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THE 1996 JOINT ECONOMIC REPORT

REPORT

of the

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

of the

1996 ECONOMIC REPORT
OF THE PRESIDENT

JANUARY 22, 1997.—Ordered to be printed

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LETTER OF TRANSMITTAL

December 31, 1996

Hon. Trent Lott
Majority Leader, U.S. Senate
Washington, DC.

DEAR MR. LEADER: Pursuant to the requirements of the Employment Act of 1946, as amended, we hereby transmit the 1996 Joint Economic Report. The analyses and conclusions of this report are to assist the several Committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

CONNIE MACK, *Chairman*

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Conclusion

Chapter One

The American Worker

AMERICA AT A CROSSROADS

Worker Anxiety or Restoring the American Dream

Prepared by

The Joint Economic Committee

June 1996

AMERICA at a CROSSROADS

WORKER ANXIETY
OR
RESTORING THE AMERICAN DREAM

United States Senate

WASHINGTON, DC 20510

MEMORANDUM

TO: REPUBLICAN SENATORS
FROM: JEC SENATE REPUBLICANS
DATE: JUNE 28, 1996
SUBJ: THE ECONOMY

Both the Administration and many in the media have convinced themselves that the economy is chugging along nicely. Yet we hear a different story from our constituents. What's really going on?

SQUEEZING THE AMERICAN DREAM

The Administration is caught in a real squeeze. The President wants anxious workers to know that he "feels their pain" while at the same time boasting - as he did during his State of the Union address - that this is the best economy in decades.

Economic statistics paint a contradictory picture. The so-called "misery index" (inflation plus unemployment) is admittedly quite low (thank you Alan Greenspan), but this economic expansion has been unambiguously poor.

Bob Dole said it well in a speech before the Economic Club of Chicago last September ...

"America stands on the threshold of a fabulous future, with greater opportunities for economic growth and prosperity than at anytime during our nation's history."

Yet, according to a recent Wall Street Journal poll, 75% of voters believe American family incomes are falling behind the cost of living. While the misery index is low, the ANXIETY index is alarming.

We've often asked our constituents whether they enjoy a better living standard than their parents did at the same age. They say yes. But when asked whether their kids will enjoy an even better living standard when they reach the same age, the answer invariably is a resounding no.

In short, the American Dream is dying; that is producing anxiety.

The American Dream is about handing over a better future to our kids. It's about working hard and making the best of opportunities. It's about hope.

And while the economy is, as Bob Dole said, ready for a fabulous future, Bill Clinton's policies have failed. The economic expansion that began in the last months of the Bush Administration has atrophied, and with it, so has hope and belief in the American Dream.

CLINTON'S GROWTH GAP

In that same September speech, Bob Dole pointed out:

"...compared with the Reagan economic expansion during the 1980's, the Clinton economy is positively anemic."

The facts are clear. No matter how you slice it, Bill Clinton's economic expansion record - anemic growth of 2.3% - is dismal.

* ***Clinton vs. 1992.*** Candidate Clinton said America was mired in the worst economy in 50 years, but the 1992 growth rate (4th qtr. to 4th qtr.) was 3.7%.

* ***Clinton vs. Previous Decade.*** For the ten years preceding this Administration (including non-expansionary years), the economy grew at 3.2%.

* ***Clinton vs. Last 5 Expansions.*** Weighted for their lengths, the average expansionary period growth was 4.4%.

* ***Clinton vs. Post-WWII.*** From 1947 through Bush's final year, 1992, the economy grew at an average annual rate of 3.3%, including recessions, oil shocks, the Carter malaise and the Reagan boom.

Yes, with deft monetary policy by the Fed, and with a Congress that put the brakes on Clinton liberalism, we've avoided a recession. But historically speaking, this expansion has been extraordinarily lethargic, especially given that unlike the previous decade or post-WWII period, there are no down years to suppress or dilute the average growth.

We strongly believe that Republicans must continue to make *GROWTH* a centerpiece of our economic plan. After all, growth really is nothing less than a proxy for the American Dream.

AMERICA'S ANXIOUS FAMILIES

What has happened to America's families and workers? Here's the picture...

Incomes are stagnating. There has been zero growth in real median family income under this Administration. The Labor Department's Employment Cost Index (both wages and benefits) rose only 0.4% for all of 1995 after adjusting for inflation - the slowest increase in 14 years.

Workers who get laid off and then are fortunate enough to find a new job typically earn 10% less than they did in their old positions.

Because incomes are stagnant, more and more families are seeing their breadwinner(s) take second jobs. The number of people working two or more jobs has increased by about 16% since January of 1994; the number of women working two or more full-time jobs has increased by 21%. Both spouses are often working outside the home, not because they choose to, but because they must.

And people are afraid - anxious - to voluntarily change jobs. Normally during expansions, as more jobs are created, people change jobs to seek out better opportunities. This isn't happening. "Job lock" has set in.

Family tax burdens are rising. Since 1950, the typical American has forfeited more than an extra month's pay to cover the growing cost of taxes. Tax Freedom Day has slid from April 3 in 1950 (no fooling) to May 7 this year.

Look at the personal and dependent exemption. Had it just kept pace with inflation since the 1950's, it would be worth more than $3800 today, or about one and a half times its current $2500 rate. For a family of four, this exemption has eroded by more than $5200. That's real money for families struggling to stay afloat.

In 1955, the typical family paid less than 28% of its income in total taxes. Forty years later, their total tax burden was over 38%.

And, in part, because the government is taking more from families than it has in years gone by, personal savings rates are dropping. As a share of disposable personal income, savings were 9% in 1975. This measure has fallen steadily to 4.5% today.

THE BOTTOM LINE IS THIS: People are less secure in their jobs. They are working harder and longer only to fall further and further behind. They can't save as much as they used to, and consequently have less to fall back on. All the while, the government is taking more of what they earn. No wonder people are anxious.

This is the Clinton crunch... the suffocation of an otherwise potentially vibrant economy.

Anemic growth means we've sacrificed the creation of nearly three million jobs. It means that this year alone, slow growth translates into $260 less each month for the typical American family -- that's $3116 for the year.

THE GROWTH AGENDA

Felix Rohatyn (not exactly a conservative policy thinker) recently wrote a long piece for the WSJ entitled RECIPE FOR GROWTH (4/11/96). In it, he notes:

> *"The social and economic problems we face today are varied. They include job insecurity, enormous income differentials, significant pressures on average incomes, urban quality-of-life and many others. Even though all of these require different approaches,* ***THE SINGLE MOST IMPORTANT REQUIREMENT TO DEAL WITH ALL OF THEM IS THE WEALTH AND REVENUES GENERATED BY A HIGHER RATE OF ECONOMIC GROWTH.*** *John Kennedy was right: A rising tide lifts all boats. Although it may not lift all of them at the same time and at the same rate, without more growth we are simply redistributing the same pie. That is a zero sum game and it is simply not good enough."*

As one of the elite liberal economic thinkers of our time, Rohatyn has helped set the stage for us to embrace a bold, imaginatively pro-growth economic agenda.

The press creates a false dichotomy when it comes to conservative economic theory. They divide our party into those who want to balance the budget and those who concentrate on growth. We assert that we can do both, we must do

both, and that only by establishing these twin objectives can either actually be realized.

Balancing the budget produces "dividends" both in terms of higher growth and lower interest rates. During the budget process last year, CBO recognized what it termed a "fiscal dividend" associated with the elimination of deficits.

Growth-oriented tax policies likewise are vital to snap our economy out of the 2 to 2.5% Clinton GDP growth rate. Unless we figure out a way to get back to growth rates in the 3 to 3.5% range (our post-WWII but pre-Clinton level of performance) balancing the budget may never occur.

Recently, CBO released its periodic economic and budget outlook. Among its conclusions... In the absence of major policy changes and if discretionary appropriations are adjusted for inflation, the deficit will begin to grow steadily in 1997 to over $400 billion in the year 2006.

WHAT TO DO NEXT

The following pages are full of economic data that show why Americans are feeling anxious about their jobs and futures. While the mainstream press are just "discovering" that Bill Clinton is vulnerable on the issue of this economy, Bob Dole and Republicans have been talking about worker anxiety for over a year.

We *must* continue to get this message out -- so the American people know that we understand how they feel, and so that Bill Clinton and his Administration can no longer get away with statements like "this is the best economy in 3 decades."

It is imperative that we continue the debate among ourselves regarding how best to achieve strong, long-term economic growth. An economic growth agenda is, without a doubt, the key to Republican success this November. The JEC will continue to put out as much information as we can about what's going on in the economy. We stand ready to assist any of you in the ongoing discussion of how best to achieve economic growth for our country, our children, and our future.

REPORT HIGHLIGHTS

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

JEC Report Highlights

Clinton's Growth Gap. Weak economic growth during Clinton's presidency has had a negative effect on the typical family's standard of living. Sluggish growth leads to stagnating incomes, fewer job opportunities, and overall worker anxiety about the future. **Slow growth under Clinton will cost the typical household $3,116 this year--that's $260 every month.**

Clinton's Tenure	2.3% Growth
vs.	
Year Before Clinton	3.7% Growth
Decade Before Clinton	3.2% Growth
Average of last 5 Expansions	4.4% Growth
Post-World War II	3.3% Growth

Stagnant Family Incomes. The growth of real median family income has been **zero** percent under Clinton. The Labor Department's Employment Cost Index, which measures **both wages and benefits, rose only 0.4 percent for all of 1995, after adjusting for inflation. This is the slowest growth in 14 years.**

Shrinking Paychecks. So far **in 1996, real after-tax incomes have dropped at a yearly rate of 1.4%.** If this trend continues, we would have the biggest drop in any year since 1974.

Multiple Jobs. Because of stagnating incomes, many people have been forced to take an extra job just to make ends meet. **Since January 1994, the number of people working two or more jobs is up 16%. The number of women working two or more full-time jobs has risen 21%.**

Job Lock. Slow growth under Clinton has created "Job Lock" a situation in which workers fear voluntarily leaving their current job because they don't believe there will be a better one (or even another one) around the corner. Five years into this recovery, the share of unemployed workers who have voluntarily left their jobs is now 27% lower than during the last recession.

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104th CONGRESS

Record Tax Burden. In 1995, **total government receipts represented a record share of America's total income: 31.4%.** The federal tax burden alone went from 19.2% of GDP in 1992 to 20.5% today.

Taxes Dominate Family Budget. The typical American family pays more in total taxes than it spends on food, clothing, and housing combined. That's more than 38% for taxes vs. 28% for food, clothing and housing. **In 1955, the typical family's total tax bite was 28% of total income vs. 38% today.**

Interest Rate Savings. Under the Republican balanced budget plan, **a one percentage point drop in interest rates would save the typical family a total of more than $1,600 on interest payments on the average mortgage, car loan, and student loan** if they refinance or the rates are adjustable. Unfortunately, since Clinton's veto of the Republican balanced budget plan, **interest rates have climbed more than one percentage point.**

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"CLINTONOMICS"

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

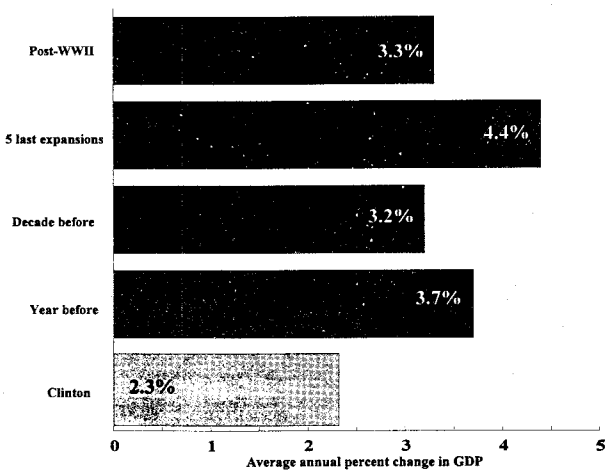
ISSUED BY
JEC MAJORITY STAFF
May 1996

CLINTON'S GROWTH GAP

Despite the best efforts of President Clinton and his administration to portray today's economy in a positive light, his economic performance pales in comparison to historic growth rates. By any measure, economic growth under Clinton has been weak.

"By any measure, economic growth under Clinton has been weak."

Clinton's Growth Gap:
Economic Growth Lags Behind No Matter How It's Measured



Source: Commerce Department

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Weak economic growth during Clinton's presidency has had a dramatic effect on the typical family's standard of living. Sluggish growth leads to stagnating incomes, fewer job opportunities, and overall worker anxiety about the future. How great are these costs? Slower growth under Clinton will cost the average household $3,116 this year - that's $260 a month.[1] No wonder there is such angst in America.

Many economists have argued that policies which increase taxes, regulations, or uncertainty slow economic growth.[2] The Clinton Administration has increased taxes, boosted regulations, and threatened massive interference in major industries. Although measuring the impact of these policies can be difficult, economists look at potential growth - how the economy *should* perform without the hindrance of anti-growth policies compared to other eras. However, no matter what period is used as a standard, the economy's performance under President Clinton has been lackluster at best.

"The Clinton Administration has increased taxes, boosted regulations, and threatened massive interference in major industries."

Judged against the entire postwar era, since 1993 GDP has fallen $308 billion behind - that's $3,116 per household in 1996 alone. This growth-gap analysis is particularly relevant because the economy was already growing in 1991 and 1992, well before the Clinton Administration made its major policy changes.

