to put their capital at risk unless there is a reward for doing so."

this Third World kind of socialist economy, all to be considered poor, Mr. Chairman. President Bush was talking about privatizing public housing, giving people a chance to homestead so they have some property rights.[20] Malcolm Wallop alluded to property. It's not simply over-regulated, Malcolm. People grow up in America who have never had a piece of private property — and that's an inalienable right. That is the asset around which people get the equity leverage to start a business. That's how John Johnson started *Ebony* magazine — with property that he sold off — and now he has a huge publishing empire and has made a lot of money. But does anyone think that John Johnson of *Ebony* and *Jet* magazine ripped off anybody? Of course not. Sam Walton started off as a shoe clerk for JC Penney. Today, according to *Forbes* magazine, he's the richest man on earth. Does anybody mind that Sam Walton made a lot of money? He's created a lot of jobs. We need to create more rich people. The trouble is, the capital stock of America is locked in, and you are not going to get people to put their capital at risk, as Trent Lott pointed out, unless there is a reward for doing so.

When the President was talking about cutting the capital gains tax and then eliminating the tax on the American dream, he looked down at his notes and found an audience of all low-income, minority men and women cheering. It wasn't Wall Street. It wasn't this panel. It wasn't the Republican party. Probably everyone there was a registered Democrat. And I tell you what, there wasn't a poor person there who didn't want to own his own home, didn't want to get a good job for his kids, didn't want a better education, didn't want a piece of the pie that we call the American dream and didn't believe that the capital gains tax was taking away their ability to get up that ladder.

I'll stop, Mr. Chairman, without endorsing any one of the bills. I think you are all on the right track. I believe with all my heart that this is the moment, as Newt pointed out, when action is absolutely essential. This is an emergency measure, but we shouldn't look upon it only as getting us out of a recession. We should look at what type of competitive America we want in the decade of the '90s. There isn't a country in the world that taxes capital gains the way we do. There isn't a country in the world that has an unindexed capital gains tax. Larry Kudlow, who is going to testify, showed what's happened to net new business formation since the 1986 tax code. I participated in writing that code, and welcomed the chance to bring down the rates as did all of you. But we made a mistake when we raised the capital gains tax from 20 to 28 percent, and left it unindexed.[21] Mexico has an indexed capital gains rate; they have no tax on anybody that invests in the Mexican stock market. *No tax*. Pedro Aspe Armella, the finance minister of Mexico, told me on a recent trip to Mexico City to meet President Salinas that not only did they want to reduce tariffs and further cut tax rates — they've cut them from 60 to 35 percent, I think, and revenues are up — but they want to further open their country to trade opportunities in the North American trade zone.

I am absolutely convinced that this whole idea of recapturing the American dream — if not doubling the U.S. economy, at least increasing it by a third by the end of the decade, creating another 20 million new jobs in the '90s, restoring value to real estate, both residential and commercial — would reduce the cost of the bailout of the S&Ls, and help the portfolio of every financial institution in America.

I'll close with this thought, Mr. Chairman. The United States economy is probably worth 30 trillion dollars — that's a rough estimate of the total net worth of the American economy, including all of its physical and intellectual assets. Blacks represent 13 percent of the U.S. population; they own less than one-half of one percent of the total net capital stock of America. Hispanics represent a smaller proportion of the population, but own even less. Poor people don't have access to seed corn, venture capital. We cannot win the war on poverty as long as we treat people as perpetually poor and think of them as perpetually dependent upon government. I really hope, Mr. Chairman, that these hearings begin to focus attention on an effort to get this economy growing again, restoring incentives to the economy, restoring value to the assets of the American people and giving poor people the opportunity to become rich. I don't think we can do it absent the type of tax reform in your recent pieces of legislation. So I thank you for your leadership and look forward to working with you.

"We cannot win the war on poverty as long as we treat people as perpetually poor and think of them as perpetually dependent upon government."

Discussion

SENATOR KASTEN: Secretary Kemp, we thank you. Abraham Lincoln said, "You cannot bring about prosperity by discouraging thrift. You cannot strengthen the weak by weakening the strong. You cannot help the wage earner by pulling down the wage payer. You cannot help the poor by destroying the rich." The point that we are trying to make here this morning is, I think, that we are reaching a bipartisan position, recognizing that people will respond to incentives, that rational people will make rational decisions.

Congressman Gingrich referred to the luxury tax; he used an airplane example. I'd like to take everyone to Pulaski, Wisconsin, and to Oconto, Wisconsin, and show them what has happened to the boat building business as

"We put a 10 percent excise tax on boats and people are no longer buying them."

a result of the luxury tax. We have lost hundreds of jobs in these small towns because people have responded. We put a 10 percent excise tax on these boats. People no longer are buying them. The government isn't getting the tax dollars — there is no tax revenue if no boats are purchased. And the other part of it is that we've put thousands of people across this country out of work — simply because we tried to levy an excise tax and didn't recognize that people would buy less as a result of it. I think what you said is very important, and I appreciate your being here today.

SENATOR LOTT: Two questions, Mr. Secretary. First, as Secretary of Housing and Urban Development, I'd like for you to comment on what the enterprise zone provisions of the Gramm-Kasten-Wallop proposal would do for housing starts and low-income housing? Most people, when they think of enterprise zones, don't think about what that could mean for housing and housing starts and low-income housing in urban as well as the rural areas.

SECRETARY KEMP: I think it would have a positive impact. I haven't quantified the results, Trent, but I think it would have a positive impact on housing and affordable housing. The president's study of affordable housing alluded to the same point that Malcolm Wallop made: housing has quietly — maybe not so quietly — become the most over-regulated industry in the United States of America. Plus, we reduced incentives to invest in housing— in the 1986 Tax Reform Act and in the 1988 FIRREA act. I think passive loss rules should apply to all businesses across the board.[22] The depreciation schedules for real estate are longer than they were prior to the 1981 tax cut.[23] We are punishing real estate. But putting that aside for the moment, you are absolutely right that affordable housing would be favorably affected by the Gramm-Gingrich bill. Enterprise zones, in which there was no tax on anyone that invests in an inner city — no tax on the capital gains of any man or woman of any color, background or socioeconomic condition that starts a business in a depressed urban or rural pocket of poverty —would have a enormously positive impact upon new business starts. We know from David Birch's study at MIT that most new jobs in America are created by employers with less than 150 employees.[24] So the secret of a high labor-intensive economy is creating a lot of new business starts, as happened in the 1980s.

I think the problem with the 1980s was that the formation of capital did not keep up with the formation of new jobs. So in effect, workers were working without the capital investment and the new tools necessary to lift their output and productivity. I think it's basic economics that you cannot improve the standard of living of a people without increasing the amount of capital invested per capita. I don't think, however, you can just pass a capital gains

"You cannot improve the standard of living of a people without increasing the amount of capital invested per capita."

tax cut absent some other changes. I think there should be a pro-labor incentive. The capital gains tax should be matched with — and I'm not speaking now for anyone but Jack Kemp — a roll back of at least the last one or two payroll tax increases.[25] We need a pro-family component. The family is the most overtaxed institution in the United States of America, and I think that is why Connie Mack suggested that the Bentsen proposal was at least a very positive step in the direction that we should go. Enterprise zones to me are essential to doing something to attack the root cause of poverty in urban and rural America. And of course, housing. I am convinced that less regulation, and some modest tax changes such as those I alluded to would have a tremendously positive impact.

The budget reflects the economy. Get the economy in good shape and the budget deficit will look a lot better. I don't think you can get to a balanced budget without getting to levels of employment and entrepreneurship and growth that will bring down both government spending and government deficits.

SENATOR LOTT: Your whole thrust goes to this question, and you and I have bantered back and forth about this before. I am concerned about the overall economy of the country. I think that these proposals need to be done for the overall good. But I also have to be concerned about an area like the one you referred to: the Mississippi Delta. There are going to be people that'll say these proposals — the capital gains changes, the enterprise zones, IRA incentives — are not going to do anything for the poor in the Mississippi Delta. I think they absolutely do, but I would like for you to respond. Suppose you are in the Delta, talking to somebody in Morehead, Mississippi. What is in this package for them?

SECRETARY KEMP: Well, first of all, I think a healthier economy is healthy for Mississippi and New York, Wisconsin and Florida, as well as Wyoming and California. The collapse of real estate values, as Connie Mack pointed out, is having a depressing impact on the financial structure of our nation. I want to keep coming back, however, to these rural and urban pockets of poverty. It's one thing to have a macroeconomic recovery — which I strongly believe in, it's essential to the health of our nation's financial institutions and to the people of America. But we've got to go further. We can't continue to tolerate the level of poverty that exists in this country in the 20th century. What we need is a compensatory tax code that would drive incentives into rural and urban pockets of poverty — to create more jobs, more ownership, and more capitalism for the poor.

Vaclav Havel, the president of Czechoslovakia, is in Washington today. Two months ago, his finance minister was here and I asked him on a C-SPAN show, "Are you going to tax capital gains in Czechoslovakia?" And he laughed and he said, "Oh, Mr. Kemp, we are not going to do to our country what you did to your country. We are not going to tax income more than once like you do in the United States. We are only going to tax income once. We don't want to destroy the rich, we want to create riches. We don't want to redistribute wealth, we want to create wealth." And what the Delta of Mississippi or the inner city of St. Louis really needs is to use the greatest tool for economic development the world has ever discovered — entrepreneurial capitalism, which leads to ownership and equity in the system. That means more private homes, more ownership of businesses. You quoted Lincoln. Lincoln said, "I want poor people to own their own homes." If you don't have a home, if you don't have property, you can't leverage it against that first business that might get you and your children out of poverty. That's how my father started his business in California. That's how many of our fathers and mothers started businesses.

This is an important point about capital gains — and I apologize for coming back to it, but it's a very important point. You can't get rich on wages. Rich people don't care about the capital gains tax, they've got theirs. It's locked in. They can husband their resources and protect their wealth by investing in municipal tax-free bonds. The people who are being hurt are poor people. If you don't have a chance to earn, save, invest, make a profit and then put your capital at risk and make a bigger profit, and maybe some day not just own a truck but a trucking company, as my father ultimately did, you cannot combat the conditions that exist from the Delta to the urban areas of America. So I think we should be bolder, more audacious, more dramatic.

"If you don't have a home, you can't leverage it against that first business that might get you and your children out of poverty."

I must say how pleased I was to see Marlin Fitzwater in that article about the Bentsen and Gramm tax initiatives. He said the package that the administration is considering will include long-term Bush proposals, such as a reduction in the capital gains tax and tax breaks for research and development. He said we need enterprise zones to encourage investment in rural and urban areas, and he said we need some form of middle-class tax cut. I think that alludes to possibly rolling back the last payroll tax increase or two, lowering the cost of labor, lowering the cost of capital, enterprise zones and a pro-family tax cut. I think that would be the mix that would help not only the macroeconomy but this microeconomy in rural and urban America.

SENATOR WALLOP: Let me suggest that the collapse of real estate values is at least in part a reflection not just of real estate taxes but of the general increase in taxes and regulations since 1986. An argument can be made that there was commercial overbuilding driven by taxes. But the general condition of real estate is not exclusively a real estate tax problem.