CLINTON STOPPED THE MOMENTUM

The year before Clinton took office, the economy grew at an annual rate of 3.7 percent (fourth quarter over fourth quarter). Instead of sustaining or improving upon this momentum, in 1993 Clinton and the Democrat-controlled Congress passed the largest tax increase in U.S. history. Their steep tax hikes on individuals and businesses stifled growth by distorting incentives, hindering investment, and preventing resources from flowing to their most efficient use. New regulatory burdens and the threat of government-run health care compounded the economy's problems, and growth slowed to only 2.3 percent annually during the Clinton years.

"...no matter what period is used as a standard, the economy's performance under President Clinton has been lackluster..."

THE LAST DECADE BEAT CLINTON'S LACKLUSTER PERFORMANCE

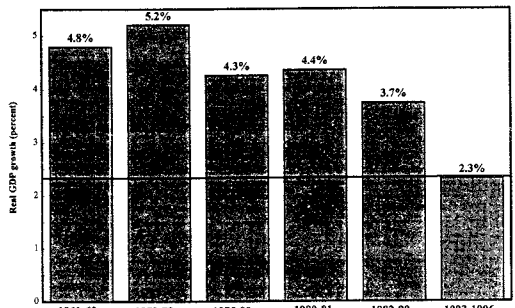
Some may consider one year too short a period to use as a standard for growth. Another comparison can be made using the entire decade before President Clinton took office. That decade included periods of both expansion and recession in the economy, yet the average annual growth rate was 3.2 percent - still higher than Clinton's 2.3 percent. While Clinton claims that today's is "the best economy in three decades," this economy doesn't even match the performance of the decade before he entered office.

PRIOR EXPANSIONS BEAT CLINTON'S SLUGGISH GROWTH

"...since 1993 GDP has fallen $308 billion behind - that's $3,116 per household..."

Was the last decade's economic growth an anomaly? Some may argue that using a decade with only Republican presidents as a baseline is political, but other analyses yield similar results. Clinton's economic growth performance is sub-par when compared to the last five expansions. These expansions include every president since John Kennedy; three Democrats and four Republicans. During the last five expansions, the economy grew at an average annual rate of 4.4 percent (weighted for the duration of each expansion) versus Clinton's 2.3 percent. Again, Clinton's economic performance looks inept.

THE CLINTON YEARS VERSUS THE LAST FIVE EXPANSIONS



Sources: Department of Commerce, NBER, and JEC calculations

"While Clinton claims that today's is 'the best economy in three decades,' this economy doesn't even match the performance of the decade before he entered office."

Some may object that treating the Clinton years as a full expansion leaves out the beginning of the recovery. However, including the beginning of this recovery yields the same growth rate of 2.3 percent: the same growth gap exists.

THE LAST 45 YEARS BEAT CLINTON'S LETHARGIC ECONOMY

Is 4.4 percent growth too much to ask? Another objective analysis compares President Clinton's performance to the average growth of the economy over the long

run. From 1947, the beginning of the postwar period, to 1992, the last year of the Bush Administration, the economy grew at an average annual rate of 3.3 percent. This includes all kinds of economic scenarios - recessions, oil shocks, double-digit inflation, wars, and periods of growth. Sadly, Bill Clinton has failed to match even the average long-term performance of the economy. This slower growth under President Clinton will cost every household in American an average of $3,116 in 1996.

In the final analysis, no matter which comparison is used, Clinton's growth gap is painfully obvious, and obviously painful. Economists and politicians may argue over which comparison is more valid, but the fact that a costly growth gap exists cannot be disputed.

Prepared by Paul G. Merski, Economist, and Phaedon I. Sinis, Associate Economist. (202) 224-5171.

ENDNOTES

1. OMB and CBO estimate 2.2% real GDP growth for all of 1996.

2. Wesbury, Brian S. "Freeing the American Economy." Washington: Joint Economic Committee, May 1995.

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

What is Clinton's Growth Gap?

The Growth Gap simply represents weak economic growth during Clinton's Presidency versus what we could reasonably expect. However analyzed, economic growth under Clinton pales in comparison to historic growth rates.

Weak economic growth during Clinton's tenure has had a dramatic negative effect on the typical family's standard of living. **Sluggish growth leads to stagnating incomes, fewer job opportunities, and overall anxiety about the future.**

The Clinton administration has smothered strong economic growth with a record tax increase, increased regulations, and higher government spending.

Bottom line: **since 1993, GDP has fallen behind the pre-Clinton pace by $308 billion-- that's $3,116 per household in 1996 alone -- $260 a month.** Clinton's growth rate has been 2.3%. By contrast, the entire post-war era has averaged 3.3%. That's the Clinton Growth Gap.

Growth Gap Methodology in Brief:

- The growth gap measures the difference between the Gross Domestic Product (GDP) level under Clinton versus what GDP would have been had growth maintained its pre-Clinton, post-WWII average of 3.3%.
- In the fourth quarter of 1992, GDP was $6865.12 billion. According to GDP growth projections by the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB), GDP will be $7514.26 billion in the fourth quarter of 1996. However, if GDP had grown over this period at an average annual rate of 3.3% (the post-WWII average), GDP would be $308 billion higher in 1996. Dividing this by the number of households in 1996 (estimated at 99 million) yields a monthly cost of $260.
- All GDP numbers were obtained from the chain-weighted GDP series, originally in 1992 dollars, and converted into 1995 dollars by using the chain weighted GDP price index for the 4th quarter of 1995.
- The "growth gap" assumes that the post-WWII average growth rate of 3.3% could have continued unabated during Clinton's tenure (1993 through 1996).

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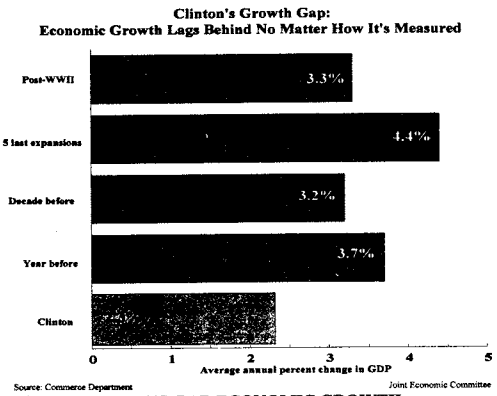
WORKER ANXIETY

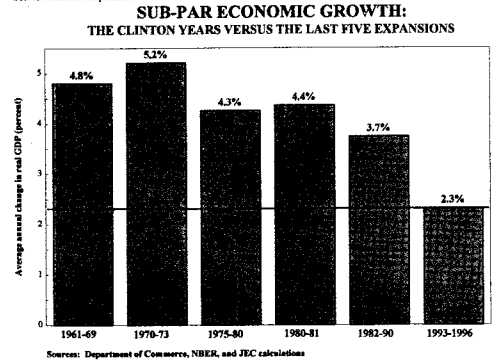
Joint Economic Committee
U.S. SENATOR Connie Mack
CHAIRMAN

TWELVE REASONS FOR WORKER ANXIETY

1. Weak Economic Growth

No matter how you analyze it, economic growth under Clinton pales in comparison to historic growth rates. Whether compared to the year before he entered office, the decade before, the last five economic expansions, or the entire postwar (1947-1992) period, economic growth under Clinton has been lackluster. Because of this slower growth, 1996 GDP has fallen behind by $308 billion. **This growth gap will cost each household $3,116 this year alone - that's $260 a month.**





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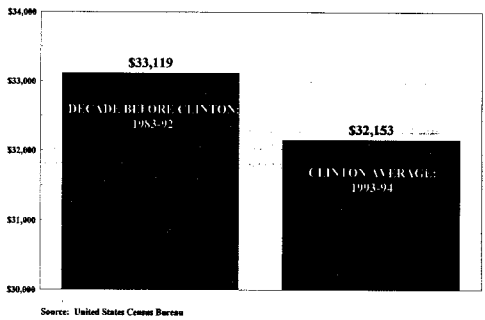
2. Stagnant Incomes.

During Clinton's tenure, incomes have stagnated. After adjusting for inflation, **median household income is actually $97 less than it was in 1992.** In the decade before President Clinton took office, America's real median household income averaged $33,119. In the years of the Clinton Administration, real median household income has averaged only $32,153, according to the Census Bureau. More recent data reveal that income stagnation continues. The Labor Department's Employment Cost Index, which measures both wages and benefits, rose only 0.4 percent for all of 1995 after adjusting for inflation; that's the slowest growth in 14 years.

REAL MEDIAN HOUSEHOLD INCOME

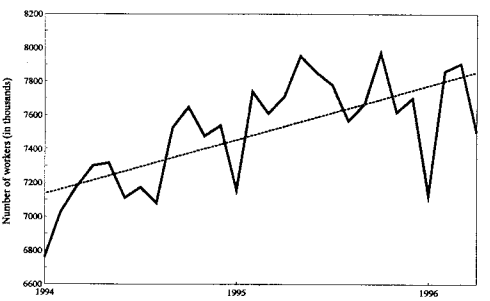


Source: United States Census Bureau

3. Multiple Jobs

In recent years, stagnating incomes have forced **many people to work more than one job** to make ends meet. The chart at the right shows the number of workers with multiple jobs. The number of people working two or more jobs has increased more than 11% since January 1994. Even accounting for the growth in the labor force, the percentage of workers with multiple jobs has risen.

MORE WORKERS FORCED INTO MULTIPLE JOBS

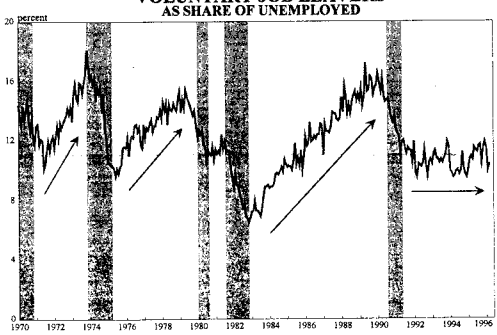


Source: Bureau of Labor Statistics

4. Job Lock

Slow economic growth under President Clinton has fostered **"job lock."** Workers fear voluntarily leaving their current jobs even though they may not have had their pay raised in years - because they don't believe there will be better jobs (or even any other jobs) around the corner. The share of voluntary job leavers as a percentage of all the unemployed is actually 27% lower now than at the end of the last recession. During normal economic expansions, as more jobs are created, people are able to quit their current jobs to look for new jobs that offer greater opportunities for advance-ment and higher pay.

VOLUNTARY JOB LEAVERS
AS SHARE OF UNEMPLOYED

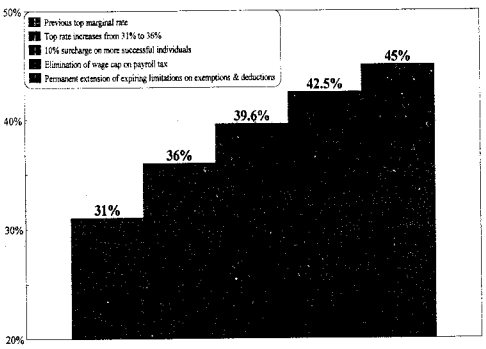


Source: Bureau of Labor Statistics

5. Higher Tax Rates

In 1993, President Clinton levied the largest tax increase in history, including higher taxes on Social Security recipients, steep income tax hikes on individuals and small business owners and higher taxes on gasoline. **This $241 billion tax increase boosted the top marginal tax rate by as much as 14.5 percentage points** (from 31% to 45%) for many individuals and small business owners. These higher taxes feed a growing government at the expense of business expansion, new hiring, and higher wages for workers.

CLINTON'S IMPACT ON TOP MARGINAL TAX RATE

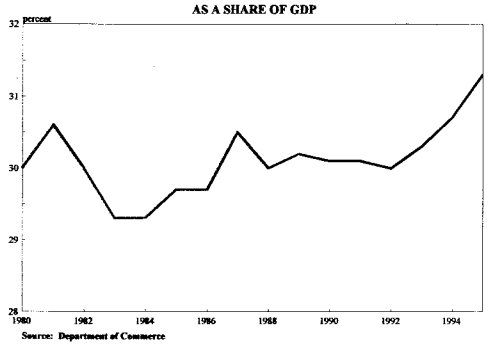


Sources: Department of the Treasury; JEC calculations

6. Record Tax Burden

In 1995, according to the Commerce Department, **total government receipts represented a record share of America's total income: 31.4%.** When the government seizes more money through taxation, individuals have less money for their own use. The federal tax burden alone went from 19.2% of GDP in 1992 to an estimated 20.5% today.

TOTAL GOVERNMENT RECEIPTS HIT RECORD HIGH
AS A SHARE OF GDP

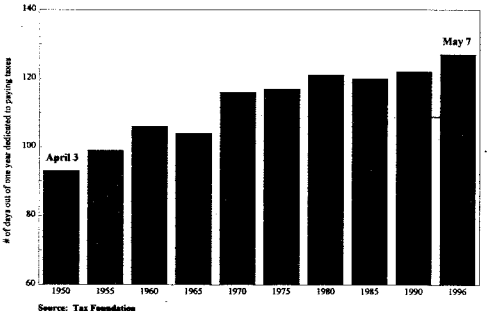


Source: Department of Commerce

7. Less Freedom

As government's share of income has grown, the share that American workers get to keep has greatly diminished. Tax Freedom Day for the typical American worker didn't arrive until **May 7** this year - the latest ever. This means working from January 1 thru May 7 just to earn enough to pay all federal, state and local taxes. **Since 1950, the typical American has forfeited more than an extra month's work to cover the growing cost of taxes.** In 1950, Tax Freedom Day was on April 3, compared to May 7 this year.