Now, because there are some members of the press here, I think it is important to flesh out an argument that you have been making. You are not arguing that the deficit doesn't count, but only that counting it to the exclusion of all other considerations is as self-defeating as has been the role of the budget agreement.

SECRETARY KEMP: Malcolm, let me clear that up. I have had this quote hanging over my head now for almost 20 years: "Jack Kemp said that he no longer worships at the shrine of a balanced budget." I went on to say I worship economically — metaphorically — at the shrine of full employment, sound money, low long-term interest rates and a job and a good education for every man, woman and child in America. In other words, how you get the deficit down, Malcolm, is more important than any other consideration.

Now, the trouble is with focusing solely on the deficit or on federal spending as the Republicans have been wont to do. We have worshiped too often at the shrine of balanced budget without considering the size of the economy, and the growth of the GNP. We are focusing solely on the numerator instead of the denominator. The numerator is the deficit. The denominator is the GNP. And I think it should be obvious even to our severest critics, Malcolm, that a 40 percent bigger GNP in the 1980s is vastly better than a 10 percent larger GNP because the revenues from a 40 percent larger GNP were literally 45 percent greater. The faster the economy grows, the higher the revenues. Clearly, freezing federal spending and getting the economy to grow at least by a third in the end of this decade would give us another $150 to $170 billion in revenue and that would be good for defense, infrastructure, helping the poor, helping the deficit, or whatever.

"We have worshiped too often at the shrine of balanced budget without considering the size of the economy and the growth of the GNP."

Look, if the deficit is $300 billion plus and the economy is $5 trillion, everybody is focusing on the $300 billion, most of which is debt service. If you double the GNP to $10 trillion, the deficit goes down as a percent of the economy. One other point that needs to be made — and I know Lawrence Kudlow will make this a little bit later, but I want to make it as a non-economist. If you increase the demand to hold financial assets, you make it easier for the Federal Reserve to lower interest rates. If the Fed were to lower interest rates right now and try to pump up the money supply, as some are calling on them to do, it would sink the long-term bond market and send long-term mortgage rates and interest rates up. But if you lower the capital gains tax rate and you increase the demand to hold financial assets, it's easier to conduct monetary policy with an eye to lowering short-term rates without losing the long-term bond market or sending long-term mortgage rates up.

"John F. Kennedy understood that high tax rates can lead to less revenue."

John F. Kennedy said it is a paradoxical truth that tax rates can be so high as to cause revenues to be low. He went on to say that it is absolutely essential in order to get more revenue, to cut high tax rates. He said that in 1963, as a result of his tax cut, revenues went up, and the budget came into balance.[26] To quote another Democrat, New York City mayor David Dinkins the other day told his own city council not to raise taxes any more on real estate, because higher taxes will drive real property owners out of New York City and revenues will go down. Even David Dinkins understands that tax rates in America can be so high as to cause revenue to contract. Now if David Dinkins understands it, and the mayor of Moscow understands it, don't you think we could get it through to the United States Congress?

SENATOR WALLOP: The answer is, probably not. Your call for bipartisanship is wise counsel, but I would note the gulf that divides us. Not the people such as Senator Bentsen, but the general cadre that constitutes Republicans and Democrats on the Hill. The Democrats will wring their hands about the headlines which you read about the access of blacks and minorities to capital. But my guess is that the policies they adopt will continue to restrict that access to capital for one reason alone: if you free the black, the Hispanic and the Asian to have access to capital, you free them from the bonds of dependency. And as soon as you do that, all kinds of voting blocs disappear. That dependency is important to a certain segment of the other party — and they will look for a way to wring their hands while their policies maintain the bonds.

SECRETARY KEMP: There is a level of elitism in this country that wants people dependent upon the government and dependent upon the welfare state. But as you point out, Malcolm, the ultimate welfare — if you take it in the highest sense of the word both in Hebrew scriptures as well as Christian scriptures — the welfare of someone means the well being of someone. Maimonides, the Jewish Talmudic philosopher, said the noblest charity is to prevent people from taking charity. The noblest welfare system would be a system in America that made welfare not a dependency or a trap, but a springboard to the ladder of opportunity. Our welfare system in America needs a radical revolutionary sea change. It fosters dependency, it treats people as perpetually dependent upon the government; it punishes them for savings; they can't start a business. Welfare took a woman who owned a computer, who happened to be on AFDC (Aid to Families with Dependent Children), and fined her and took away her computer because she wanted to start a business.

The whole AFDC welfare system is absolutely turned upside down. If a woman on welfare wants to get off welfare, and does so, her income goes down, not up. If a father who is unemployed wants to go to work, and comes off the unemployment rolls, his income goes down. We've got a system that treats poor people as if they are going to be perpetually dependent and is not looking out for the well being of people. It is basically making them perpetually dependent upon Washington, DC. And that, I think, is an absolute outrage. If the Congress doesn't do something about it, I think this stain is going to be on us all, on our democracy. I wish you would have another hearing on welfare reform because in Milwaukee, Bob, I think you know the case of Grace Cappicitio, the welfare mother who was fined $15,000 for saving $3,000 in a bank account so her child could go to college, and she was almost put in jail. Our welfare system says don't save. We not only say that, we punish you for saving.

"The great record of the 1980s was not just 20 million new jobs; it was 4.5 million new entrepreneurs."

SENATOR KASTEN: We should consider the whole set of welfare empowerment issues. As you know, in Wisconsin we are making a lot of changes. We are trying to get the federal government to allow us to make changes — to provide incentives so kids stay in school. There are major, major problems in our society, and I hope that we can work together to solve them.

SENATOR WALLOP: Mr. Chairman, would you just yield for a second. I've got appointments but I wanted to just say that I have read Larry Kudlow's statement and it's very important undergirding for the arguments that we are trying to make here. It's not only statistically but philosophically based, and is first class.

SECRETARY KEMP: Malcolm, you are absolutely right. I think what the Kudlow testimony does is provide empirical evidence that after 1986 the new business formations, the growth of small businesses, the growth of non-farm proprietors' income — that income of men and women in small business — began to decline for the first time in a long time. The great record of the 1980s was not just the 20 million new jobs, it was the 4.5 million new entrepreneurs. That included an 80 percent increase in Hispanic-owned businesses, a 50 percent increase in female-owned businesses, a 40 percent increase in black-owned businesses and probably a 60 percent increase in Asian-owned businesses. The decade of the 1980s, of minority entrepreneurship, has come to a grinding halt with a suffocating impact upon the economy.

"Minority-owned businesses increased by 80 percent for Hispanics, 50 percent for women, 40 percent for blacks and 60 percent for Asians."

"In 1980, the top 1 percent of taxpayers paid 18 percent of the taxes; today they pay 27 percent."

SENATOR MACK: Having been one who has been with you in the debate about capital gains tax rate reduction, I know that the whole debate gets lost in the claim that it's a break for the wealthy. Now it's interesting if you go back and look at the changes in who's paying taxes in the country. If my memory holds, in 1980 the top 1 percent of the people in the nation paying taxes were paying 18 percent of the taxes. That figure has now gone to 27 percent, which again makes our case.[27] But frankly, we've still got the problem. Senator Bentsen's talking about giving a tax break to the middle class, and the issue of what happens to the economy, the issue of what really happens to growth, to new business starts, to new jobs, gets lost in the debate about who benefits. What can you tell us that we can tell people around the country about this issue of a tax break for the wealthy?

SECRETARY KEMP: Connie, I believe with all my heart that if we had a national referendum on eliminating the capital gains tax on any assets held in this country for longer than three years the vote would be overwhelmingly in favor — not only by property owners but by people who hope to hold property; not only by people who hold stocks and bonds and equities, but janitors and schoolteachers and football players — people who would *like* to own stock in America.

SENATOR MACK: It was interesting when Senator Dole came back from a meeting about a year and a half ago, where he made a presentation to a group of individuals — I think it was in New York — at the end of his presentation, not a soul asked him about capital gains except one fellow — the waiter. The waiter came up and said, "When are you guys going to cut the capital gains tax?" That's a true story.

SECRETARY KEMP: I was at AFL-CIO meeting in Buffalo, NY, one time defending my voting record, which on the COPE index didn't look quite pro-labor enough for the union. But I thought I was the best friend the working man and woman ever had because I wanted to cut tax rates across the board by 30 percent and increase their earnings after taxes. People don't work for pretax income, they work for aftertax income. And I represented steel workers and auto workers and factory workers and schoolteachers. It was a blue collar district, and it was never unpopular to talk about tax rate reduction along Kemp-Roth lines. At the end of my speech, a guy got up in the back of the room and said, "Mr. Kemp." And I said, "Yes, sir," and I thought, "Here come the questions from COPE." And the guy said, "What can we do to help you?" I said, "Well, gosh, thank you. Which part of this did you like best — lowering the tax rate *a la* Kemp-Roth or cutting the capital gains?" He said, "I loved the part about cutting the tax rates, but I loved even more the idea of eliminating the capital gains tax on businesses that form in Buffalo." I said, "Why, do you have any capital gains?" He said, "No, sir, but someday I hope to." He worked 40 hours a week in a steel mill and went home at night and had a little auto engine repair shop and he hired one worker and he was an entrepreneur.

"The way to tax the rich is to set the tax rate at a level that encourages people to put their capital at risk."

Now that's why I think, if we had a referendum on the issue, we would win. Unfortunately, politics gets in the way. Now as far as who pays taxes, I would say, if I were Connie Mack in Florida, "I want to tax the rich and the only way to tax the rich and get more revenue to do the things that have to be done to defend our shores and to build roads and highways is to get more revenue out of people who are escaping taxation by investing in tax-free municipal bonds and not investing in new businesses where you pay taxes — income tax, sales tax, property tax, franchise tax, corporate tax, etc. The way to tax the rich is to set the rate at the level at which it encourages people to put their money and their capital at risk. If they are 'incentivized' only to put their money into tax-free municipal bonds or offshore safe harbors, we are letting some of the vast resources of America get away without being taxed." So I would take the populist side of the issue: I want to tax the rich; get the rates down to where they have no incentive to invest in shelters and every incentive to put their capital into widget factories in Miami or Overtown or the Delta or wherever.

Don't let the demagogues on the far left get away with saying that this is a tax break for the rich. A tax break for the rich is keeping the capital gains tax so high that the only incentive is to keep capital locked up in mature instruments so we can't get new entrepreneurial high tech businesses and pro-jobs enterprises started in America.

As far as real estate goes, Connie said one time at our RTC oversight hearing, Mr. Seidman or Mr. Greenspan, what would you think about eliminating the tax on all of the properties held by the RTC? Any man, any woman who buys a property out of the RTC inventory would pay no capital gains tax on his or her investment. What would happen to the value of the assets in the RTC or the government portfolio? The reply was that their value would zoom. Then you came wisely to the conclusion that the break should apply not just to government property, but to all real estate, financial assets, stocks, bonds, equities and formation of new capital. We should eliminate the tax on capital gains, or cut it to 15 percent and index it and let me eliminate it in the inner city.