TAX FREEDOM DAY IS LATEST DATE EVER

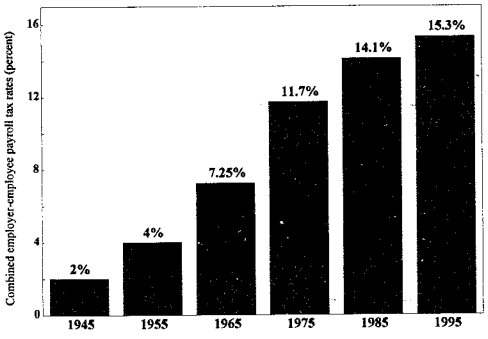


Source: Tax Foundation

8. Mushrooming Payroll Taxes

The combined employer-employee payroll tax has risen a full 13.3 percentage points, from 2% in 1949 to 15.3% today. President Clinton further increased the payroll tax bite in 1993 when he eliminated the wage cap on the health insurance portion of the payroll tax. Economists believe that the employer's share of the payroll tax erodes workers' wages by the amount of the tax. And, as workers become more expensive to hire, fewer jobs are created.

RISING PAYROLL TAX RATES

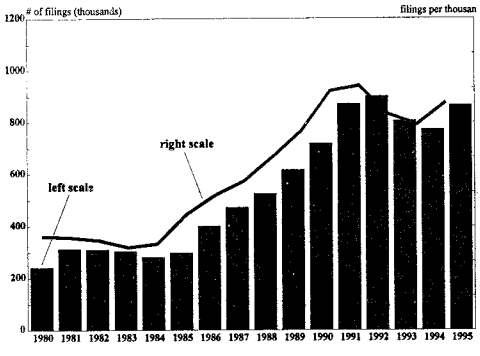


Source: Department of the Treasury

9. Soaring Personal Bankruptcies

As many as 1.1 million people are expected to declare personal bankruptcy in 1996, the highest level in more than 16 years. Today's working families have a much **smaller "savings cushion"** to fall back on should they lose their jobs or voluntary leave their jobs in search of a better opportunities. In 1975, savings as a percentage of disposable personal income was 9%, but by 1995 they were just 4.5%. High tax rates and the double taxation on savings have contributed to the decline.

RECORD PERSONAL BANKRUPTCY FILING

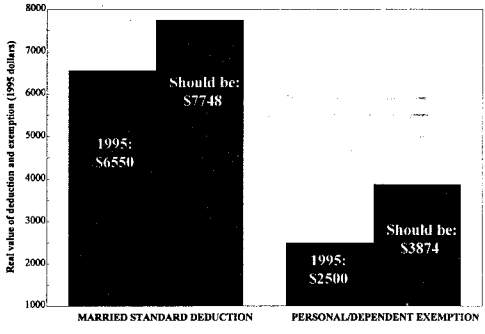


Sources: U.S. Administrative Office of the Courts; SMR Research

10. Diminished Personal and Dependent Exemptions

The tax burden on the typical family has increased because inflation has eroded the value of the standard deduction and personal exemptions for each member of the family. **If the standard deduction and personal exemptions had merely kept pace with inflation since 1950, a typical family with two children would pay $1,012 less in federal income taxes today.**

DEDUCTIONS AND EXEMPTIONS ERODED

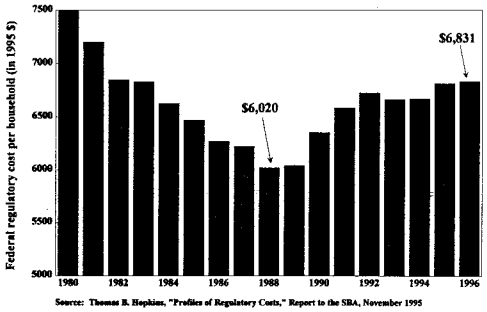


Sources: Internal Revenue Service; Bureau of Labor Statistics

11. Growing Regulatory Costs

The surge of federal regulations has taken a growing toll on workers. **Total federal regulatory costs are estimated at $6,831 per household in 1996.** While federal regulatory costs per household dropped from $7,495 in 1980 to $6,020 by 1988, they have since climbed back up to $6,831 today.

GROWING REGULATORY COSTS PER HOUSEHOLD

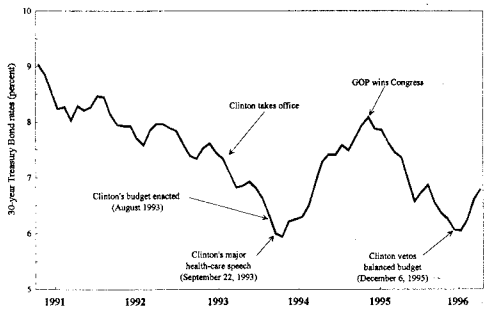


Source: Thomas B. Hopkins, "Profiles of Regulatory Costs," Report to the SBA, November 1995

12. Rising Interest Rates

Major policy initiatives foster shifts of future expectations. On November 8, 1994, interest rates hit a turning point, as investors anticipated less federal spending, lower taxes, and an economic environment conducive to growth. Rates fell from 8.16% on November 8 to 5.95% by December 1995. Unfortunately, President Clinton's veto of the Republican balanced budget and his refusal to adopt pro-growth policies has caused rates to rebound to higher levels. **Higher interest rates force families to pay more for home mortgages, car loans, and student loans.** A typical family with a $75,000 mortgage, a $15,000 car loan, and an $11,000 student loan could save $1,771 every year if interest rates drop a single percentage point because of a balanced budget.

INTEREST RATES ON THE RISE
30-YEAR TREASURY BOND YIELDS



Source: Treasury Department

Prepared by Paul G. Merski, Chief Economist and Phaedon I. Sinis, Associate Economist. (202) 224-5171.

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

ISSUED BY:
CHAIRMAN CONNIE MACK
MAY 1996

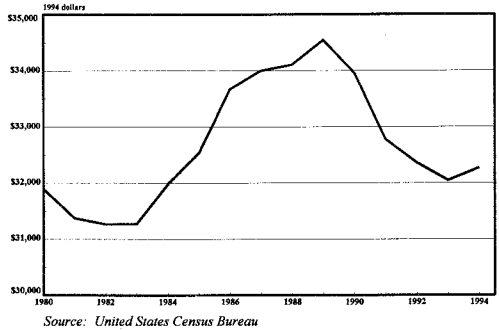
GOVERNMENT GROWTH FOSTERS WORKERS' ANXIETY

Working Americans are feeling anxious about the economy, particularly when it comes to their paychecks and the security of thier jobs. Too many Americans believe their economic opportunities and standards of living are worse than previous generations. Many workers are caught in "**job-lock**." They fear voluntarily leaving a job today - even one in which they may not have received a raise in several years - because they don't think there will be a better one (or even another one) around the corner.

WORKERS' INCOME ANXIETY

This working middle-class anxiety has intensified because the growth rate of real median family income has been **zero percent** during the Clinton Administration.[1] The Census Bureau recently reported that real median household income "showed no statistically significant change" between 1993 and 1994.[2] Sadly, most middle class workers simply are not getting ahead. After adjusting for inflation, median household income is **$97 less** today than it was in 1992, and it has fallen in four out of the last five years. Total worker compensation, a broader income measure that includes all wages, salaries and benefits, rose only 0.4 percent in 1995 after adjusting for inflation, the slowest growth in more than fourteen years.[3]

Real Median Household Income



Source: United States Census Bureau

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104th CONGRESS

WORKERS' GOVERNMENT BURDEN SWELLS

Increased worker anxiety has paralleled the mushrooming cost of government for the typical American worker. Just look at President Clinton's latest budget to see the record tax bite imposed by government at all levels. In 1995, Clinton's own OMB says total government receipts represented a record share of America's total income, 30.4% of GDP.[4] (The U.S. Department of Commerce projects an even bigger bite: 31.4%).

Taxes as a Percentage of GDP
1950-1995

Year	Total Government Receipts	Federal Government Receipts	State & Local Government Receipts
1950	21.4%	14.8%	6.6%
1955	23.9%	17.0%	6.9%
1960	26.2%	18.3%	7.9%
1965	26.1%	17.4%	8.7%
1970	29.7%	19.6%	10.2%
1975	29.3%	18.5%	10.8%
1980	29.6%	19.6%	10.1%
1985	29.1%	18.5%	10.6%
1990	29.5%	18.8%	10.7%
1995	**30.4%**	**19.3%**	**11.0%**

Source: Office of Management and Budget.
Totals may not add due to rounding.

WORKERS PAY MORE TAXES, HAVE LESS FREEDOM

As government's share of income has grown, the share that American workers get to keep has greatly diminished. Tax Freedom Day for the typical American worker won't arrive until **May** 7 this year - the latest ever. This means working from January 1 thru May 7, just to earn enough to pay all federal, state and local taxes.[5] Since 1955, the typical American has forfeited nearly an extra month's pay to cover the growing cost of taxes. In 1955, Tax Freedom Day was on April 9, compared to May 7 this year. But even working until May 7 doesn't cover the $145 billion in additional federal deficit spending estimated for 1996. If the 1996 federal deficit was included, Tax Freedom Day wouldn't arrive until May 16.[6] Even that doesn't tell the whole story of the cost of government. Including all federal, state, and local regulatory costs, along with their taxes, workers have to work until July 3 this year to pay for the total cost of government.[7]

Tax Freedom Day

1996	**May 7***
1995	**May 7**
1985	**April 30**
1975	**April 27**
1965	**April 14**
1955	**April 9**
1945	**April 1**
1935	**March 1**
1925	**February 6**

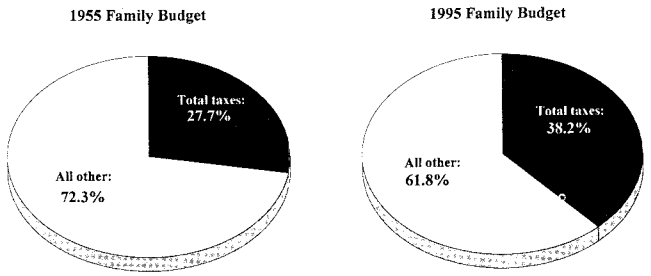
Source: Tax Foundation. *Leap year makes Tax Freedom Day appear one calendar day earlier.

Another way to look at the impact on workers from government growth is to examine the tax bite in the eight-hour day. Today, the typical worker labors nearly **three hours out of an eight-hour workday** just to pay taxes. In 1996, the tax bite in the typical 8-hour workday averages 2 hours and 47 minutes. Workers forfeit nearly an extra hour of their pay each day to government compared to fifty years ago. In 1945 the tax bite in an 8-hour day was 1 hour and 59 minutes versus 2 hours and 47 minutes today. No wonder workers feel they are working longer and harder with little to show for it - they are.

ARE TODAY'S WORKERS BETTER-OFF THAN THEIR PARENTS?

Do today's young working families feel better-off than their parents? Judging by their tax burden, a two-earner family today shoulders a larger tax burden than an identical family did forty years ago. In 1955, the median family paid 27.7 percent of its income in total taxes. By 1995, their total tax burden took 38.2 percent of their income.[8] In other words, a family that pays $21,320 in taxes today would have paid just $7,046 back in 1955 after adjusting for inflation and allowing for real income growth - a three-fold increase. Family tax deductions have also eroded. The personal and dependent exemption that totaled $600 in 1950 was $2,500 in 1995. But, had this deduction just kept pace with inflation, it would be more than $3,800 today. In other words, **this exemption has eroded by more than $5,200 for a family of four.**

Taxes Take a Larger Share of the Family's Budget



Year	Total Taxes as a Percent of Income
1955	27.7%
1965	29.3%
1970	37.3%
1985	38.1%
1990	37.7%
1991	37.7%
1992	37.6%
1993	36.7%
1994	38.0%
1995	38.2%

Source: Tax Foundation.

WORKERS ABSORB SHARP INCREASE IN PAYROLL TAXES

A major reason for the dramatic increase in a worker's tax burden over the years has been the sharp rise in federal payroll taxes. The combined employer-employee payroll tax rate has risen a full 13.3 percentage points from 2 percent in 1949 to 15.3 percent today.[9] Economists generally agree that the business share of federal payroll taxes reduces workers' wages by the amount of the tax. In other words, workers' wages are nearly 6 percent lower than they should be, given 1950 payroll tax levels. This tax erosion of wages offers a valid explanation for today's worker anxiety.

Payroll Tax Rates

Year	Combined Employer-Employee
1945	2%
1955	4%
1965	7.25%
1975	11.7%
1985	14.1%
1995	15.3%

Source: U.S. Department of Treasury

WORKERS HAVE SMALLER SAVINGS CUSHION

Another explanation for the increased anxiety among today's workers is the decline in the savings rate. Today's working families have a much smaller "savings cushion" to fall back on should they lose their jobs or voluntary leave their jobs in search of a better opportunities. As the worker's share of the government tax bite has risen, the savings rate has declined. Today's personal savings rate is less than half what it was just twenty years ago. In 1975, savings as a percentage of disposable personal income was 9 percent, but by 1995 it had fallen to just 4.5 percent.[10]

Personal Savings Rates

1975	9.0%
1980	8.2%
1985	6.9%
1990	5.0%
1995	4.5%

Source: Bureau of Economic Analysis.

RECENT TAX HIKES ADD TO WORKERS' ANXIETY

In 1993, President Clinton levied the largest tax increase in history, including higher gasoline taxes, tax hikes on Social Security recipients, and steep income tax hikes on individuals and small business owners. This **$241 billion tax hike** also boosted the top marginal tax rate by as much as 14.5 percentage points - from 31 percent to 45.5 percent - for many individuals and small business owners.[11] These higher taxes feed a growing government at the expense of business expansion, new hiring, and higher wages for workers.