Statement by Lawrence A. Kudlow

I want to make some analytical points, and then touch on some policy issues. I'm particularly interested in the economic foundation for what I hope will be a period of tax reduction and redirection of fiscal policy.

It is my view that we are in fact entering into a recovery, and I will walk through some numbers on that in a few moments. I make that point (a) because I'm an optimistic person, (b) because the data show it and, most importantly, (c) because I think it would be wise not to hang the hat of potential tax relief on the peg of an ongoing recession. If that forecast turns out to be incorrect, you may lose your peg and your hat. And I feel we have to address longer-term issues in the economy immediately, because we've had this atmosphere which is so anti-entrepreneurial the last couple of years, as Senator Wallop and others have pointed out.

If I had my "druthers," I would also request that we not think of this as getting the economy moving again, or jump-starting the economy. Not that that's wrong particularly, but in its presentation it has a certain Keynesian, quick-fix, demand-side feel to it that may be unsettling to financial markets. More importantly, it is not good economic policy. What we really want to do, if anything, is to jump-start the *incentives* in the economy — to reignite incentives which have been rolled back in recent years to the detriment of business activity and individual opportunities.

"Regulatory increases in recent years have significantly limited the potential of the economy to grow in the 1990s."

I think the most pressing problem we have is the admission by the government under its own economic forecasts of what a lackluster recovery this is likely to be. Not that we won't have a recovery, but that it is an inadequate recovery and is not going to move the economy forward sufficiently to create the jobs, the businesses, the capital and the opportunities.

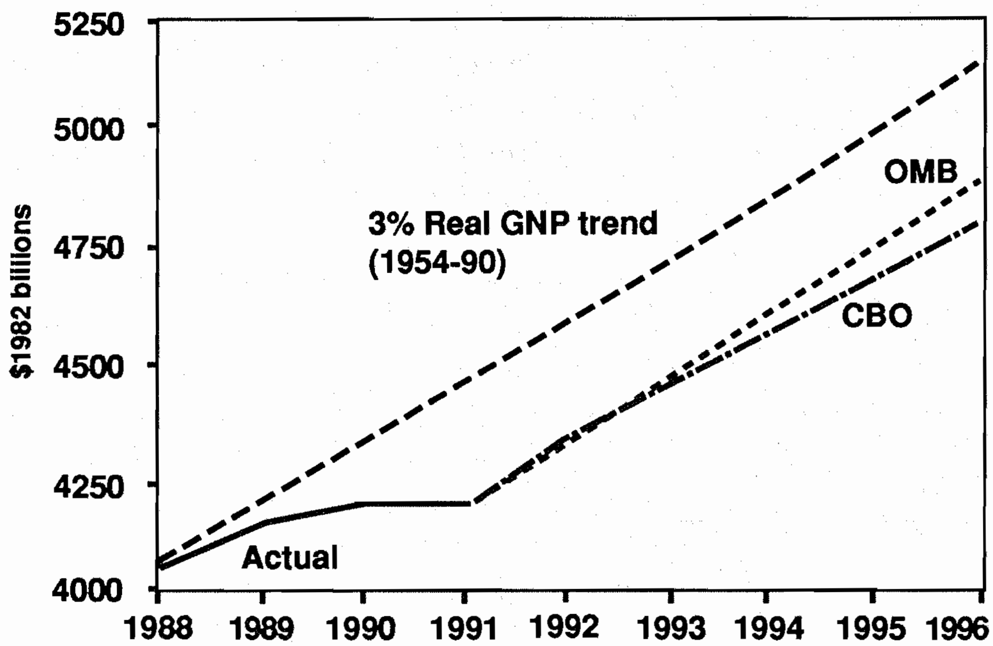
After surveying the financial markets and the economy, it is my view that we are clearly entering into recovery, but there are disturbing signs suggesting a relatively weak rate of recovery by historical standards. In addition, there are very few signs of significant new business formation and job creation, or of any animal spirits or entrepreneurial juices, all of which provided the backbone of the outstanding economic recovery of the 1980s.

Because of a spate of federal, state and local tax and regulatory increases in recent years, the potential of the economy to grow in the 1990s has been significantly limited. Consequently, without a redirection of economic policy, the level of real output in the next five years seems likely to remain

"CBO and OMB forecasts imply a cumulative loss of $1.6 to $1.8 trillion of GNP through 1996."

FIGURE III

Real Gross National Product: Projections



Source: Department of Commerce, Office of Management and Budget, Congressional Budget Office and Bear Stearns.

below the post-World War II path associated with long-term 3 percent real economic growth.

The numbers here are startling. Both the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) are forecasting subpar recovery rates. Compared to the long-run 3 percent postwar growth trendline, OMB's implied estimate is an output loss of $273 billion from the trendline in 1996 and a cumulative $1.6 trillion loss over the 1991-96 period, assuming their 2.6 percent real GNP growth forecast. [See Figure III.]

For CBO the numbers are even worse: a $366 billion loss in 1996 and a cumulative $1.8 trillion loss over the five-year period using a 2.3 percent average growth path. No responsible economic policymaker should accept this subpar record. By my calculations, *the loss of jobs implied by CBO's and OMB's growth projections relative to the long-term trend baseline comes to a whopping 6 million.* That is to say, the level of jobs, the level of non-farm payrolls, would be 6 million below what it should be if we stayed on the long-term growth path which for years and years has been the goal of both Democratic and Republican economists.

This is an unacceptable situation. This is not my own forecast, incidentally. This is what the government is saying after last year's budget deal. They're telling us that this is the best we can do. OMB gives us a slightly more optimistic tilt, but the basic story is the same: we are looking for reduced output of nearly $2 trillion and a lower jobs path of nearly 6 million over the next 5 years under present policy circumstances. Partisan or nonpartisan, there isn't a Democrat or Republican who wishes to go home and face the people and be proud of this.

I think this is the basic reason, Senator Kasten, why we need to undertake these pro-growth tax reforms — not to outguess the economy in the next couple of quarters, not to jump-start it in the fourth quarter, but to deal with this long-term stagnant path which has been outlined by the government itself, by your Congressional Budget Office and by Bush's budget office. It's really quite remarkable, and it is of great concern to me. It is precisely this point which must be immediately addressed in order to prevent a protracted period of U.S. economic stagnation.

"The forecasts imply a whopping 6 million lost jobs relative to the past trend."

Recovery Thus Far

For nearly 12 months, broad stock market indicators have been gradually signaling economic recovery. In real inflation-adjusted terms, the Dow Jones has increased by 15 percent, the S&P 500 by 19 percent and the Nasdaq by 37 percent. These forward-looking stock market movements are principally reflecting the sharp decline of inflation and interest rates, which provide the equivalent economic impact of a significant tax cut.

Inflation has declined from 7 percent in fourth quarter 1990 to just 3 percent in the third quarter of 1991, and as a result short- and long-term interest rates are approaching 20-year lows. These inflation and interest rate developments have been capitalized into higher asset values, thus providing businesses and families with a more solid resource base from which to make more aggressive spending and investment decisions. The rise of financial asset prices and the decline of inflation and interest rates are powerful recovery stimulants which have to a greater extent been ignored by excessively pessimistic media reporters and analysts. Since the fourth quarter 1990, real household net worth has increased by an estimated $600 billion to slightly above its pre-recession high. *Never has the U.S. experienced major interest rate declines and stock market advances during a recession which did not correctly signal future recovery.*

Following on the tax-cutting effects of lower inflation, lower interest rates and higher financial asset values, recent statistical trends on the economy are showing a recovery pattern for consumer spending, business activity and housing. If we looked at the same variables during the last half of 1990, the trends were clearly downward. So there has been a statistical inflection point. There is a recovery out there, although the magnitude of this recovery pattern is somewhat indecisive and lackluster in comparison with the recovery of the early 1980s. Some of the highlights are shown in Table I.

Holes in the Story

"There is a recovery out there, but it is indecisive and lackluster in comparison with the early 1980s."

The principal factor behind the relative sluggishness of the recovery so far is the failure to *reignite new business formation, which is the backbone of the entrepreneurial economy and one of the best indicators of risk-taking animal spirits.* Dun & Bradstreet new business incorporations peaked in the 1986-1988 period at around 66,000 per month, or 788,000 per year, moving up from around 41,000 per month or 488,000 per year in the early 1980s. Through June of 1991 this measure remains 12 percent below its prior peak and shows no rebound so far. Related to this, nonfarm proprietors' income — which measures the strength of self-employed business people — is also

TABLE I

Data Scoreboard

Economic Indicator	Percent Change at Annual Rate from Trough	Trough Month
Industrial Production	**6.0%**	**March**
Purchasing Managers' Survey	**17.3 basis points**	**37.7% in Jan** **55% in Sept**
Durable Goods Orders	**31.6%**	**March**
Durable Goods Shipments	**22.5%**	**March**
Real PCE	**3.9%**	**January**
Housing Starts	**34.7%**	**January**
Building Permits	**34.9%**	**January**
Existing Home Sales	**21.6%**	**January**
New Home Sales	**57.7%**	**January**
Leading Indicators Index	**8.4%**	**January**
Median Existing Home Prices:		
Nominal	**12.8%**	**February**
Real	**10.3%**	**February**

showing virtually no sign of recovery. In real terms, this measure is growing at only 1.6 percent over the last four quarters, following a 1987 peak of 11 percent and a 1983 peak of 17 percent. [See Figure V.]

The continuing weakness of new business formation and proprietors' income holds the key to the weak payroll employment figures reported so far this year. Since its trough in April, nonfarm payrolls have increased by only 0.5 percent at an annual rate, and this anemic rise can be directly traced to the lack of new business creation. When the 1982-90 expansion generated over 18 million new jobs, more than 90 percent of these new jobs were created by small businesses and new businesses. People forget that the largest American companies have been downsizing and restructuring for years; it was not this established corporate sector which created the job surge of the last decade.

"The growth of new business formation and proprietors' income continue to be sluggish."

Now not only has overall employment growth stagnated, but minority employment appears to have come to a halt. Black unemployment, for example, which dropped from 21 percent in 1983 to 10.6 percent in May 1990, stands currently at 12.1 percent through September 1991. For Hispanics, the unemployment rate dropped from 15.7 percent in 1982 all the way to 6.8 percent in 1989, but during this recession has increased to 11.1 percent. From 1982 through 1987, Hispanic new business creation rose by 80.5 percent, and new businesses owned by blacks increased by 37.6 percent. While more recent data are not yet available, the disappointing unemployment rates in these minority areas suggest that minority entrepreneurship has sagged.

Summing Up the Economy

Taking all this into account, my outlook for the next six quarters suggests a 3 percent recovery rate for real GNP. This is certainly an improvement over the 0.6 percent average annual rate of GNP growth over the past ten quarters, stretching from fourth quarter 1988 to second quarter 1991. It nonetheless compares quite unfavorably with historical performance over the past eight postwar cycles, where real GNP growth averaged 5.7 percent during the first six recovery quarters. In other words, even a relatively optimistic view suggests that the U.S. economy will post only about one-half the rate of a normal recovery cycle.

"The outlook for the next six quarters suggests a 3 percent growth rate — compared to 5.7 percent during a normal recovery."

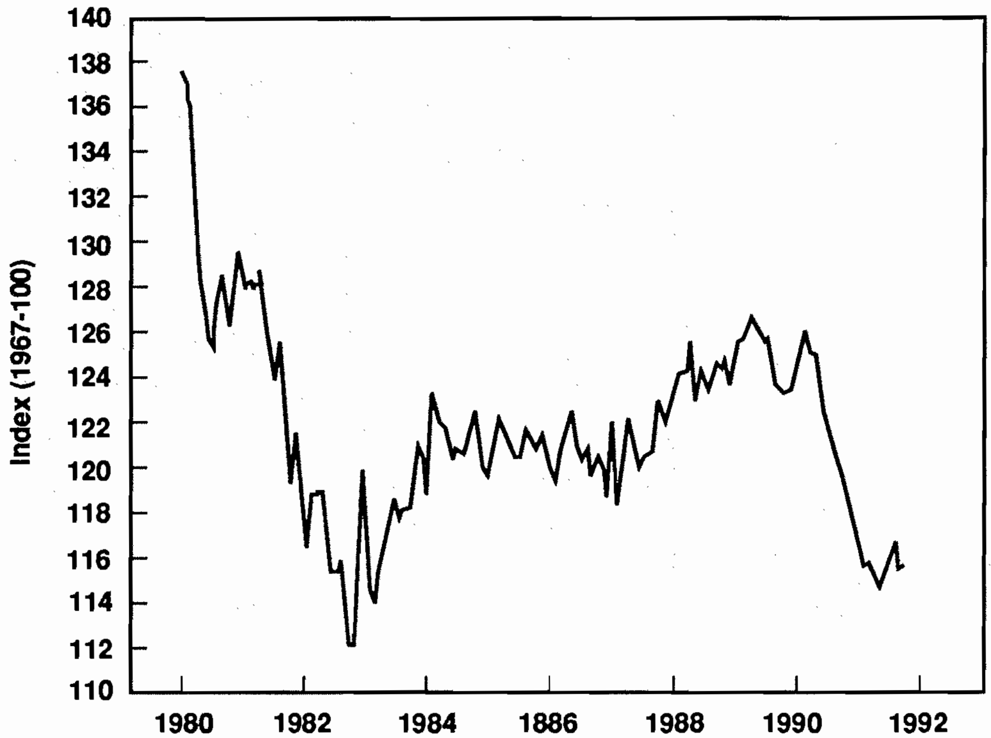
What's Wrong Here? It's Not The Fed

While administration spokesmen continually bash the Federal Reserve for easier money, the fact remains that monetary policy has been near-perfect in recent years. By modernizing Fed policy in the direction of a domestic commodity price rule, including gold, to restore a predictable standard of

"The sluggishness of the recovery is due to the failure to reignite new business formation."

FIGURE IV

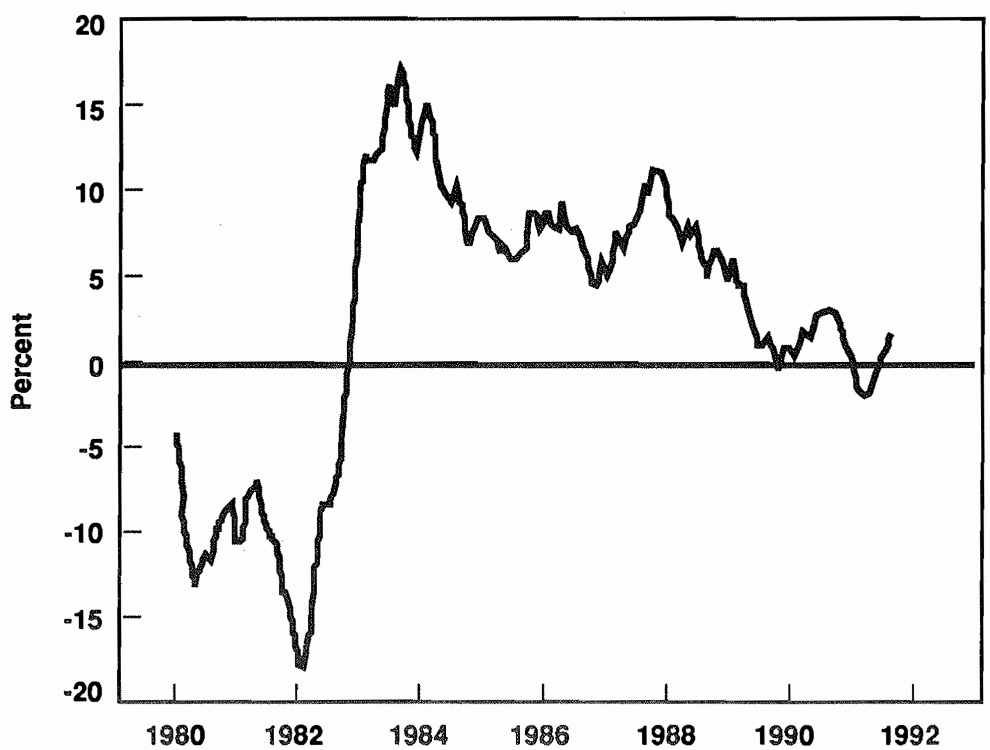
Index of Net Business Formation



"The income of self-employed people is showing virtually no sign of recovery."

FIGURE V

Real Nonfarm Proprietors' Income



value, Greenspan & Company have managed to bring interest rates down to nearly 20-year lows without reigniting inflation or inflation expectations.

Since the spring of 1989 the federal funds rate has fallen by nearly 50 percent, from just under 10 percent to just over 5 percent. Longer-term rates such as the Treasury 10-year note have dropped from roughly 9 1/2 percent to around 7 1/2 percent. Fixed-rate mortgage yields have fallen below 9 percent, while adjustable rate mortgages have recently dipped under 7 percent. This has all been made possible by a substantial decline of reported inflation, with the year-to-year change in the Consumer Price Index falling from 6.4 percent to 3.4 percent, and the Producer Price Index from 7 percent to 0.7 percent. Gold prices this year have been ranging steadily between $350 and $375, while the widely followed CRB futures index has ranged between 210 and 220. Meanwhile, the exchange rate of the dollar also has been fluctuating in a relatively narrow range.

Going forward, it is essential that the Fed continue to target inflation-sensitive market prices in order to maintain credibility and confidence in the Fed's goal to achieve long-term price stability. In particular, I believe the movement of long-term interest rates — which are subject to the financial markets' expectations of longer-run inflation — are even more important than short rates with respect to future economic growth. Long-term rates are crucial to business and individual investment decisions, debt burdens and balance sheets and, of course, the important housing sector. Stable or lower long-term rates can be achieved only through stable long-run price expectations.

"Monetary policy has been near-perfect in recent years."

The best part of macroeconomic policy in recent years has been the steady conduct of monetary policy. By bringing down price expectations and interest rates, the *Federal Reserve has generated a powerful tax cut effect to promote economic growth.* This is the single largest factor in my anticipation of at least a mild economic recovery. However, should the Fed be forced into an easy money position, then long-term interest rates and inflation would soon rise, creating a tax increase effect which would abort the recovery and send us back into double-dip recession. Hopefully, the Fed will continue its adherence to market price-level targeting, which is the only way to effectively balance money supply and money demand.

As an important sidebar, a properly crafted tax-cut program will make the Fed's counter-inflation job easier. Supply-side tax cuts will increase the output of goods and services, thereby rendering the same growth of the money supply less inflationary, since it will be chasing *more* goods.

What's Wrong Here? Fiscal Policy

"A whole series of misbegotten steps has created an atmosphere which is anti-entrepreneurial, anti-risk taking and anti-growth."

A series of mistaken fiscal decisions in recent years has created an atmosphere which is anti-entrepreneurial, anti-risk taking and anti-growth. A whole series of misbegotten steps helped set the recessionary stage. In 1989, a savings and loan bill made the problem worse, devalued the franchises and sent a chilling regulatory signal. Then came the breakdown of the capital gains tax relief plan. Then in 1990 came a highly burdensome and expensive Clean Air Act, along with a spate of burdensome environmental regulations or regulatory threats including the spotted owl, toxic waste, nuclear waste, disabilities and CAFE fuel standards.

Environmental regulation has increased at a significant pace, now comprising 38 percent of the entire regulatory budget. The EPA budget has increased by 31 percent in the last three years and staffing has expanded by 23 percent, according to a recent study sponsored by Washington University. After sharp cutbacks during the Reagan Administration, Federal Register pages have increased from 55,000 towards 70,000. All this has created tall barriers and substantially higher costs for all forms of commerce and investment.

Then came the disastrous November 1990 budget deal, ending a six-month period during which senior officials in the White House and the Congress continuously discussed in public various tax raising schemes. Together, this had a debilitating effect on consumer and business confidence, calling a halt to the vital animal spirits and entrepreneurial juices so essential to the workings of a vibrant free enterprise economy. Taking their cue from the federal debate, more than half the states and numerous cities around the country substantially increased taxes on income, sales and property.

"If the economy is to revive and reach its full potential, recent fiscal policy decisions must be completely reversed."

If the economy is to revive and reach its full potential in the 1990s, recent fiscal policy decisions must be completely reversed. I believe this is possible, and I remain an optimist with respect to the current opportunity to take strong steps toward an *across-the-board* tax cut program, which would encompass all income classes and business categories and would be financed by added revenue generation from accelerating economic growth as well as budgetary cost savings from a suitably lower U.S. defense budget. Some proposals from a working group in which I am participating are:[28]

- Capital gains rate reduction, indexation and tax-free rollover provision.
- To assist middle income taxpayers, a sizable increase in the earned income tax credit (EITC).
- Increased personal exemptions and child care tax credits.
- For businesses, an investment tax credit (ITC), which will effectively accelerate capital cost recovery and lower the corporate tax rate.
- For commercial real estate, restoration of the active investor loss provision, which will permit full-time real estate professionals to deduct expenses against losses.
- Expanded Bentsen-Roth IRAs.
- Repeal of the luxury tax.
- Establishment of enterprise zones.

Optimism and Leadership

I do not pretend to have all the wisdom on a comprehensive tax-cutting package. Undoubtedly there are other permutations and combinations or new ideas which will make good economic and political sense. But I believe that these proposals constitute a solid pro-growth incentivizing reform package, providing *across-the-board* tax relief to all segments of the population.

"Capital gains reform by itself does not constitute a serious tax policy."

This is a key point. For as much as I favor capital gains tax relief, which would help new business creation, provide enhanced capital access for the "have nots" — especially those in poverty-stricken urban areas — and raise real estate asset values and thus reduce the cost of the S&L and bank bailout programs, and lower capital costs in line with our foreign competitors, I do not believe that capital gains reform *by itself* constitutes a serious tax policy.