Clinton's Impact on the Top Marginal Tax Rate

Previous top marginal income tax rate	**31.0 %**
Top rate increases from 31 percent to 36 percent ($115,000 single return, $140,000 joint return)	+ 5.0 %
10 percent surcharge on more successful individuals and small businesses (incomes over $250,000)	+ 3.6%
Elimination of $130,000 wage cap on health insurance payroll tax	+ 2.9 %
Permanent extension of expiring limitations on both personal exemptions and itemized deductions	+ 2-3%
New top marginal income tax rate	**44.5-45.5%**

Source: U.S. Department of Treasury; Joint Economic Committee

WORK HARDER – PAY MORE

Due to recent tax hikes, a working family that faced a top federal income tax rate of 28 percent in 1990 could now face a marginal rate in excess of 40 percent. These steeply graduated tax rates take a bigger and bigger share of workers' incomes as they earn more. In other words, the tax code punishes people who work hard and take risks to improve their standard of living. Workers automatically forfeit more of their money to taxes when they are pushed into higher tax brackets - cutting government in on a larger share of their earnings.

GROWTH OF REGULATIONS COST WORKERS TOO

While workers may be well aware of the burden from the increase in taxes they pay directly, the cost of government regulations also takes a large and growing toll. Total federal regulatory costs per household are estimated at $6,831 in 1996.[12] Regulatory costs per household dropped from $7,495 in 1980 to $6,020 by 1988, but they have climbed back up to $6,831 today.

Federal Regulatory Cost Per Household (In 1995 Dollars)

1980	$7,495
1981	$7,203
1982	$6,850
1983	$6,830
1984	$6,625
1985	$6,469
1986	$6,269
1987	$6,224
1988	$6,020
1989	$6,044
1990	$6,353
1991	$6,582
1992	$6,725
1993	$6,662
1994	$6,670
1995	$6,809
1996 (est.)	$6,831

Source: Thomas B. Hopkins, "Profiles of Regulatory Costs," Report to the SBA, November 1995.

CONCLUSION

In the final analysis, most worker anxiety is the direct result of the growth in government. Government expansion has coincided with the present decline in workers' incomes and savings. Because of recent tax rate hikes, many workers feel they have to work as hard as they possibly can just to keep up. Reversing the growth of government taxing, spending and regulating is a sure way to ease worker anxiety.

Prepared by Paul G. Merski, Economist. (202) 224-5171

ENDNOTES

1. Joint Economic Committee Report, "The Middle Class Crunch...By The Numbers," April 1996.

2. U.S. Department of Commerce, Bureau of the Census: *Current Population Reports-Consumer Income, P60-189*, 1995.

3. U.S. Department of Labor, Bureau of Labor Statistics; *News, Employment Cost Index*; February, 1996.

4. U.S. Office of Management and Budget, Fiscal Year 1997 Budget, Historical Tables, p.256.

5. Tax Foundation, Special Report No. 58: "Tax Freedom Day 1996 is May 7," Patrick Fleenor; April, 1996.

6. Joint Economic Committee calculation based on Office of Manage and Budget FY1996 federal budget deficit estimate.

7. Americans For Tax Reform Report: "Cost of Government Day is July 3, 1996."

8. Tax Foundation, Special Report No. 54: "Taxes Force American Family to Tighten Belt," Arthur P. Hall; November, 1995.

9. Social Security Administration, total OASDHI payroll taxes.

10. Department of Commerce, Bureau of Economic Analysis, Disposition of Personal Income data.

11. Joint Economic Committee Report, "The President's Forgotten Middle Class." March, 1996.

12. Thomas D. Hopkins, Profiles of Regulatory Costs; Report for the Small Business Administration; November, 1995.

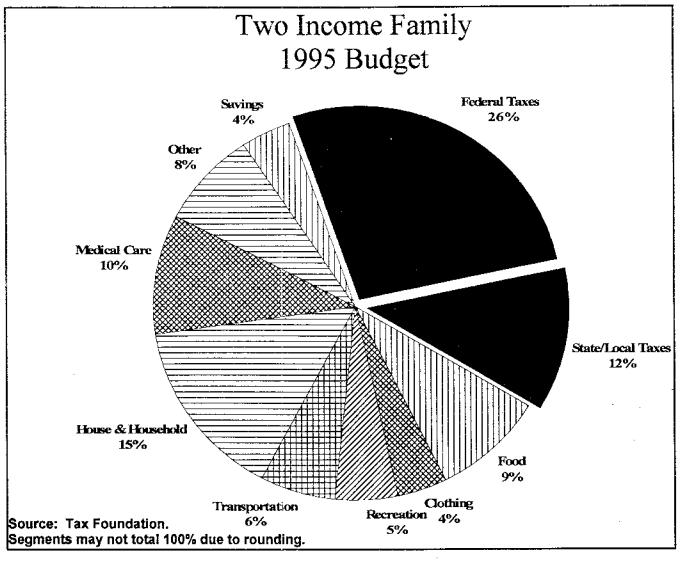
THE TAX BURDEN

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

TOP TWELVE TAX FACTS

1. Taxes Dominate Family Budget

The typical American family pays more in total taxes than it spends on food, clothing, and shelter combined. That's ***over 38 percent for total taxes vs. 28 percent for food, clothing and housing***. *(Tax Foundation)*



2. More Taxes = Less Freedom: Tax Freedom Day Is Latest Ever!

Tax Freedom Day for the typical American taxpayer didn't arrive until ***May 7 in 1996*** -- the latest date ever. This means he or she has to work from January 1 thru May 7 to earn enough to pay all federal, state and local taxes. *(Tax Foundation)*

Tax Freedom Day

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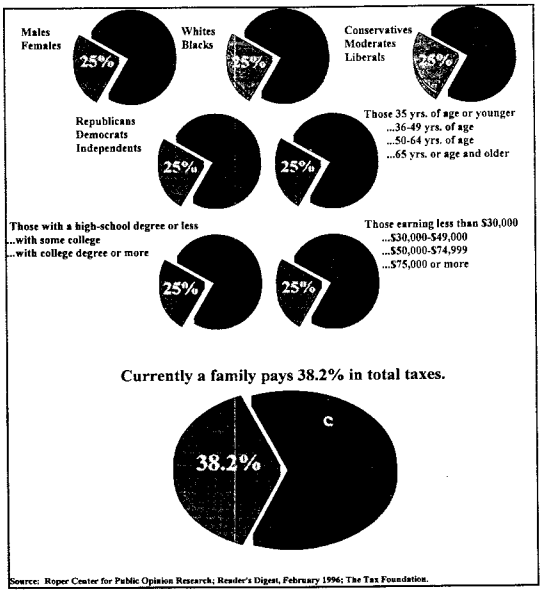
3. Government Takes A Bigger Bite: Tax Bite In The Eight-Hour Work Day Grows

The typical worker now toils nearly ***three hours out of an eight-hour workday*** just to pay taxes. In 1996, the tax bite in the typical 8-hour workday was 2 hours and 47 minutes. By comparison, in 1945, the tax bite in an 8-hour day was 1 hour and 59 minutes. *(Tax Foundation)*

4. America Speaks: How Much Should Families Pay In Total Taxes?

According to a recent Reader's Digest poll, the maximum tax burden ***Americans believe a family should pay is 25 percent.*** That's not just for federal income taxes, but taxes from all levels of government, including social security taxes, sales taxes, excise taxes, property taxes, etc. Unfortunately, the total tax burden on the typical American family is far greater than the desired 25 percent: it now stands at 38.2 percent.



Survey Question: What's the highest percentage you think would be fair for a family making $200,000 a year to pay when you add all their taxes together?
(JEC Note: 99.2 percent of taxpayers have incomes below $200,000 per year).
Median Responses by Type: Male 25 percent, Female 25 percent, White 25 percent, Black 25 percent, H.S. degree or less 25 percent, Some college 25 percent, College degree or more 25 percent, Age 35 or younger 25 percent, 35-49 25 percent, 50-64 25 percent, 65 or older 25 percent, Less than $30k in income 25 percent, $30k-$49k 25 percent, $50k-$74k 25 percent, $74k or more 25 percent, Republican 25 percent, Democrat 25 percent, Independent 25 percent, Conservative 25 percent, Moderate 25 percent, Liberal 25 percent, Married 25 percent, Separated/divorced 25 percent, Single 30 percent, Children at home 25 percent, No children at home 25 percent, Protestant 25 percent, Catholic 25 percent.

5. Clinton's Taxing Policies: Tax Take Rises Under Clinton

In 1993, President Clinton levied the largest tax increase in history, including higher gasoline taxes, tax hikes on Social Security recipients, and steep income tax hikes on individuals and small business owners. This ***$241 billion tax hike*** also boosted the top marginal tax rate by as much as 14.5 percentage points from 31 percent to 45.5 percent. *(Treasury Department; JEC; JCT)*

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Elimination of $130,000 wage cap on health insurance payroll tax	+ 2.9%
Permanent extension of expiring limitations on both personal exemptions and itemized deductions	+ 2-3%
New top marginal income tax rate faced by small businesses	**44.5-45.5%**

Source: U.S. Department of Treasury; Joint Economic Committee.

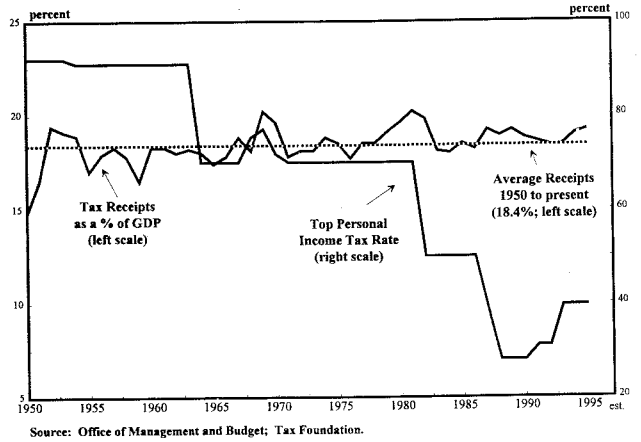
6. The Happiness Quotient: 1950s vs. Today

In the "Happy Days" of 1955, the median family paid 27.7 percent of its income in total taxes. By 1995 its total tax burden claimed 38.2 percent of income. In other words, ***the family that pays $21,320 in taxes today, would have paid just $7,046 back in 1955 after adjusting for inflation-a three-fold increase!*** *(Census Bureau; Tax Foundation)*

7. The 19 Percent Truism: Federal Receipts Hover Around 19 percent of GDP

No matter how high tax rates have been set, historically, ***federal revenues oscillated closely around 19 percent of GDP***. Regardless of whether the top marginal rate was 90, 70, 50, or 28 percent, revenues remained close to 19 percent of GDP. *(JEC; OMB)*

Tax Receipts and Tax Rates



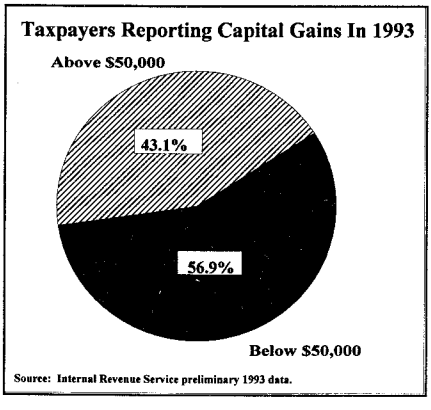
Source: Office of Management and Budget; Tax Foundation.

8. Social Security Taxes Take Heavy Toll

While President Clinton claims his tax hikes hit only "the wealthy," he ignores the huge tax increase he placed on the middle-income elderly. That's because he subjected 85 percent of Social Security benefits to federal income taxes for unmarried seniors earning more than $34,000 and married seniors with combined income of $44,000 or more (only $22,000 per person). These income levels were not even indexed for inflation, which means that ***each year more elderly Americans have their benefits taxed.*** Social Security taxes also levy a heavy burden on working families. ***More than half of working families now pay more in total Social Security payroll taxes than they pay in income taxes.*** That's because the total payroll tax rate has grown from just 2 percent in 1949 to 15.3 percent today. *(Treasury Department; Department of HHS; Social Security Administration)*

9. The Real Returns On Capital Gains: Middle Class And Elderly Americans Would Benefit From Capital Gains Tax Cut

IRS tax return data show that more middle-income taxpayers and seniors stand to benefit from a capital gains tax cut than those at the upper end of the income scale. In fact, ***56.9 percent of all tax returns reporting capital gains came from taxpayers with total incomes below $50,000 per year.*** Many middle- and lower-income elderly Americans depend on cashing in their capital gains as their source of retirement income. *(IRS; JEC)*



10. The Diminished Dependent Deduction: Dependent Deduction Hasn't Kept Up With Inflation

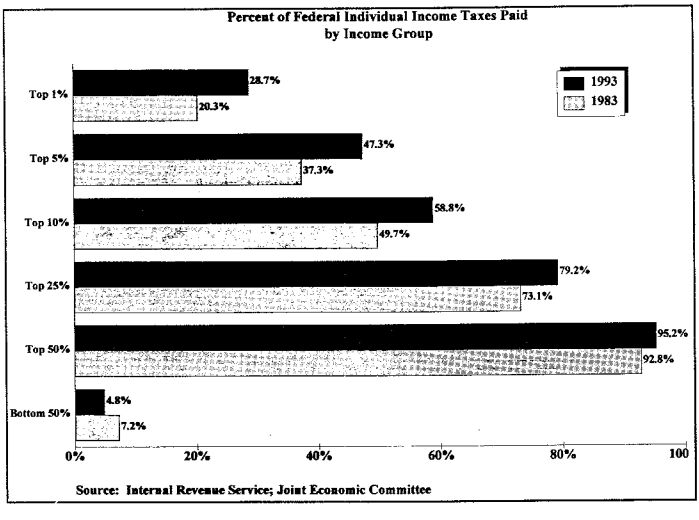
The personal and dependent exemptions that totaled $600 in 1950 was $2,500 in 1995. Unfortunately, had then deductions merely kept pace with inflation, they would be more than $3,800 today. In other words, ***these exemptions have eroded by more than $5,200 for a family of four.*** *(Treasury Department; JEC)*

11. Good Money After Bad: Interest Payments On The National Debt Remain A Major Taxpayers' Expense

Interest payments on the national debt account for one out of every seven dollars taxpayers send to Washington. Reducing runaway deficit spending while balancing the budget is the only way to bring down the national debt and lower the high cost to taxpayers of interest payments. *(OMB; JEC)*

12. Liberal Class Warfare vs. The Facts: Who Pays The Taxes?

High-income earners continue to pay a large and growing share of the rising income tax burden. ***The top tenth percent of earners saw their share of the tax burden rise from 49.7 percent in 1983 to 58.8 percent by 1993.*** By contrast, ***the bottom half of income earners saw their share of the tax burden fall from 7.2 percent to 4.8 percent between 1983 and 1993.*** *(IRS)*



Prepared by the Joint Economic Committee

Contact: Paul Merski, Economist; Ross Lindholm, Deputy Director; or Shelley Hymes, Communications Director: (202) 224-5171

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

1980s TAX CUTS:
MYTHS vs. FACTS

June 7, 1996

The large tax cuts of 1981 have been vilified as "voodoo economics." But if there is such a thing as voodoo economics, it is the haphazard collection of myths, such as those listed below, used to attack tax cuts:

Myth 1:
The 1981 tax cuts "exploded the deficits."