As a single issue, it would not clearly stimulate economic recovery throughout the nation in a way that all citizens and taxpayers can clearly and readily understand. It strikes me that many of us have forgotten that the original Kemp-Roth concept more than 10 years ago provided tax rate relief to all Americans. Because of the evenhandedness of the original Kemp-Roth proposal, the more people found out about it, the more they favored it. This is why its early legislative defeats continued to generate wider and broader support, eventually ending in victory.[29]

I don't know why we've lost this. It is my great regret that the White House in the last three years — by selling capital gains as a standalone issue, "*The budget deal is the biggest barrier standing between us and a serious tax-cutting reform.*"

and not really selling it much at all — has done enormous damage to the cause of capital formation and tax cuts. I'm arguing for a broad tax policy for the Republican party which clearly impacts all the categories of people and business in this country, across the board. Across the board. And inside that should be some solid capital gains tax reform, so that at the end of the day you're doing two, or maybe three things. You are putting new incentives into the economy; you are providing the wherewithal to get our long-term growth and jobs back on track, and you're also showing people that Republicans care about everybody, that we know a lot of people need relief and help out there, and we want to do it the right way.

My other point is this: get off the bloody budget deal.[30] It is just nothing more than a tax trap. It is the biggest barrier standing between us and serious tax-cutting reform. *Get off the budget deal.* I'm glad Senator Bentsen buried it on Sunday. I was quite happy to hear that. If you ask the average American which is more important, your job or the budget deal, what do you think he's going to say? If you ask the average American which is more important, the future of your family or the budget deal, what is he going to say? Let's look at it politically. Every time I see a White House spokesman defend the budget deal, every time I see a senator, every time I see a congressman, you know what their message is? We're going to preserve the budget deal — no tax relief, no long term growth, no enterprise. It's that simple.

I have worked with Jack Kemp on a metaphor. If the classic ratio for the budget is budget outlays as a percentage of Gross National Product, with outlays as the numerator and GNP as the denominator, let's not waste our time with the numerator. Let's work on the denominator so we can grow the economy faster and then there won't be any demand for the numerator. Not in our lifetime are we going to strip away large chunks of that budget.

"*So far, neither Republicans nor Democrats nationally have fully embraced the anti-corruption, anti-tax and anti-government revolt brewing at the local level.*"

Additionally, I do not believe that an attitude of excessive economic pessimism is necessarily the cleverest way of achieving much-needed tax relief to spur economic growth. Nor do I believe that permanent tax reduction should be tied to some near-term numerical point estimate of the economy. We ought not to be proposing Keynesian quick fixes. Instead, we should seek tax relief because it is good tax policy which will grow the economy and create capital and jobs over the longer term. Indeed, a pro-growth tax package such as this could well push real GNP growth to 4 or 5 percent in 1992 and 1993. The Dow could reach 4000.

Finally, I believe that optimism is an essential tool. Optimism is the very essence of leadership. We have a vision of enhanced individual creativity and inventiveness and opportunity and prosperity for all income levels, business segments and geographic locations. I firmly believe that the public at large has an innate sense of optimism that problems can be solved; but the electorate is waiting to line up and follow the right leadership and the right vision. So far, neither Republicans nor Democrats at the national level have opened their arms to fully embrace the anti-corruption, anti-tax and anti-government revolt that is brewing at the local level. We have a unique opportunity to flesh out an optimistic vision of tax cutting and governmental reform.

Discussion

SENATOR LOTT: Could you give us a couple of examples of the wrong kind of tax cut? Of course, I think I know the right kind, but cite some examples because that is an important point.

MR. KUDLOW: The wrong kind of tax cut is a temporary quick fix which does not change the rate structure, which does not effect incentives, but which merely puts money into people's pockets for a short period of time, presumably to spend or consume. This kind of tax cut will not increase the output of goods and services, it will merely raise the level of demand. The Ford rebates in the 1970s — and there were a couple of them if I am not mistaken — all that kind of thing does is front-load demand on to the system by borrowing in the capital markets. The money is transferred. It does not create any new incentives through rate relief. That's absolutely wrong. Now that hasn't been proposed. But something that sounded a bit like it was proposed on Sunday, so that needs to be covered.

"The wrong kind of tax cut merely puts money into people's pockets for a short period of time."

Obviously the right kind of tax cuts will change the incentive and reward structure for labor and capital, so that I have an incentive to work harder and produce more or to invest more in order to get a higher rate of return. And if I can raise my capital, and I can raise my output, that is disinflationary. If the classic definition of inflation is too much money chasing too few goods — more money, less goods, that's higher prices, that's inflationary — the trick is to keep money steady by tying it to a commodity standard of some kind and generating fiscal policy which will reincentivize and lower capital and labor costs so that the entire economy is producing more goods and services. That makes the same dollar worth more, with more opportunities, more competition, more goods to chase. That will bring inflation down.

Now, I believe that is partly what happened in the early 1980s. At the time the tax cuts were proposed in early 1981, the inflation rate was in double digits. All the Keynesians — all the Brookings economists, Charlie Schulz, Walter Heller, James Tobin, the whole gang — said the inflation rate was going to go from 12 percent to 20 percent. What happened was the inflation rate went from 12 percent to 3 percent. And there is a long story associated with that, but you've got to keep that point in mind. You are actually helping the Fed to control inflation, and to make long-term interest rates stable or lower, with a constructive, pro-growth, incentive-oriented tax cut.

Statement by Gary Robbins

Despite claims that the current recession has been mild and, according to some, already over, its impact on jobs and incomes has been very serious. By the end of June 1991:

- The current recession had cost 1.5 million jobs relative to the prior peak employment level. Employment to date is 5.4 million below the economy's trend line.

- Had the economy continued on trend, those jobs would be producing another $254 billion in real GNP (expressed in 1982 dollars).

The economy has continued to deteriorate further since June. The cumulative loss in real GNP through the second quarter relative to its prior peak level now stands at $217 billion.

"The economy is in serious danger of reverting to the slower growth 'malaise' of the late 1970s."

During the past six quarters the U.S. economy has lost 3 percent of real GNP due to the downturn. The average aftertax income of U.S. families has fallen by exactly the same amount as it would have if federal taxes had increased by 15 percent. Moreover, specific individuals affected are those who can least afford the income loss — the newly unemployed, first-time job seekers, including new graduates and the working poor who are generally the first to be laid off. Failure to act to restore growth has levied the cruelest kind of tax on the least fortunate in our society — those who have lost all their income, not just a portion of it.

I would like to address four points today. First, extending the analysis done by Larry Hunter at the U.S. Chamber of Commerce,[31] I will expand on the implications of continued slow growth. I will then review the growth implications of "The Emergency Economic Growth Act," along with some variations that have been considered over the past year. Next, I will examine the effect of the proposal on the growing costs of financial bailouts. And last, I would like to offer some results from a forthcoming National Center for

Policy Analysis paper on the impact of taxes on capital — results which bear directly on the question of how to stimulate growth in the near term.

The Return of Malaise

Until the first quarter of 1990, the economy had shown an extremely steady growth of about 3.3 percent over the prior five years. Since then there has been virtually no growth. A number of factors have combined to slow the economy:[32]

- A substantial Social Security payroll tax rate increase combined with an unexpectedly large increase in covered earnings has raised the tax on working and raised the cost of hiring labor.
- Increased regulations, most notably in the environmental area, have increased future costs of production.
- State and local governments have increased tax rates to offset a drop in the *rate of increase* in their revenues.
- Federal government spending and tax rates increased as a result of last year's budget summit.
- The attractiveness of home ownership and commercial real estate dropped dramatically as the real estate market absorbed the "hit" of a substantial, retroactive increase in capital gains tax rates.

"The causes of the recession are unwise government policies."

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

Unless we remedy the causes of the current downturn, our economy faces a permanent reduction in its rate of growth. There even seems to be a growing consensus that after it recovers, the economy will be considerably less robust than it was during the mid- to late 1980s. With the return to higher levels of regulation, government spending and taxes, combined with a looser monetary policy, the economy is in serious danger of reverting to the slower growth "malaise" of the late 1970s.

Getting There From Here

To illustrate the implications of slower growth, consider the following economic scenarios. Starting from the second quarter of 1991:

- If, instead of growing at the previous trend rate —3.3 percent from 1985 through 1989 — real GNP grew by 2.5 percent, we would lose nearly half a year's income over the next five years, or $2.3 trillion. By the end of 1996, real GNP would be $500 billion below the previous trend and the gap would be widening. [See Figure VI.]

- If the economy grows at 3.3 percent without the typical recovery spurt, the loss in real GNP would be $1.8 trillion over the next five years. By the end of 1996, real GNP would be $305 billion below the previous trend. [See Figure VII.]

Even if we return to the old trend rate of growth, we will lose more than one-third of a year's GNP and output will be permanently lower by 5 percent. This would have the same effect on aftertax family income as a 25 percent increase in federal taxes. [See Figure VIII.]

To attain the level of GNP projected by the old trend growth, the economy would have to grow by an average of 5.4 percent over the next three years. Thus far, the current downturn is roughly half the GNP loss of the 1981-82 recession and equal in terms of job loss. Recovery periods generally experience very rapid rates of growth. [See Figure IX.] This recovery, however, is expected to be much slower than others, presumably because the recession is "mild." Among the real reasons for a lackluster recovery, however, is the fact that marginal tax rates are rising, while in the early 1980s they were falling.

Lost Jobs

The most significant social concern during a downturn must be workers who are either displaced directly, discouraged from looking or facing a soft demand for their services. The slower economy results in lower take-home pay as well as fewer available jobs. There is literally no way to insulate the worker from a downturn in production. Workers are a significant part of variable costs which must be reduced during hard times. Recessions mean lost output *and* lost job opportunities. This is the directly visible social cost of a downturn.

"To date we have lost nearly 5.4 million jobs relative to the rate of job growth during the previous five years."

To date, we have lost nearly 5.4 million jobs relative to the rate of job creation during the previous five years. By August, we were 1.9 million jobs below the prior peak employment level. The economy has lost forever nearly 5.2 million man-years of labor, and workers have lost the income they would have earned doing that work. The real outrage is not that unemployed workers have run out of benefits but that they have been deprived of job opportunities. Given a choice between unemployment benefits and the opportunity to earn

"A 2.5 percent growth rate implies a loss of 9 million jobs, relative to the previous trend."

FIGURE VI

Potential GNP Loss With Low Growth

Prior Trend Growth vs. 2.5 Percent

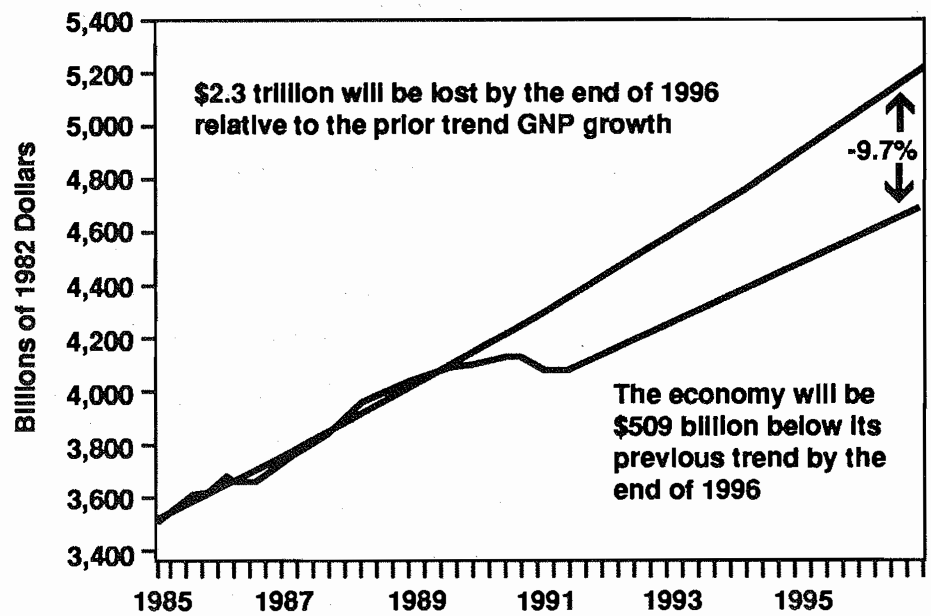
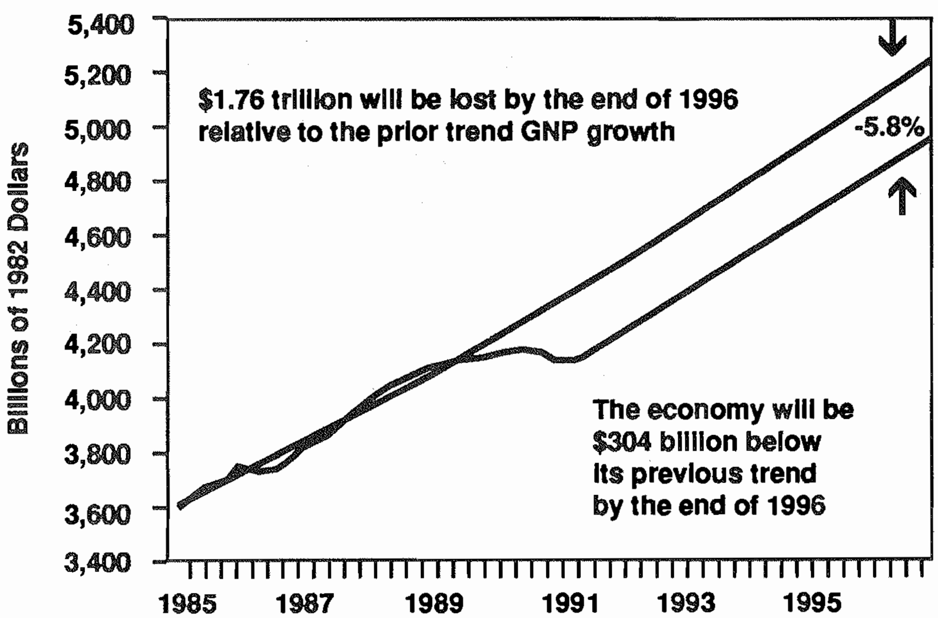


FIGURE VII

Potential GNP Loss With Low Growth

Prior Trend Growth vs. No Catch Up



"The growth rate during the recovery must be 5.4 percent to return to the previous trend."

FIGURE VIII

Potential GNP Loss With Low Growth

Prior Trend Growth vs. Normal Recovery

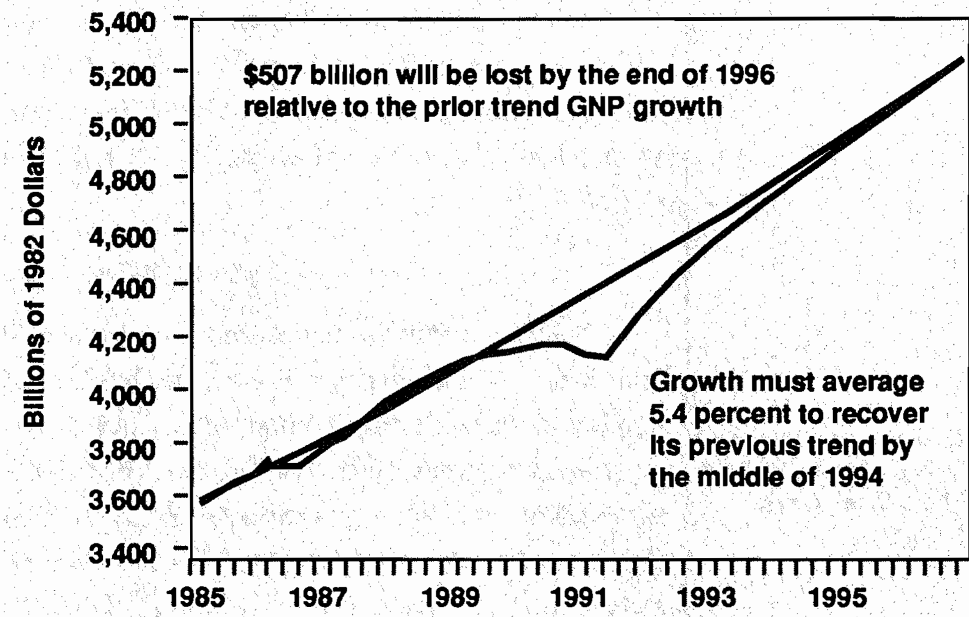
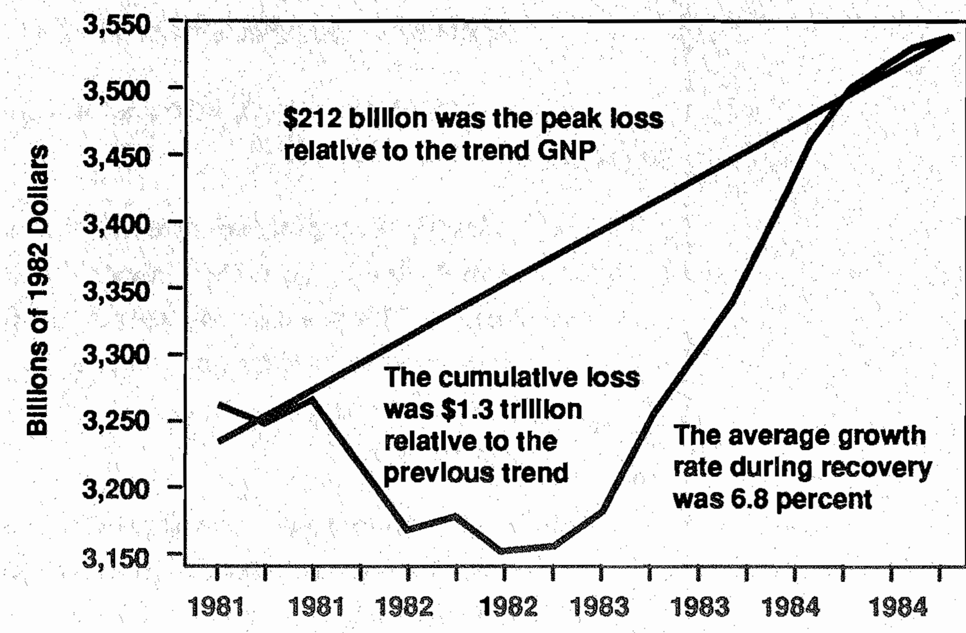


FIGURE IX

GNP Loss During the 1982 Recession

Deviation from Trend Growth



significantly more through work, I believe the choice would be for the chance to work. Further, the lost labor income is many times the amount of unemployment benefits arising from a rise in the unemployment rate.

Similarly, a slower than normal GNP recovery will mean a slower than normal creation of jobs in the future. If real GNP grows at 2.5 percent, there will be 44 million man-years lost from 1990 through 1996. We are talking about a loss of *9 million jobs* relative to our prior rate of job creation by the end of 1996.

Growth Incentives

"The Gramm-Kasten-Wallop proposal would increase GNP by $337.2 billion over the next five years."

Senators Phil Gramm, Robert Kasten and Malcolm Wallop have introduced "The Emergency Economic Growth Act." The bill contains a number of work, saving and investment incentives including a reduction in the capital gains tax rate, inflation-indexing for capital gains, an IRA Plus plan, home ownership incentives and a reduction in the penalty on work imposed by the Social Security earnings test. We estimate that the proposed bill would have a positive impact on the economy.[33] Specifically, it would:

- Increase GNP by $337.2 billion (expressed in nominal terms) over the next five years. By the year 2000, GNP would be over $1.4 trillion higher.
- Increase employment by almost 500,000 over the next five years. By the year 2000, employment would be over 1.1 million higher.
- Increase the stock of U.S. capital by over $1.7 trillion (expressed in nominal terms) over the next five years. By the year 2000, the capital stock would be almost $3 trillion higher.

Two other measures could be considered in addition to those contained in the proposed bill. They are:[34]

- Indexing tax depreciation for inflation and the time value of money as in the bill proposed by Senator Wallop and Congressman DeLay. This provision could provide the equivalent stimulus of an immediate $100 billion business tax cut — several times the stimulus of the proposed capital gains cuts — with no immediate revenue loss.
- Further lowering the capital gains tax rate to 15 percent, as proposed last year by Senators Robert Kasten, Connie Mack and Richard Shelby, would raise even more revenue as people unlock their capital gains in the short term.

Financial Bailouts

"The capital gains tax rate reduction proposed by President Bush last year would lower the S&L bailout cost by almost $6 billion."

Stimulating economic growth, particularly through a lower capital gains tax, would have an immediate beneficial effect on real estate values.[35] This, in turn, would reduce the cost of the savings and loan bailout. We have estimated that the reduction in the capital gains tax rate proposed by President Bush last year would:

- Lower the S&L bailout cost by 4 percent ($5.8 billion assuming the cost is $150 billion).
- Reduce potential RTC real estate value losses by $4 billion.

Adding inflation-indexing of capital gains as contained in "The Emergency Economic Growth Act" would:

- Lower the S&L bailout cost by 14 percent ($20.8 billion assuming the cost is $150 billion).
- Reduce potential RTC real estate value losses by $9.9 billion.

A reduction in the capital gains tax rate to 15 percent and indexation of capital gains for inflation would:

- Lower the S&L bailout cost by 16 percent ($23.2 billion assuming the cost is $150 billion).
- Reduce potential RTC real estate value losses by $11.9 billion.

These bailout cost estimates do not address the losses which are building in commercial banks — banks that hold roughly the same level of real estate investments as savings and loans. Insurance companies hold about one-third the level of real estate investments as S&Ls.

Typically, it is the real estate and financial sectors that are most influenced by attempts of the Federal Reserve to reduce interest rates. In the current circumstance, the capital gains tax increase has worked against this traditional monetary tool for boosting economic growth. In contrast with earlier periods, Fed expansion of the money base has not been translated into an expansion in M2, its target. The Fed has been thwarted because, unlike in the past, the risk of higher inflation and, therefore, higher capital gains taxes have offset potentially lower financing costs. The 1986 capital gains changes have directly reduced the ability of the Federal Reserve to affect economic growth.

The Benefits of Capital

The wages of workers and the stock of capital are inescapably linked. The only way that the real wages, and thus the well-being, of workers can rise is if they have more capital with which to work. Furthermore, most of the benefits from capital accumulation flow to people in their role as wage earners, rather than to the owners of capital.[36] [See Figure X.]