Facts

- Tax cuts resulted in increased revenues. Federal receipts rose from $599 billion in 1981 to $991 billion in 1989 - an increase of 65.3 percent.

- Even adjusting for inflation, receipts (in 1996 dollars) *rose* from $1.03 trillion in 1981 to $1.23 trillion in 1989 - an increase of 19.5 percent.

- In fact, when the tax cut went into full effect in 1983, the real increase in receipts from 1982 to 1989 was 24.1 percent.

- Despite claims that the deficit increased by 39.6% in real terms between 1981and 1989, such claims obfuscate the facts. During the relevant years - when the tax cuts took hold, between 1982 and 1989 - the deficit actually *fell* by 7.8 percent in inflation-adjusted dollars.

Myth 2:
The deficits were a "credit card" for the economy that enabled it to grow

Facts

- Although deficits persisted throughout the 1980s, long-term interest rates fell from more than 14 percent in 1981 to less than 8 percent in 1986 and 1989. The downward trend during the whole decade is pronounced and consistent.

- While deficits and long-term rates came down, the economy was booming. The entire expansion, which began in the fourth quarter of 1982 and ended in the third quarter of 1990, yielded an average growth rate of 3.7 percent. Today, a common refrain is heard - that the economy cannot grow faster than 2.5 percent. This may be true under Clinton's high taxes, onerous regulations, and burdensome government spending. But with 1980s-style tax reform, 4 percent growth - such as that experience between 1982 and 1989 - could easily be achieved.

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- Some argue that growth was rapid only because the economy was coming out of a deep recession. This is wrong. In the second quarter of 1983, real GDP surged past previous levels, indicating that the economy had already made up for the recession. But in the *following* year, the economy grew at a stunning rate of 7.5 percent - even as inflation was declining!

- Deficit spending does not and cannot create growth. When deficit spending rose after President Reagan left office, economic growth dropped by more than a third - from 3.9 percent in 1988 to 2.4 percent in 1989 - and then fell into recession, with a -1.7 percent contraction in 1990.

Myth 3:
The "rich became richer and the poor became poorer" during this "Decade of Greed"

Facts

- Liberal critics take curious satisfaction in manipulating data to rekindle the flames of class warfare. One area in which this is common is income growth.

- All income groups saw their incomes rise in the 1980s. This was largely the result of the 1981 tax cuts and their positive impact on growth.

Real Income Growth, 1982-1989	
20th percentile	11.0%
40th percentile	11.0%
60th percentile	11.6%
80th percentile	13.8%

Source: U.S. Census Bureau

Prepared by Paul G. Merski, Chief Economist, and Phaedon I. Sinis, Associate Economist.

Joint Economic Committee
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CHAIRMAN

A TAX CUT IS A RAISE

President Clinton and the Democrats have offered their solution to falling wages: raising the minimum wage. But only 15% of the people who earn the minimum wage, or just above it, are heads of households - single parents or sole earners in married families. Overall, that's 1.3 million workers nationwide. By contrast, 28 million households nationwide would have gotten a tax credit of $500 per child if Clinton had signed the Republican tax cut, which he vetoed instead. Put simply, Clinton's plan to raise wages would leave almost 27 million workers out in the cold.

As the following chart clearly shows, the Republican tax cut would do a better job of putting more money in more people's pockets than raising the minimum wage would - even if the minimum wage didn't kill the more than 600,000 jobs that economists expect.

STATE	NUMBER OF HOUSEHOLDS ELIGIBLE FOR $500 TAX CREDIT[1]	HEADS OF HOUSEHOLDS BENEFITTING FROM MINIMUM WAGE INCREASE[2]	DIFFERENCE BETWEEN COLUMNS 1 & 2
Alabama	458,305	43,760	414,545
Alaska	50,764	504	50,260
Arizona	344,152	20,618	323,534
Arkansas	204,550	24,476	180,074
California	3,220,961	153,755	3,067,206
Colorado	443,390	13,475	429,915
Connecticut	450,950	3,491	447,459
Delaware	84,403	2,381	82,022
District of Columbia	58,234	1,724	56,510
Florida	1,220,002	91,188	1,128,814
Georgia	731,198	41,067	690,131
Hawaii	119,847	0*	119,847

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Idaho	87,656	5,929	81,727
Illinois	1,306,658	61,960	1,244,698
Indiana	686,448	32,167	654,281
Iowa	352,426	10,920	341,506
Kansas	269,855	12,815	257,040
Kentucky	384,228	31,630	352,598
Louisiana	490,407	35,102	455,305
Maine	131,997	5,002	126,995
Maryland	635,082	13,057	622,025
Massachusetts	656,736	12,122	644,614
Michigan	1,133,824	37,410	1,096,414
Minnesota	529,451	12,014	517,437
Mississippi	234,841	25,408	209,433
Missouri	582,332	31,886	550,466
Montana	66,566	4,907	61,659
Nebraska	187,140	6,466	180,674
Nevada	125,699	4,774	120,925
New Hampshire	128,774	3,936	124,838
New Jersey	929,953	18,709	911,244
New Mexico	161,684	12,657	149,027
New York	1,791,245	63,168	1,728,077
North Carolina	758,648	42,876	715,772
North Dakota	69,979	3,580	66,399
Ohio	1,316,904	54,009	1,262,895
Oklahoma	326,092	22,451	303,641
Oregon	369,147	8,198	369,949
Pennsylvania	1,247,727	56,429	1,191,298
Rhode Island	94,031	2,966	91,065
South Carolina	415,514	30,433	385,071

South Dakota	84,654	3,706	80,948
Tennessee	570,268	37,163	533,105
Texas	2,016,767	156,892	1,859,875
Utah	222,830	6,739	216,091
Vermont	90,396	1,406	88,990
Virginia	784,417	25,542	758,875
Washington	602,878	10,163	592,715
West Virginia	155,077	23,273	131,804
Wisconsin	560,604	14,718	545,886
Wyoming	68,441	2,926	65,515
Totals	28,014,132	1,341,958	26,672,174

*Hawaii's minimum wage already exceeds Clinton's proposal

1. Heritage Foundation; Conferees' $500 Per-Child Tax Credit Frees 3.5 Million Families From Income Tax Rolls; Scott Hodge; November 15, 1995.

2. Employment Policies Institute; A State-By-State Profile of Today's Minimum Wage Workers.

Joint Economic Committee
U.S. SENATOR Connie Mack
CHAIRMAN

ISSUED BY
JEC MAJORITY STAFF
MARCH 1996

TAX BURDEN ON TYPICAL AMERICAN FAMILY FAR EXCEEDS FAIR

"According to a recent Reader's Digest poll, the maximum tax burden Americans believe a family should bear is 25 percent."

How much should American families pay in total taxes? According to a recent *Reader's Digest* poll, the maximum tax burden Americans believe a family should bear is 25 percent.[1] And that's not just for federal income taxes but all levies, including social security taxes, sales taxes, excise taxes, property taxes, etc.

Unfortunately, the tax burden imposed on a typical family is remarkably out of step with their wishes. Most American families forfeit far more than 25 percent of their income to taxes. In fact, the typical family of four now pays a total of 38.2 percent of their income in taxes - more than they spend on food, clothing, and housing combined[2] (Table 1, Figure 1). While Americans believe 25 percent of their income should be the maximum levy for all taxes, federal taxes alone claim for 26.5 percent of the typical family's earnings. Total state and local tax levies take an additional 11.7 percent of the typical family's income.

"...the typical family of four now ays a total of 38.2 percent of their income in taxes - more than they spend on food, clothing, and housing combined."

Table 1
1995 TAX BURDEN ON THE TYPICAL AMERICAN FAMILY*

Median Family Income	$52,039
Federal Income Tax	$4,926
Payroll Taxes:	
Employee Portion	$3,822
Employer Portion	$3,822
Other Federal Taxes	$2,244
Total Federal Taxes	**$14,814**
Total State/Local Taxes	**$6,506**
Total Taxes	**$21,320**
After Tax Income	$34,541
Total Taxes as a Percent of Income 38.2%**	

Source: Tax Foundation, U.S. Bureau of the Census.
*Two-earner family of four, 1995-estimate.
**Effective tax rate calculation adds employer's share of the payroll tax to the family's income.

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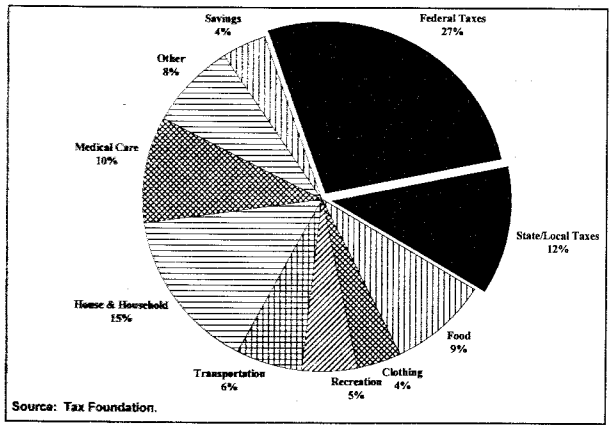
Figure 1
TWO INCOME FAMILY
1995 BUDGET



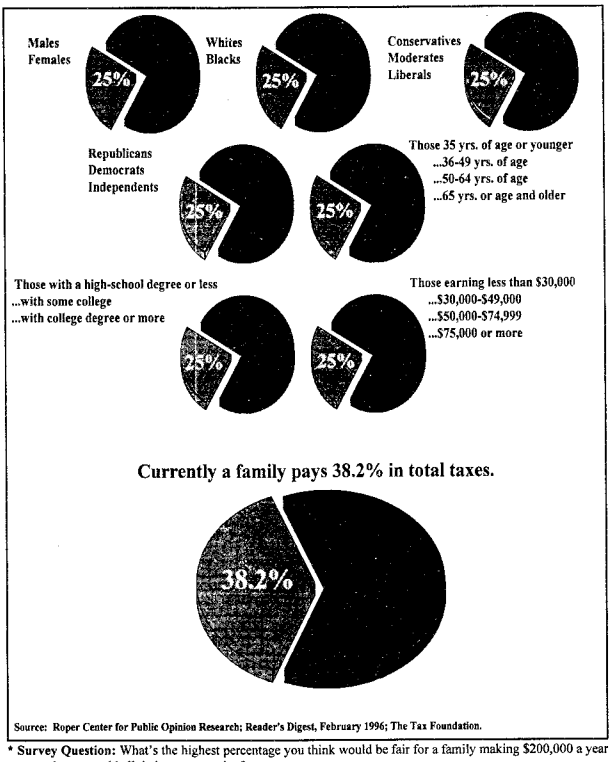
All told, the current 38.2 percent family tax burden is more than 50 percent higher than the preferred maximum of 25 percent. In other words, at the current tax rate, an individual toils more than three hours of an average eight hour workday just to pay the tax collectors. However, if a maximum tax rate of 25 percent were used, Americans would forfeit two out of eight hours work to taxes.

"...at the current tax rate, an individual toils more than three hours of an verage eight hour workday just to pay the tax collectors."

WHAT CLASS WARFARE?

Interestingly, the survey's median 25 percent maximum tax bite response cut across individuals of all income levels, races, political parties, genders, ages, and ideologies (Figure 2). Americans are remarkably uniform in their assessment of what maximum tax burden is fair despite the abundance of class warfare rhetoric. Simply stated, there is a widespread consensus that all Americans are overtaxed.

Figure 2
WHAT MAXIMUM TAX BURDEN IS FAIR?*



* **Survey Question:** What's the highest percentage you think would be fair for a family making $200,000 a year to pay when you add all their taxes together?
(JEC Note: 99.2 percent of taxpayers have incomes below $200,000 per year).
Median Responses by Type: Male 25%, Female 25%, White 25%, Black 25%, H.S. degree or less 25%, Some college 25%, College degree or more 25%, Age 35 or younger 25%, 35-49 25%, 50-64 25%, 65 or older 25%, Less than $30k in income 25%, $30k-$49k 25%, $50k-$74k 25%, $74k or more 25%, Republican 25%, Democrat 25%, Independent 25%, Conservative 25%, Moderate 25%, Liberal 25%, Married 25%, Separated/divorced 25%, Single 30%, Children at home 25%, No children at home 25%, Protestant 25%, Catholic 25%.