- For every additional dollar of sales generated by an additional unit of capital, the private sector keeps 47.4 cents while governments take 43.6 cents. The remaining 9 cents goes toward replenishing the used capital.
- The private sector's share goes primarily to labor, which receives 43.7 cents of the additional dollar of sales. Owners of capital, on the other hand, receive only 3.7 cents.
- In other words, workers get to keep $12 in aftertax wages for every $1 of additional aftertax income to owners of capital.
- Similarly, federal, state and local governments receive $12 in additional tax revenues for every $1 of additional aftertax income to owners of capital.

"Workers get to keep $12 in aftertax wages for every $1 of additional aftertax income to owners of capital."

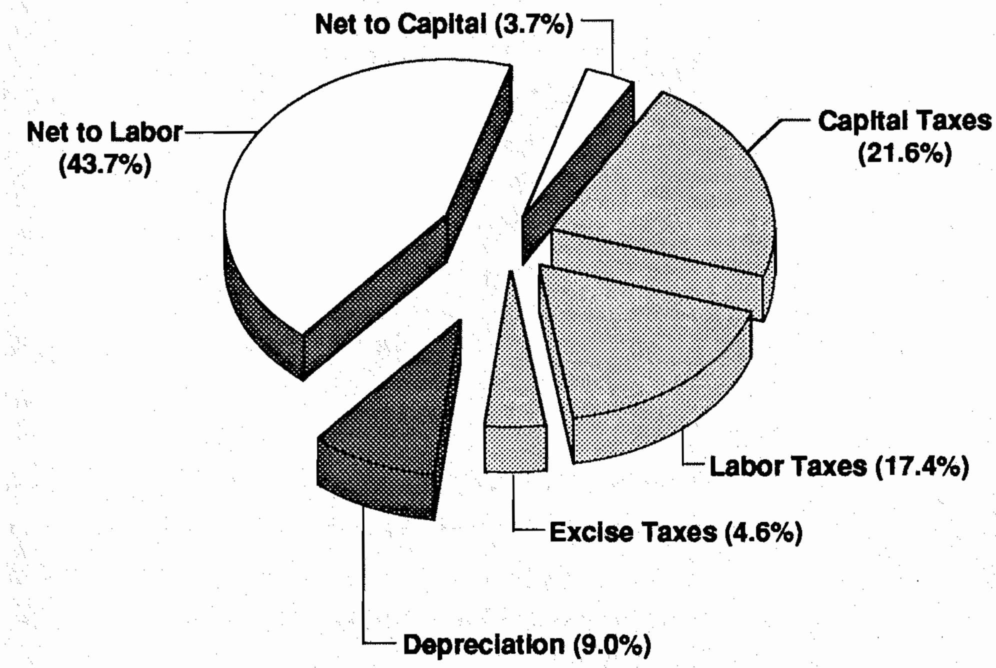
Reducing the tax rate on capital will be rapidly translated into an increase in the stock of capital sufficient to bring the temporarily higher rate of return on capital back down to its long-term level. The distribution of the increased GNP resulting from the higher level of capital will be in the proportions just outlined.

In today's political debate, it is common for some to assert or imply that taxes on income from capital only affect the well-being of the rich. For example, those who argue for a higher tax rate on capital gains frequently imply that the rest of us will be better off because the rich will bear a larger share of the burden of government. They unfortunately ignore the fact that less capital means lower wages for everyone, even those who own no capital.

Workers and government stand to lose even more income in the near term if some growth measure is not adopted. An additional $2 trillion loss in GNP over the next five years would mean almost 40 million lost man-years of labor and $875 billion in lost compensation. Furthermore, the federal government stands to lose $520 billion in foregone revenues while state and local tax revenues will be $350 billion lower. In the face of these potential losses, it is hard to ignore the need for a pro-growth program.

FIGURE X

Proceeds of Additional GNP



"Government gets $12 in additional revenue for every $1 of additional aftertax income to owners of capital."

APPENDIX

Prepared Statement by Secretary Jack Kemp

Senator Kasten and members of the Task Force on Economic Growth, it is a pleasure to appear before you today to discuss the Emergency Economic Growth Act of 1991, commonly known as the Gramm-Gingrich bill. Your proposals to reduce the tax on capital gains, provide incentives for the creation of Enterprise Zones and allow the use of IRAs for first-time home buyers are dear to the heart of the Administration and this Secretary of HUD.

It is refreshing to see some in Congress promoting the idea of economic growth and job creation. For the majority party in Congress, the only response to the slow economic growth is to propose ways of dividing what they see as a shrinking economic pie. They view the economy as static, with only so much wealth to go around. This is the same approach that has led us to spend more than $2.6 *trillion* since 1965 at all levels of government on the types of welfare programs that have done little more than perpetuate the very dependency and hopelessness they were intended to relieve.

This kind of limited thinking is represented by the recent debate over extending unemployment benefits. No one questions the need to help the long-term unemployed get through tough economic times. But extended unemployment assistance is not an economic policy. To propose merely extending their government benefits is an embarrassing and unconscionably inadequate response to the plight of these American workers. Unfortunately it is typical of those in Congress whose first impulse is to reach for the same short-sighted, government-oriented policies that have failed us in the past. They seek to treat the symptoms of the problem but not the disease itself. Extending government unemployment benefits will not create a single new job — either in the inner cities or anywhere else. But that seems to be all the present congressional leadership has to offer.

"We have spent $2.6 trillion since 1965 on the types of welfare programs that perpetuate dependency and hopelessness."

We are living in perhaps the most exciting and challenging time in history. Think back just ten years. When Ronald Reagan and George Bush came into office, communism was advancing on every front. The Third World was mesmerized by Soviet power and caught up in the myth of centralized economic planning. But democracy survived. It has come through this century not weakened, but grown strong. The United States has been the model for all that has happened in Eastern Europe, the Soviet Union, Asia and Latin America.

Yet we cannot in good conscience claim that America has totally fulfilled its mission. Not when the American dream remains out of reach for too many low-income families. This is our next great challenge: to expand the reach of American prosperity — to make our nation an example for all the world in what President Bush has called a Pax Universalis.

The president believes we must inaugurate a new era of boundless economic opportunity and growth for all people. It is time for a new round of 1981-style tax rate cuts in capital and labor — new incentives for risk-taking and entrepreneurial growth, this time paying particular attention to the classic American formula for escaping poverty. We must commit ourselves to waging — and winning — a new war on poverty guided by the logic of marketplace incentives which strengthen the link between effort and reward.

The Gramm-Gingrich bill we are discussing today takes just that approach. It would create jobs, greater opportunity and expanded growth for all in our society. Instead of redirecting the way wealth is distributed, this bill promotes the conditions that create wealth in the first place.

One of the best ideas the bill adopts is the president's proposal to cut the tax on capital gains. This country has always thrived on growth and

"When the capital gains tax rate was reduced from 49 percent to 20 percent, investment seed capital increased almost a hundredfold."

opportunity. Millions of Americans escaped poverty and helplessness by acquiring assets and property, starting a business, owning a home. The key to this kind of growth is to again open the flow of entrepreneurial venture capital that was locked up by the liberal Democrats' huge 65 percent increase in the capital gains tax in 1986. If there is anything that highlights the differences between Democratic and Republican philosophies, it is the way we respond to sluggish economic growth. President Bush has rightly said we must respond by creating millions of new jobs. And you cannot create employees without first creating employers.

The tax on capital is a tax on the ability of Americans to create new wealth; it is a tax on the American Dream. Stifling tax rates have driven up the cost of capital to the point where even Jesse Jackson has said that you can't have a "capitalistic economy with no capital." But his Democratic party sees the capital gains tax as just another tax, which they think affects only the wealthy. The administration and its supporters in Congress see it as a tax on innovation, risk-taking and job creation, and thus a tax on the poor, the jobless and the future of the nation.

Under the current capital gains tax, we will have to continue to settle for a meager 1 percent or 2 percent economic growth each year when we need a decade of 4 percent and 5 percent annual growth and a doubling of our economy by the end of the century. As Abraham Lincoln said, "You cannot help the wage earner by pulling down the wage payer."

Both experience and common sense show us that an expanding economy *increases* income to the government as well as provides opportunity and a better life for our people. Government revenues steadily increased during the growth years of the 1980s, and there is no reason we should stop there. A $10 trillion economy gives us another $250 billion in revenues which the government can use to rebuild roads and bridges, help educate our children and clean up the air and water.

From 1978 to 1986, when the capital gains tax rate was incrementally reduced from 49 percent to 20 percent, investment seed capital — the lifeblood for the entrepreneur — increased almost a hundredfold. At the same time, federal revenues from capital gains nearly quadrupled from the resulting jump in economic activity. Moreover, the number of black-owned businesses soared, increasing by more than a third in just four years. Blacks, Hispanics and other minorities have the most to gain from a capital gains tax cut because most of their capital gains are ahead of them.

In the worst urban and rural communities, there is no reason for any capital gains tax at all, and even greater incentives should be created for these most needy areas of our country. The Economic Growth Act adopts the president's proposal to create 50 Enterprise Zones over four years all across America. In these zones targeted for growth, capital gains taxes would not exist and a range of other federal tax incentives would be put in place.

"We must flood the inner cities with new capital and new opportunities."

We must flood the inner cities with new capital and new opportunities. We must also introduce private property ownership into the enclaves of urban socialism. Some of the most poverty-stricken neighborhoods in America were built and paid for by the U.S. government. Public housing residents are isolated from the power and private property opportunities of the mainstream economy. Dating from President Lincoln's Homestead Act of 1862, owning property has been the road to success and prosperity in this country. Home ownership is also important to social independence. My friend Representative Mike Espy, an African-American member of Congress from the Mississippi Delta area, put it most eloquently when he said, "Experience has taught us that the person who owns your home controls your life." For this reason, I have made a top priority the HOPE[37] program to give low-income Americans living in public housing the chance to buy their own homes. These families have fallen into the welfare trap; the government owns their homes and, through this and a maze of federal social programs, controls their lives.

While I realize HOPE is not part of the economic growth package, I mention it because it is an essential element of our party's overall effort to empower low-income families. Today, the majority party in Congress is fighting the administration's plan to reduce the cost of capital and promote access to assets as if these were a direct attack on the country and the Constitution. Class warfare rhetoric and the politics of envy have become a substitute for economic policy. The voices of gloom and doom see in our economy the makings of an apocalypse. The response, according to people like Robert Reich of Harvard, is massive new federal spending for education, job training and road-building, all channeled through the ever-growing federal bureaucracy. In other words, make the 1990s look like the 1970s, complete with stagflation, low productivity and high taxes. This approach can only make America poor, not rich. You cannot help the poor when the nation is getting poorer.

Now is not the time to turn back to the failed politics of economic limits and timid aspirations. We must seize this opportunity to make the revolution of democratic capitalism complete in this country. Now is the time to follow the logic and heed the results of the 1980s — to unlock our nation's greatest source of wealth, the American entrepreneur, and unleash our greatest asset, our people and their dreams. Mr. Chairman, you and Senator Gramm, with Newt Gingrich and others, are doing this country a great service by focusing on the powerful and compelling alternatives to the appalling lack of vision that plagues the majority party in Congress.