"...a national debt exceeding $4.9 trillion and persistent federal deficit spending over the past 26 years have come from the failure to keep spending within the bounds imposed by revenues."

A 17 Percent Federal Rate

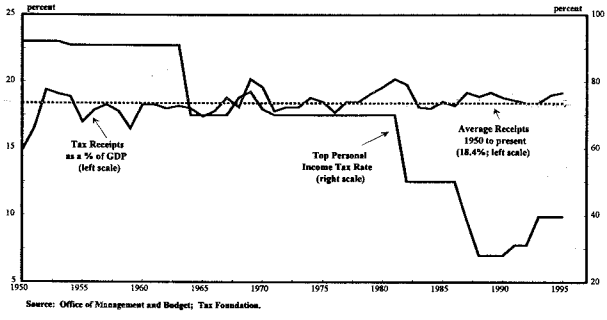
Currently, the typical family's tax burden is split approximately 70 to 30 between federal and state/local taxes respectively. If we were to preserve this ratio under the desired maximum tax bite of 25 percent, federal taxes on the family would have to drop from 26.5 percent to 17.4 percent. Likewise, total state and local taxes would need to fall from 11.7 percent to 7.6 percent.

Spending Contradictory

At the desired 25 percent maximum tax rate, the current level of government spending at all levels is also severely out of step with taxpayers' wishes. In 1995, total government spending at the federal, state, and local levels hit an estimated $2.28 trillion, including $160 billion in federal deficit spending.[3] A household's maximum tax burden of 25 percent would make the appropriate level of total government spending some $890 billion per year lower. A 25 percent maximum tax take, with no deficit spending, would allow total government spending of $1.39 trillion, roughly the same as in 1986.

"While tax rates have been raised repeatedly under the guise of deficit reduction, each $1 in new taxes raised by Congress resulted in $1.59 of new spending..."

Figure 3
Tax Receipts and Tax Rates



Source: Office of Management and Budget; Tax Foundation.

"Only by reducing both spending and the related tax burden can government get into step with the desires of the American family."

Historically, federal revenues have oscillated closely around 19 percent of GDP, no matter how high tax rates were set (Figure 3). Regardless of whether the top marginal income tax rate was 90, 70, 50, or 28 percent, revenues remained around 19 percent of GDP. Unfortunately, a national debt exceeding $4.9 trillion and persistent federal deficit spending over the past 26 years have come from the failure to keep spending within the bounds imposed by revenues.

A VICIOUS CYCLE

Unchecked deficit spending has permitted the federal government to expand far beyond its revenues. While tax rates have been raised repeatedly under the guise of deficit reduction, each $1 in new taxes raised by Congress resulted in $1.59 of new spending,as a widely circulated Joint Economic Committee report uncovered.[4] This vicious cycle of budgetary pressures has engulfed the typical American families with a tax burden far higher than they consider fair. Only by reducing both spending and the related tax burden can government get into step with the desires of the American family.

Prepared by Joint Economic Committee economist Paul G. Merski. (202) 224-5171.

ENDNOTES

1. *Reader's Digest*, Special Report: "How Fair Are Our Taxes," Rachel Wildavsky; February 1996; pp.57-61. Survey conducted by the Roper Center for Public Opinion Research.

2. Tax Foundation, Special Report No. 54: "Taxes Force American Family to Tighten Belt," Arthur P. Hall; November, 1995.

3. Office of Management and Budget: Budget of the United States Government, Historical Tables, Fiscal Year 1996, Table 15.2, p.237; and JEC estimates.

4. Joint Economic Committee study: "Taxes and Deficits: New Evidence," Richard Vedder, Lowell Gallaway, and Christopher Frenze; October 30, 1991.

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

ISSUED BY:
JEC Majority Staff
March 1996

THE PRESIDENT HAS FORGOTTEN THE MIDDLE CLASS

"We will lower the tax burden on middle class Americans." [1]

Presidential candidate Bill Clinton, 1992

"Probably there are people in this room still mad at me because you think I raised your taxes too much. It might surprise you to know that I think I raised them too much, too." [2]

President Bill Clinton, October 17, 1995

"The Omnibus Budget Reconciliation Act (OBRA '93), signed into law on August 10, 1993, contained the largest tax increase in history."

Despite inheriting an improving economy upon entering the Oval Office, President Clinton abandoned his campaign promise of middle-class tax relief and instead levied a $241 billion tax hike. The Omnibus Budget Reconciliation Act (OBRA'93), signed into law on August 10, 1993, contained the largest tax increase in history. This $241 billion net tax hike included retroactive income tax increases effective January 1, 1993; before Clinton assumed office.[3]

TAXING THE MIDDLE CLASS

Instead of middle-class tax relief, President Clinton chose to include in his $241 billion tax plan higher federal gasoline taxes, tax hikes on Social Security recipients, and steep income tax hikes on small business owners. The President even tried unsuccessfully to institute a brand new $71 billion BTU energy tax that would have cost the typical family nearly $500 per year. Clinton's tax hikes directly and indirectly increased the tax burden on millions of middle-income taxpayers. It's little wonder why President Clinton recently stated that he may have raised taxes too much.

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TAXING THE ELDERLY

When President Clinton claims his tax hike hit only the "wealthy," he ignores the huge tax increase he placed on the middle-income elderly. Under the Clinton tax hike, millions of middle-class seniors now pay higher taxes. That's because 85 percent of Social Security benefits are now subjected to federal taxes for unmarried seniors earning more than $34,000 and married seniors with combined income of $44,000 or more (only $22,000 per person). These income levels were not even indexed for inflation, which means that each year even more elderly have their benefits taxed. Despite the Administration's "soak-the-rich" rhetoric, middle-income seniors ended up getting drenched. To add insult to injury, the Clinton Administration originally counted their increased tax burden on the elderly as a spending cut. This five-year $25 billion tax hike impacts more than six million Social Security recipients, leaving them with less money to meet their living expenses.

"Estate taxes regularly tax money that has already been taxed once, if not twice."

President Clinton's tax hike also reinstated the highest estate and gift tax rate. Federal estate (death) and gift taxes represent punitive double taxation and unfairly transfers income from families to the government. Estate taxes regularly tax money that has already been taxed once, if not twice. Clinton's reinstatement of the steep 55 percent top estate tax rate frequently forces many families to liquidate or sell their businesses or farms just to pay the tax collector. Families are forced to pay massive taxes rather than being able to pass their belongings onto their next generation -- often wiping out a lifetime of hard work.

THE MIDDLE-CLASS DRIVES, TOO

One of the largest items in Clinton's tax hike plan increased federal gasoline taxes to the tune of $32 billion.[4] President Clinton raised the federal gasoline tax a total of 6.8 cents per gallon, forcing all drivers to pay more each year for their commuting and traveling. Americans now pay 18.4 cents per gallon of gasoline just in federal excise taxes. And higher gasoline prices mean consumers pick up the increased transportation costs in the price of the goods they purchase. As a share of income, middle-income families face nearly triple the burden of higher income families from the regressive gasoline tax burden.

"...much of the $241 billion in tax hikes has fallen on middle-income households as well as small-business owners and their workers."

Traditionally, federal gasoline taxes have been earmarked to go into the Highway Trust Fund for road construction. However, for the first time, Clinton allowed his additional gasoline tax to go into the general fund for general spending.

MASSIVE TAX HIKE ON SMALL BUSINESS OWNERS

The architects of Clintonomics have done their best to convince the American people that their tax hikes were targeted at the so-called "rich." However, much of the $241 billion in tax hikes has fallen on middle-income households as well as small-business owners and their workers.

The largest revenue raiser in OBRA'93 was the retroactive income-tax hike that kicked in on January 1, 1993. Although these taxes were touted as hitting only the "rich," hundreds of thousands of small businesses (and their employees) continue to absorb the increased tax burden. That's because most small businesses pay individual income taxes and are organized as Subchapter S corporations, partnerships, or sole proprietorships. Of all the businesses in America, 80 percent are unincorporated and pay taxes as individuals. Instead of encouraging small-business growth and more employment, Clinton's higher taxes have continued to transfer small-business resources to a growing government at the expense of expansion, new hiring, and higher wages for workers.

"Clinton's higher taxes have continued to transfer small-business resources to a growing government at the expense of expansion, new hiring, and higher wages for workers."

TABLE 1
CLINTON'S IMPACT ON THE TOP MARGINAL TAX RATE

Previous top marginal income tax rate	**31.0%**
Top rate increases from 31% to 36% ($115,000 single return, $140,000 joint return)	5.0%
10% surcharge on more successful individuals and small businesses (incomes over $250,000)	3.6%
Elimination of $130,000 wage cap on health insurance payroll tax	2.9%
Permanent extension of expiring limitations on both personal exemptions and itemized deductions	2-3%
New top marginal income tax rate faced by small businesses	**44.5-45.5%**

Source: U.S. Department of Treasury; Joint Economic Committee.

Table 1 shows how Clinton's "soak the rich" tax hikes have caused many individuals and small businesses to face as much as a 14.5 percentage point increase in their marginal income-tax rate--a whopping 46 percent hike. The Clinton administration justified and sold this major tax hike largely by claiming that only a limited number of small businesses would have to pay. However, an examination of the latest 1993 tax return data paints a different picture of who pays.

TABLE 2
SMALL-BUSINESS INCOME SUBJECT TO TAX INCREASE*

Small-Business Income Level	Business or Professional (% of total income)	Partnership or S Corporations (% of total income)	Totals
$200,000 - $500,000*	8.0%	11.6%	19.6%
$500,000 - $1 million	5.4%	16.1%	21.5%
More than $1 million	2.7%	23.0%	25.7%
Totals	16.1%	50.7%	**66.8%**

** This table actually underestimates the full amount of business income subject to Clinton's higher taxes since the new tax rate applied to income starting at $115,000 single and $140,000 joint return (for combined business and personal income).*

Source: Internal Revenue Service, 1993 tax return data; Joint Economic Committee.

Table 2 shows that at least two-thirds of the taxpayers with adjusted gross incomes of more than $200,000 (those assumed to have incomes high enough to be affected by Clinton's income-tax hikes) reported business income on their individual income tax returns.[5]

"Eighty-four percent of these new jobs are created by businesses with 500 or fewer employees."

Simply stated, the bulk of small-business income has been subject to Clinton's new income-tax hikes. Looking at partnerships and Subchapter S corporations reveals that more than half of the income generated by this group of small businesses is subject to Clinton's higher taxes. Any tax increase on this pool of income is precisely what reduces the ability of these successful small businesses to reinvest and expand, to increase wages and benefits, or to hire new workers. The amount of after-tax income available for expansion is critical to job growth and the ability to pay higher wages. The sharp increase in marginal tax rates of small businesses earning as little as $115,000 diminishes business expansion and wage growth.

Punishing Success

The fundamental economic point missed by the supporters of Clintonomics is the relationship between risk and reward. To entice individuals to undertake the substantial risks involved with starting and expanding a business (or even hiring additional workers), a commensurate possibility for substantial reward must exist. This reward comes largely as personal income. Higher income-tax rates mean less reward, less risk taking, and fewer jobs created.

Prosperous small businesses are the true engines of economic growth and job creation in our economy. Businesses with 500 or fewer employees created eighty-four percent of new jobs last year.[6] These expanding operations are exactly the small businesses punished by Clinton's tax hikes.

"Despite the economic recovery of recent years, real median household incomes have stagnated."

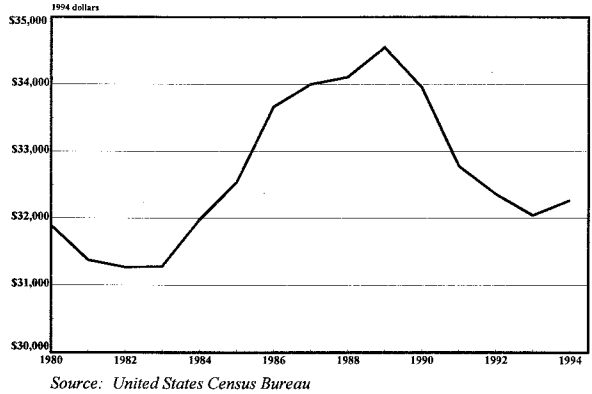
Although the proponents of Clintonomics would like Americans to believe that only a few wealthy businesses were affected by the new tax hikes, most small-business owners realize they will directly or indirectly absorb the blow. Simply put, 100 percent of small businesses face the increased burden of tax hikes, whether from Clinton's boost in income taxes, corporate taxes, payroll taxes, and fuel taxes, or because their customers now have less after-tax income to spend on their products and services. Fewer than half of new small businesses survive their first five years. The additional tax burden Clinton levied on them, as well as their customers, has made it that much more difficult to stay afloat.

Tax Hikes Diminish Middle Class Income Growth

Despite the economic recovery of recent years, real median household incomes have stagnated. The Census Bureau recently reported that real median household income "showed no statistically significant change between 1993 and 1994."[7] Median household income rose only 0.7 percent in 1994, or $223. Clinton's tax increases have only aggravated the problem. Even this meager income gain was nearly cut in half since federal income and payroll taxes rose $105. Therefore, the median household's disposable income rose only 32 cents per day in 1994. As illustrated in figure 1, real

median household income remains 6.3 percent below its 1989 level. The Labor Department's recently released employment cost index revealed that American worker's wages and benefits rose only 2.9 percent for all of 1995. Sadly, this is the smallest rise in employee compensation since the government began monitoring it in 1981. Worse yet, after allowing for 1995's 2.5 percent inflation, American workers witnessed an abysmal 0.4 percent rise in their total wages and benefits.

FIGURE 1
REAL MEDIAN HOUSEHOLD INCOME 1980-1994



Source: United States Census Bureau

"...Internal Revenue Service tax return data shows that 59.6 percent of taxpayers reporting capital gains have income below $50,000 per year."

REVERSING THE TAX BURDEN ON THE MIDDLE CLASS

The $241 billion tax burden that Clinton levied on all Americans, combined with stagnant middle-class incomes, have made federal tax relief an important part of the Republican agenda. The Republican balanced budget plan includes tax relief that would significantly offset some of the damage done by recent tax hikes.

The bulk of the proposed tax cuts would help middle-income families. For example, the largest item in the Republican tax relief proposal, the $500 per child tax credit, is 60 percent of the total proposed tax relief. A family with two children earning $30,000 would have their 1996 federal income tax reduced 51 percent (from $1,958 to $958) by taking advantage of the $500 per child tax credit.

The Republican capital gains tax relief plan would also benefit middle-income households. While Democrats attempt to portray the proposed capital gains tax relief as a "giveaway to the rich," Internal Revenue Service tax return data shows that 56.9 percent of taxpayers reporting capital gains have incomes below $50,000 per year.

More than one-third, or 36.8 percent, of taxpayers reporting capital gains had incomes of $30,000 or less.[8] Many elderly Americans fall into these lower income categories because they often depend on cashing in their capital gains as a source of retirement income. Perhaps most important, capital gains tax relief would spur increased investment needed to improve both long-term economic growth and stagnant household incomes.

While Republican tax relief efforts will help roll back some of the past tax burden increases, additional tax relief as well as tax reform are critical to improving the incomes of Clinton's forgotten middle class.

Prepared by Paul G. Merski, Economist, Joint Economic Committee.
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ENDNOTES

1. The Clinton for President Committee, "Putting People First, A National Economic Strategy for America," by Governor Bill Clinton, 1992.

2. President Bill Clinton at Democratic fundraiser in Houston, Texas October 17, 1995.

3. Revenue-raising provisions in OBRA'93 totaled $268 billion (1994-1998). Including the revenue-losing provisions e.g., extending existing tax credits and the repeal of certain luxury taxes, results in a net tax increase of $241 billion (1994-1998) for the total tax package.

4. Joint Committee on Taxation estimates (1994-1998), JCT-11-93; August 4, 1993.

5. Internal Revenue Service, Statistics of Income Bulletin: Volume 15, Summer, 1995.

6. Dun and Bradstreet 1995 survey.

7. Department of Commerce, Bureau of the Census: Current Population Reports - Consumer Income, P 60-189, 1995.

8. Joint Economic Committee Report, "Give the Middle Class a Break: Cut the Capital Gains Tax Rate," November, 1995.

INTEREST RATES

Joint Economic Committee
U.S. SENATOR
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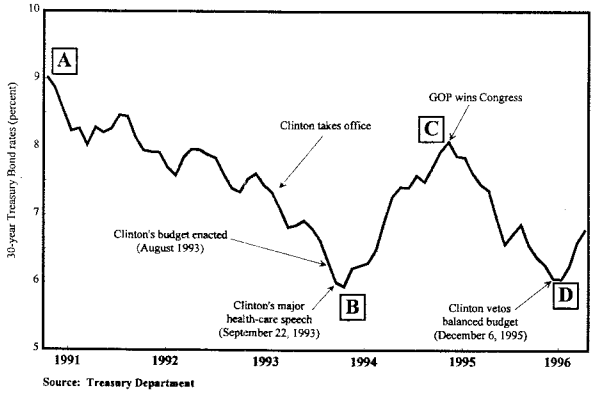
CHAIRMAN

5/28/96 Joint Economic Committee Analysis

Clintonomics Equals Higher Interest Rates

Movements of interest rates reflect uncertainty about the future health of the economy: the bleaker the future looks, the higher rates climb. While Clinton will probably try to take credit for lowering interest rates on the campaign trail, as this chart shows, in fact, Clinton's policies have done more to hurt than to help.

30-YEAR TREASURY BOND YIELDS



Source: Treasury Department

A. The fall in rates during 1993 was simply the extension of a trend that started in 1990. Yields on 30-year Treasury bonds fell from more than 9 percent in September 1990 to less than 6 percent in October 1993. Why? The economy was slow, the Federal Reserve held rates down artificially, and candidate Bill Clinton had campaigned ~~on the~~ ***promises*** of lower taxes and more economic opportunity.

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B. The downward trend reversed in October 1993 after two key events: the enactment of Clinton's record tax hike and his speech to Congress on nationalizing health care. Interest rates rose once again, from under 6% to more than 8%. Higher taxes and more regulation--both real and threatened--mean less investment and output, leading to too much money chasing too few goods. Interest rates rise on expectations of inflation.

C. But the rise in rates after Clinton's tax hike and health care speech wasn't permanent. When Republicans won control of Congress, rates headed right back down from more than 8 percent to almost 6 percent. Why? Republican policies mean getting government's fiscal house in order, with less spending and lower taxes. The markets know this will boost growth and lower inflation.

D. Unfortunately, interest rates turned back up again in December after Clinton vetoed the Republican Balanced Budget Plan. The markets know he is unwilling to back up his rhetoric by signing a real balanced budget and a genuine tax cut for American families, which would mean a real opportunity for economic growth.

Monthly Payments for Typical Consumer Loans				
	November 8, 1994	January 1996: Clinton veto and bal. budget negotiations break down	Today (May 1996)	Balanced budget plan implemented
Mortgage ($75,000 30-yr)	$613	$500	$547	$495
Auto Loan ($15,000 4-yr)	$384	$370	$377	$363
TOTAL	$997	$870	$924	$858
ANNUAL SAVINGS/ COSTS		$1,524 (from Nov. 1994)	-$648 (from Jan. 1996)	$792 (from today)

- Since November 8, 1994, when the Republicans gained control of Congress and promised to balance the budget and cut taxes, interest rates (30-year Treasury bond yields) fell to a low of 5.95 percent in January 1996. This represented $1,524 in yearly interest savings for a family with a $75,000 mortgage and a $15,000 car loan.

- However, since Clinton's veto of the Republican balanced budget plan and the breakdown of negotiations, interest rates increased nearly one full percentage point. This would cost a typical family $648 more per year in higher interest payments on that same mortgage and car loan.

- But, if a balanced budget becomes a reality, economists agree that interest rate will drop at least one percentage point lower, saving the family an additional $1,668, compared to where interest rates were on November 8, 1994.

Joint Economic Committee
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INTEREST SAVINGS FORGONE
FROM NOT BALANCING THE BUDGET

A TWO-PERCENTAGE-POINT DROP

May 31, 1996

If rates drop from today's levels by 2 percentage points...			
	Today's rates	Rates 2 percentage pts. lower than today	TOTAL LIFE-OF-LOAN SAVINGS, TODAY VS. 2% LOWER
Mortgage ($75,000 30-yr fixed)	7.93	5.93	$36,360
Student loan ($11,000 10-yr)	8.6	6.6	$1,440
Car loan ($15,000 4-yr)	9.5	7.5	$672

Source: Joint Economic Committee

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ISSUE UPDATES

Joint Economic Committee
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June 7, 1996

MULTIPLE JOB MISERY UPDATE

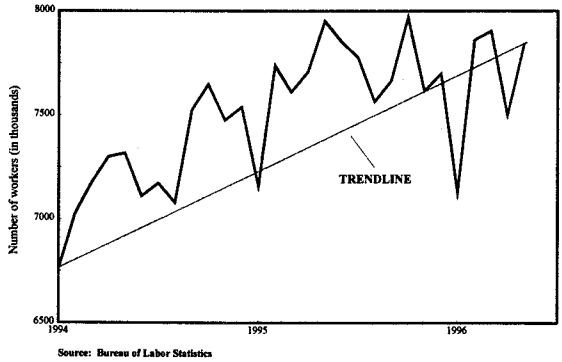
Last month we reported on data from the Bureau of Labor Statistics showing that the number of people having to work two or more jobs to make ends meet was on the rise. The latest data from BLS shows this trend continuing.

- Since January 1994, the **number of people working two or more jobs of any kind is up 16 percent** - from 6,756,000 to 7,846,000. The **number of women working two or more full-time jobs has risen 21 percent** - from 72,000 to 87,000.

- Since January 1995, **one-fifth of new jobs have gone to people taking an extra job to make ends meet, not to people entering the job market or getting off welfare**.

A political joke has been making the rounds. Someone asks a worker if he has heard about all the new jobs. The worker's reaction: "Yeah, I know . . . I have three of them." The Clinton administration is worried about this idea, that the number of jobs is growing because so many people have to take an extra job to make ends meet. President Clinton's Council of Economic Advisers recently tried to discredit this idea. But the facts speak for themselves.

WORKERS WITH MULTIPLE JOBS



Source: Bureau of Labor Statistics

Contact: Bob Stein, Economist, (202) 224-5171, or Shelley Hymes, Communications Director, (202) 224-7683

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

June 7, 1996

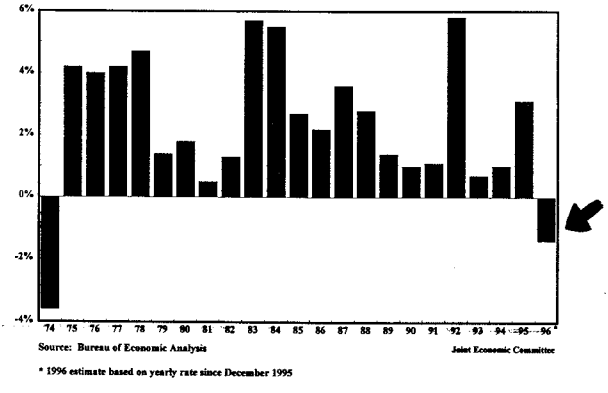
WORKERS' SHRINKING PAYCHECKS

Workers are anxious. A close look at real disposable income shows why. Real income is how much workers get paid after adjusting for inflation. Real *disposable* income is real income *after taxes*. In other words, real disposable income is how much of workers' pay is controlled by workers themselves, rather than by politicians and bureaucrats.

So far in 1996, real disposable incomes have dropped at a yearly rate of 1.4 percent. If this trend holds we would have the biggest drop in any year since 1974. Remarkably, the drop in '74 came with a major recession. By contrast, this year's drop wouldn't even take a recession. All it would take is slow growth and President Clinton's tax hike.

The poor performance of workers after-tax paychecks is nothing new under Clinton. In the ten years before Clinton took office, real disposable personal income rose at a yearly rate of 3.2 percent. Since he took office it has risen at a yearly rate of only 1.3 percent.

Real Disposable Income
(percent change, December over December)



Source: Bureau of Economic Analysis — Joint Economic Committee

* 1996 estimate based on yearly rate since December 1995

Contact: Bob Stein, Economist, (202) 224-5171, or Shelley Hymes, Communications Director, (202) 224-7683

Joint Economic Committee

ISSUED BY
JEC MAJORITY STAFF
June 1996

U.S. SENATOR
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Executive Director

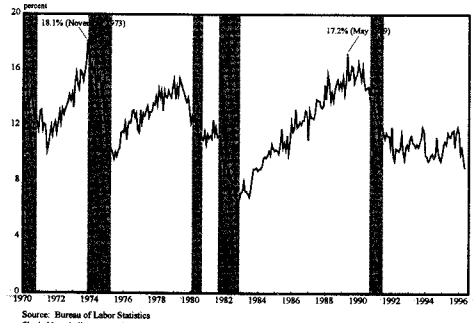
JOB LOCK UPDATE

Last month, we reported on "job lock" among American workers - when people so fear losing their jobs, and don't like their prospects of finding new ones, that they find themselves trapped by uncertainty in their current jobs. The most recent employment report from the Bureau of Labor Statistics shows that job lock worsened in May, as the share of unemployed workers who willingly left their jobs fell from 9.7 percent in April to 9.0 percent in May. As a result, workers' anxiety continues unabated.

During every other expansion during the last 25 years, the share of unemployed workers who voluntarily left their jobs rose. Why? Because when workers feel confident about the economy, many are willing to leave their jobs on their own in anticipation of finding something better down the road. For example, in the late 1980s, after a particularly long and strong expansion, the share of unemployed workers who had voluntarily left their old jobs hit a 16-year high (see chart below).

However, Clinton's anemic expansion is the *only* expansion in which the voluntary job leavers indicator stagnated. In fact, five years into this recovery and expansion, the share of unemployed workers who have left their jobs on their own is 27 percent lower than at the end of the last recession! This helps to explain the flood of stories in the press about worker anxiety. People fear losing their jobs, and their prospects of finding new ones are dim. The reason: Clinton's tax increases and big government have caused slow growth in employment and stagnating incomes. The result: workers are mired in "job lock."

VOLUNTARY JOB LEAVERS AS A PERCENTAGE OF CIVILIANS UNEMPLOYED



Source: Bureau of Labor Statistics
Shaded bars indicate recessions

Prepared by Bob Stein, Economist, and Phaedon Sinis, Associate Economist.

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104th CONGRESS

Joint Economic Committee

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Republican Economic Update

June 11, 1996

Yes, but.....