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] Editor's note: Senators Phil Gramm, Robert Kasten and Malcolm Wallop have introduced "The Emergency Economic Growth Act," which includes a reduction in the capital gains tax rate, inflation indexing for capital gains, an IRA Plus plan (which allows aftertax deposits and tax-free withdrawals), home ownership incentives and a reduction in the penalty on work imposed by the Social Security earnings test.

[2] Editor's note: Senator Lloyd Bentsen has proposed (1) a tax credit of $300 per child, (2) expanded rights to make contributions to IRAs and (3) penalty-free IRA withdrawals to pay for a first home, college tuition or costly medical expenses. These proposals would be financed by a reduction in defense spending.

[3] Editor's note: Senator Gramm and Representative Gingrich have proposed the "Economic Growth Act," which includes a capital gains tax reduction with indexing, enterprise zones, an IRA Plus plan, a roll back of the Social Security earnings penalty, home ownership incentives and the elements of the Peace Dividend Investment Act described above (with tax reductions in the form of an increase in the personal exemption).

[4] Editor's note: Senator Malcolm Wallop and Representative Tom DeLay have proposed a capital gains tax cut with indexing, depreciation indexing, a decrease in the payroll tax (returning the Social Security system to pay-as-you-go), an IRA Plus plan and a roll back of the Social Security earnings penalty.

[5] Editor's note: The Joint Committee on Taxation (JCT) and the Congressional Budget Office (CBO) forecast the effects of legislative proposals using "static analysis" — an approach which generally assumes that changes in incentives do not change behavior or affect economic growth. For an analysis of static forecasting see Gary Robbins and Aldona Robbins, "Prejudicing the Policymaking Process: The Importance of Economic and Budgetary Forecasts," Institute for Policy Innovation, IPI Report No. 106, September 1990. For an analysis of how the JCT and CBO analysis of taxes on investment income are inconsistent with economic experience, see Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, forthcoming.

[6] Editor's note: A proposal made by George McGovern in the 1972 presidential campaign would have called on the federal government to give every American $1,000. The proposal would have been funded by a progressive income tax.

[7] Editor's note: Senator Albert Gore and Representative Tom Downey have proposed to replace the personal exemption for children with an $800 tax credit to be paid for by increasing income tax rates on above-average income taxpayers — including establishing a 38 percent tax bracket.

[8] Editor's note: In 1981, when the highest marginal tax rate was 70 percent, the wealthiest 1 percent of taxpayers paid 18 percent of total income taxes. In 1988, at a tax rate of 28 percent, their tax share had increased to 27 percent. See Aldona Robbins and Gary Robbins, "Tax Fairness: Myths and Reality," National Center for Policy Analysis, NCPA Policy Report No. 90, March 1991.

[9] Editor's note: The Steiger capital gains tax cut in 1978 increased the amount of capital gains excluded from taxation from 50 to 60 percent.

[10] Editor's note: The right of taxpayers to make tax-favored contributions to IRA accounts would be restored. People could take a tax deduction for the contribution, or they could make aftertax contributions, with the right to make tax-free withdrawals at the time of retirement.

[11] Editor's note: See the references at note 17.

[12] Editor's note: Both the Joint Committee on Taxation and the Congressional Budget Office have consistently maintained that a change in the capital gains tax rate will not affect investment. One consequence of this position is that the JCT and the CBO predicted that capital gains income would continue to rise, rather than fall (as it actually did) as a result of the capital gains tax increase passed in the 1986 Tax Reform Act. For 1989 and 1990, both agencies over-predicted capital gains income by 50 percent. See Representative Dick Armey and the Joint Economic Committee Republican Staff, "Distorting the Data Base: CBO and the Politics of Income Redistribution," April 1991. For the CBO's views on capital gains taxes, see Congressional Budget Office, "Effect of Lower Capital Gains Taxes on Economic Growth," CBO Papers, August 1990. For the JCT's views, see Joint Committee on Taxation, "Explanation of the Methodology Used to Estimate Proposals Affecting the Taxation of Income from Capital Gains," Washington, DC: U.S. Government Printing Office, March 27, 1990. For a critique of both agencies, see Robbins and Robbins, "Capital, Taxes and Growth."

[13] Editor's note: A "luxury tax" on airplanes and other products was part of the budget summit package passed in the fall of 1990.

[14] Editor's note: Currently, senior citizens between the age of 65 and 69 can earn up to $9,720 without loss of Social Security benefits. For each additional $3 of wage income above that amount, they lose $1 of benefits. For a forecast of the effects of allowing Social Security recipients the right to earn more wage income without loss of benefits, see Gary Robbins and Aldona Robbins "Paying People Not to Work: The Economic Cost of the Social Security Retirement Earnings Limit," National Center for Policy Analysis, NCPA Policy Report No. 142, September 1989.

15 Editor's note: University of Chicago economist Ronald Coase won the Nobel Prize in economics, partly because of his demonstration of the economic efficiency of clearly-defined property rights.

16 Editor's note: The Wallop-DeLay proposal is assumed to be revenue neutral based on a forecast of a similar proposal made by the U.S. Chamber of Commerce and the National Center for Policy Analysis. See Gary Robbins and Aldona Robbins, "A Pro-Growth Budget Strategy: Vision for the 1990s," National Center for Policy Analysis, NCPA Policy Report No. 154, October 1990.

17 Editor's note: Any reduction in capital gains taxes automatically increases the value of real assets. See Gary Robbins, "Taxing Capital Gains," National Center for Policy Analysis and The Institute for Policy Innovation, NCPA Policy Report No. 143, October 1989. For a forecast of the effects of a capital gains tax cut on real estate in general and RTC holdings in particular, see Gary Robbins and Aldona Robbins, "Adding to the S&L Solution: A Case for Lower Capital Gains Taxes," U.S. Chamber of Commerce, August 1990.

18 Editor's note: The Jenkins-Archer capital gains tax cut passed the House of Representatives in 1989. The measure was blocked in the Senate by procedural rules.

19 Editor's note: The Kasten-Mack capital gains proposal would lower the tax rate on capital gains to 15 percent, with inflation indexing.

20 Editor's note: "Homesteading" is a method by which low-income families can acquire property rights in abandoned housing.

21 Editor's note: The 1986 Tax Reform Act lowered the maximum personal income tax rate from 50 percent to 28 percent. At the same time, the act eliminated the 60 percent exclusion for capital gains income. Prior to the act, the maximum tax rate on capital gains income was 50% (tax rate) X 40% (portion of income taxable) = 20%. Under the new law, the maximum tax rate was increased to 28 percent.

22 Editor's note: In general, the tax code discriminates against real estate. As a result of the Tax Reform Act of 1986 any real estate investment is deemed to be "passive."

23 Editor's note: In 1986, the depreciation period was increased by more than 50 percent — rising from 18 years to 27 1/2 or 31 1/2 years.

24 Editor's note: See David Birch, *Job Creation in America* (New York: Free Press, 1987).

25 The Social Security (FICA) payroll tax was increased from 14.3 to 15.02 percent in 1988 and to 15.3 percent in 1990. These tax increases were originally legislated during the Carter Administration.

26 Editor's note: As a result of the Kennedy tax cut, the highest personal income tax rate was reduced from 91 percent to 70 percent. In 1963 when the top tax rate was 91 percent, the top 5 percent of taxpayers paid 35.6 percent of all income taxes. By 1965, when the top rate had been lowered to 70 percent, the top five percent of taxpayers paid 38.5 percent of all income taxes. See John C. Goodman, "Should Income Tax Rates for Wealthy Taxpayers Be Increased?" National Center for Policy Analysis, NCPA Policy Backgrounder No. 102, July 30, 1990.

27 Editor's note: See Robbins and Robbins, "Tax Fairness."

28 Editor's note: The National Center for Policy Analysis has estimated the economic effects of several of these proposals. For capital gains tax reform, see the prior references. For the effects of expanding child care tax credits, see David Henderson, "Child Care Tax Credits: A Supply-Side Success Story," National Center for Policy Analysis, NCPA Policy Report No. 140, July 1989. For the Bentsen-Roth IRA bill, See Gary Robbins and Aldona Robbins, "The Case for IRAs," National Center for Policy Analysis, NCPA Policy Report No. 112, April 1991. For reductions in taxes on investment income generally, see Robbins and Robbins, "Capital, Taxes and Growth."

29 Editor's note: The Kemp-Roth tax bill was the basis for the 1981 Reagan tax cut, which reduced personal income tax rates across-the-board by 23 percent.

30 Editor's note: Under the 1990 budget summit agreement between President Bush and Congress, all measures before Congress must be "deficit neutral." Thus, any tax reduction must be financed by a spending reduction or by some other tax increase. In arriving at an estimate of the effects of a particular proposal, the conferees agreed to use static forecasting methods. Thus, tax cuts on investment income are automatically assumed to have no effect on total investment or economic growth (and thus are assumed to cause a loss of revenue) even though economists may generally believe that the tax cuts would increase government revenue because of the higher level of economic activity. For an analysis of the budget summit agreement and the implications of the decision to use static forecasting techniques, see Gary Robbins and Aldona Robbins, "Taxes, Deficits and the Current Recession," National Center for Policy Analysis, NCPA Policy Report No. 156, January 1991.

31 Lawrence A. Hunter, "The Never-Ending Recession," *Wall Street Journal*, September 19, 1991.

32 Editor's note: For an analysis of the effects of payroll tax increases, see Gary Robbins and Aldona Robbins, "Reducing Social Security Taxes: Sound Policy for Today and Tomorrow?", Institute for Policy Innovation, IPI Report No. 110, March 1991; for

increased regulations see Ron Utt, "The Growing Regulatory Burden: At What Cost to America?" Institute for Policy Innovation, IPI Report No. 114, November 1991; for state and local tax increases on capital, see Robbins and Robbins, "Capital, Taxes and Growth"; for the effects of the 1990 budget summit agreement, see Gary Robbins and Aldona Robbins, "Taxes, Deficits and the Current Recession" and Robbins and Robbins, "If the Budget Summit Was a Success, Why is the Five-Year Deficit Heading Toward $1 Trillion?," National Center for Policy Analysis, NCPA Backgrounder No. 109, March 11, 1991; for the effects of increased taxes on real estate, see Robbins and Robbins, "Adding to the S&L Solution."

[33] These estimates are based upon those done for a similar proposal put forth by Senator Gramm and Representative Gingrich last August. See Gary Robbins and Aldona Robbins, "Responding to the Recession," Institute for Policy Innovation, IPI Issue Brief No. 112-1, July 31, 1991.

[34] Editor's note: See Robbins and Robbins, "A Pro-Growth Budget Strategy: Vision for the 1990s."

[35] See Robbins and Robbins, "Adding to the S&L Solution."

[36] Editor's note: See Robbins and Robbins, "Capital, Taxes and Growth."

[37] Editor's note: HOPE (Homeownership Opportunities for People Everywhere) actually consists of three programs aimed at giving residents of government-owned housing the opportunity to buy their houses or apartments.