Today's economy is mixed. While the so-called "misery index" may be low, the American people's *anxiety index* is high: wages are stagnant and the economy is sluggish. Sure, some data have been acceptable, but other statistics show why Americans are anxious:

JOBS

In May, the economy added 348,000 jobs, bringing the average growth in non-farm payrolls this year to 222,000 per month. At the same time, the unemployment rate rose from 5.4% in April to 5.6% in May - due to the fact that while more people were looking for jobs, in this slow growth economy, they weren't finding them.

High-paying manufacturing jobs showed very little growth, and would have declined again had the auto strikes not ended.

But while President Clinton boasted about the numbers, he neglected to mention that, since January 1995, about 1 in every 5 net new jobs went to people forced to take a second, or even a third job just to make ends meet, not to people entering the job market or getting off welfare.

Since January 1994, the number of women working two or more full-time jobs is up 21% - from 72,000 to 87,000.

You've heard the joke: a worker is asked if he's heard about all the new jobs, and replies "Yeah, I know . . . I've got three of them." The Clinton Administration ought to be worried that the number of jobs is growing because so many people have to get an extra job just to make ends meet.

President Clinton has claimed credit for adding 9.7 million jobs to the economy. While it would be nice if this type of job growth would continue into the future, the kind of policies advocated by the Clinton Administration in the past (and which they are likely to continue to advocate in the future), have not historically led to sustained job growth.

INCOMES

Workers are anxious. A close look at real disposable income shows why.

- Real income is how much workers' pay is worth after adjusting for inflation.
- Real disposable income is real income *after taxes*.

In other words, real disposable income is how much money workers get to control themselves, rather turn over to politicians and bureaucrats.

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So far in 1996, real disposable incomes have dropped at a yearly rate of 1.4%. If this trend holds, it would be the biggest drop in any year since 1974.

It took a major recession to force that '74 drop, but President Clinton's tax hike has proven to be so big and far-reaching that it has made the current "recovery" look like a recession.

No surprise there, since taxes as a percentage of GDP have reached an all-time high.

The poor performance of workers' after-tax paychecks under Clinton is nothing new. In the ten years before he took office, real disposable income rose at a yearly rate of 3.2%. Since he took office, it's only risen at the anemic yearly rate of 1.3%.

Average hourly earnings rose 0.3% in May, boosting the 12-month gain to 3.5%, the highest since January 1991. Even so, they're barely keeping pace with inflation. In real world terms: Americans' purchasing power remains stagnant.

ECONOMIC GROWTH

Last week the Commerce Department revised its estimate of the current economic growth rate down from 2.8% to 2.3%. Coincidentally, 2.3% is also the average growth rate experienced during the entire term of the Clinton Administration.

By contrast, the growth rate for 1992, the year before Clinton came into office was 3.7%; the growth rate for the decade before Clinton was 3.2%, the average growth for the past 5 expansions was 4.4%, and even the post-WWII era surpassed this President's anemic record with a 3.3% growth rate. Bill Clinton's anemic 2.3% slow growth economy is nothing to boast about.

- Prepared for Republican Conference Secretary by Joint Economic Committee -

THE ECONOMY: WHERE DO WE STAND?

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ON THE SUPPLY SIDE

An Antidote for Clintonomics

By Connie Mack

WHILE traveling across my home state of Florida, I often ask the people I meet whether they are enjoying a better standard of living than their parents did at the same age.

Generally, the answer is yes. But when asked whether their own kids will enjoy a better living standard when they reach the same age, the answer is invariably a resounding no.

The American dream is dying on President Clinton's watch. What's the American dream all about?

It's about handing over a better future to our kids. It's about working hard and making the best of opportunities. It's about hope.

OPINION/ESSAYS

Reducing taxes on low-income jobs, middle-class savers, and entrepreneurial investment will spur genuine recovery.

The economic data show that growth under Bill Clinton pales in comparison to average growth during the postwar era. Since 1993, GDP has fallen $308 billion behind that average, which means that this administration's high tax, heavy regulation policies will cost a typical household $3,116 this year, or $260 a month.

American families are working harder and keeping less. There has been zero real median family income growth under this administration.

More and more families are seeing their breadwinners take second jobs to make ends meet – a 16 percent increase since January 1994.

And at the same time that incomes are stagnating, family tax burdens are rising. Since 1950, the typical American has forfeited more than an extra month's work to cover the growing cost of taxes. Tax Freedom Day, the day that families can begin to work for themselves rather than work to pay off their taxes, has slid from April 3 in 1950 to May 7 today.

How can we return to the more robust growth rates of our recent past? By providing meaningful tax relief for every American and by adopting an honest balanced budget plan that will bring down the deficit and promote economic growth.

Republicans know that we *can* and *must* do both. In fact, only by establishing these twin goals can either actually be accomplished.

Eliminating wasteful government programs and streamlining the bureaucracy are important parts of the Republican vision. But, taken alone they are not enough.

Cutting taxes and freeing up capital are integral ingredients for a successful and prosperous society.

Reducing the tax burden on low-income jobs, middle-class savers, and entrepreneurial investment will spur a genuine recovery.

We know what works. As President Kennedy once said, "...the soundest way to raise revenues in the long run is to cut rates now." When President Reagan cut taxes in the 1980s, the economy created 21.5 million new jobs, 4 million new business. Revenues increased by 40 percent, the gross national product grew by one-third, and inflation remained low.

THE best way to get this economy moving again and restore hope and opportunity for Americans is to give people more of their own money back, balance the budget, and create an environment conducive to strong economic growth. Economic growth through less taxing, less spending, smaller government, and more freedom is nothing less than a proxy for the American dream.

■ *Sen. Connie Mack (R) of Florida is the chairman of the Joint Economic Committee.*

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

THE REAL CLINTON ECONOMY

By Senator Connie Mack, Chairman, Joint Economic Committee

If Bill Clinton and the Democrats are satisfied with today's slow 2 - 2.5 percent economic growth rate, and all the problems that go along with a sluggish economy, then Roger Altman's op-ed of June 6th is the right economic recipe for this country.

But if you believe, as Bob Dole and the Republicans do, that America's economy is operating far below its potential, then a new policy prescription is in order.

The facts are clear. Bill Clinton's economic program, including the largest tax increase in history, has created a "Growth Gap" — a wide chasm between the more dynamic economic growth rates of the past and the performance of the Clinton economy. Since Bill Clinton took office, our economy has grown at an average annual rate of 2.3 percent — an economy Mr. Clinton calls the "strongest in three decades." The truth is, the economy was growing at 3.7 percent when he was elected in 1992; it grew at 3.2 percent annually during the 1980s; and it grew an average of 4.4 percent per year during the last five expansions. In fact, since World War II, our economy has grown at an average annual rate of 3.3 percent.

Slow growth has real life consequences such as stagnating incomes, fewer job opportunities, and greater worker anxiety about the future. According to a study by the Joint Economic Committee, President Clinton's slow growth economy will cost the average household $3,116 this year or an extra $260 per month. During the Clinton years, real median household income growth has been zero.

And while Mr. Altman and many Clinton advisors argue that the federal government can't afford to cut taxes and let people keep more of their own money, the family tax burden continues to rise. Compared to 1950, the typical American family has to work an extra month just to cover the growing cost of taxes. Tax Freedom Day — the day when families stop working for the government and start working for themselves — has slid from April 3 in 1950 to May 7 this year, the latest in history. No wonder families today spend more on their taxes than they do on food, shelter, and clothing combined.

Mr. Altman argues that we can't "afford" to cut taxes, as if the money really belongs to the federal government. Bob Dole and the Republicans say we can't afford not to cut taxes and balance the budget if we want to create the kind of dynamic economy that leads to more opportunity and rising living standards for our people. The fact is, the only way to return to the rapid growth rates of the past is to give people relief from the enormous federal tax burden and to reduce the size and scope of government by honestly balancing the budget.

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We know what works — we saw it happen in the 1960s and the 1980s. President Kennedy understood that "...the soundest way to raise revenue in the long run is to cut rates now." President Reagan followed that advice and produced the longest peacetime expansion in American history — over 21 million new jobs, 5 million new businesses, a 40 percent increase in federal revenues, and an economy that grew by a third. That's the kind of economic growth that America deserves now and that our kids deserve in the future.

There's no reason why America can't again attain its full economic potential and reverse the decline in American living standards — what Mr. Altman called "our overriding economic and social problem." With the right economic policies we can. And with the right presidential leadership we will.

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

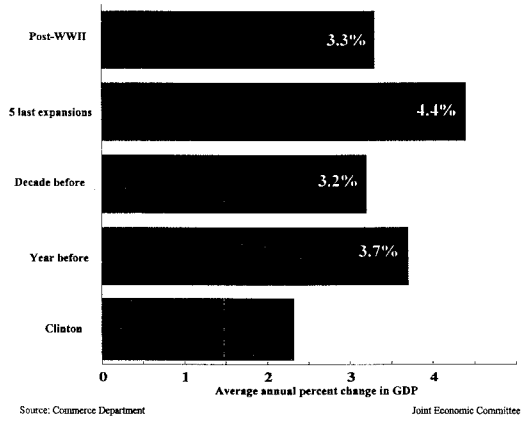
CLINTON'S GROWTH GAP

By Senator Connie Mack, Chairman, Joint Economic Committee

Washington is in a spin, and oh...what a spin it's in. This new spin revolves around contradictory facts and figures about whether or not workers *are* anxious, and whether or not workers *should* be anxious. These conflicting interpretations cause the President to either boast about his economy, or feel the deeper pain of very anxious workers concerned about their jobs and futures. However, the single best predictor of jobs, incomes and prosperity is economic growth. A close look at economic growth under Bill Clinton reveals that the American people are understandably anxious, and that much of this anxiety is due to what is known as the "Clinton Growth Gap."

The Clinton Growth Gap is the widening gap between stronger past economic growth, compared with the slow growth experienced under Bill Clinton. Despite rhetoric to the contrary, President Clinton's economy is weak. This slow growth economy has led to stagnating incomes, anemic job growth, and anxiety about the future. In fact, Clint-anemia (Clinton's economy coupled with anemic growth) *will cost a typical American family $3,116 this year, or about $260 per month.*

Clinton's Growth Gap:
Economic Growth Lags Behind No Matter How It's Measured



Source: Commerce Department

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By *any* measure, economic growth under Clinton has been poor. Economic growth rates are not just abstract concepts economists debate - working people know that the overall health of the economy dramatically effects their family's standard of living. Sluggish growth leads to stagnating incomes, fewer job opportunities, and overall worker anxiety about the future. How great can these costs be? Under Bill Clinton, slower growth means that the economy has failed to produce $308 billion worth of incomes and jobs. That failure translates into a cost to the average household of $3,116 this year - that's $260 a month. No wonder there is anxiety in America - people are working just as hard but keeping less and less of their own money.

The combinaiton of high taxes, heavy regulations, and the threat of more government red-tape is a prescription for slow growth. While measuring the precise impact of these policies can be difficult, looking at *potential* growth (how the economy *should* perform without the hindrance of anti-growth policies) tells an important story. For example, our economy was growing in 1991 and 1992, the two years before this President implemented his anti-growth policy changes. No matter what period is used in comparison, either the year before Clint-anemia, the decade before, or an era before, the economy's performance under President Clinton has been lackluster at best.

Clinton stopped the momentum.

The year before Clinton took office, the economy grew at an annual rate of 3.7 percent (fourth quarter over fourth quarter). Instead of sustaining or improving upon this momentum, in 1993 Clinton and the Democrat-controlled Congress passed the largest tax increase in U.S. history. Their steep tax hikes on individuals and businesses stifled growth by distorting incentives and hindering investment. New regulatory burdens and the threat of government-run health care compounded the economy's problems, and *growth slowed to only 2.3 percent a year.*

The last decade beat Clinton's lackluster performance.

Some may consider one year too short a period to use as a standard for growth. However, Clint-anemia Another comparison can be made using the entire decade before President Clinton took office - a decade including periods of both expansion and recession in the economy. *The average annual growth rate for the past decade was 3.2 percent - still higher than Clinton's 2.3 percent growth rate.* While Clinton claims that today's is "the best economy in three decades," this economy doesn't come close to the performance of the decade before he entered office.

Prior expansions beat Clinton's sluggish growth.

Was the last decade's economic growth an anomaly? Some may argue that using a decade with only Republican presidents as a baseline is political, but other analyses yield similar results. Clinton's economic growth performance is weak when compared to the last five expansions. These

expansions include every president since John Kennedy; three Democrats and four Republicans. *During the last five expansions, the economy grew at an average annual rate of 4.4 percent (weighted for the duration of each expansion) versus Clinton's 2.3 percent.* Again, Clinton's economic performance looks weak.

The last 45 years beat Clinton's lethargic economy.

Is 4.4 percent growth too much to ask? Another objective analysis compares President Clinton's performance to the average growth of the economy over the long run. From 1947, the beginning of the postwar period, to 1992, the last year of the Bush Administration, *the economy grew at an average annual rate of 3.3 percent.* This includes all kinds of economic scenarios - recessions, oil shocks, double-digit inflation, wars, and periods of growth. Bill Clinton has failed to match even the average long-term performance of the economy. *This slower growth under President Clinton means GDP has fallen $308 billion behind, or $3,116 for every household in American in 1996.*

The final analysis

No matter how you slice it, Bill Clinton's recipe of high taxes and heavy regulations will cost the typical American family $3,116.00 this year, or $260 a month all year long. Economic growth is the best way to measure any economy, and strong economic growth is the most assured way of attaining the American dream of hope, opportunity and freedom. Pro-growth policies of less taxing, less spending, less government regulations and more freedom will boost every Americans standards of living, help to regain some of the lost revenues from the Clinton economy, and help position Americans for prosperity for the future.

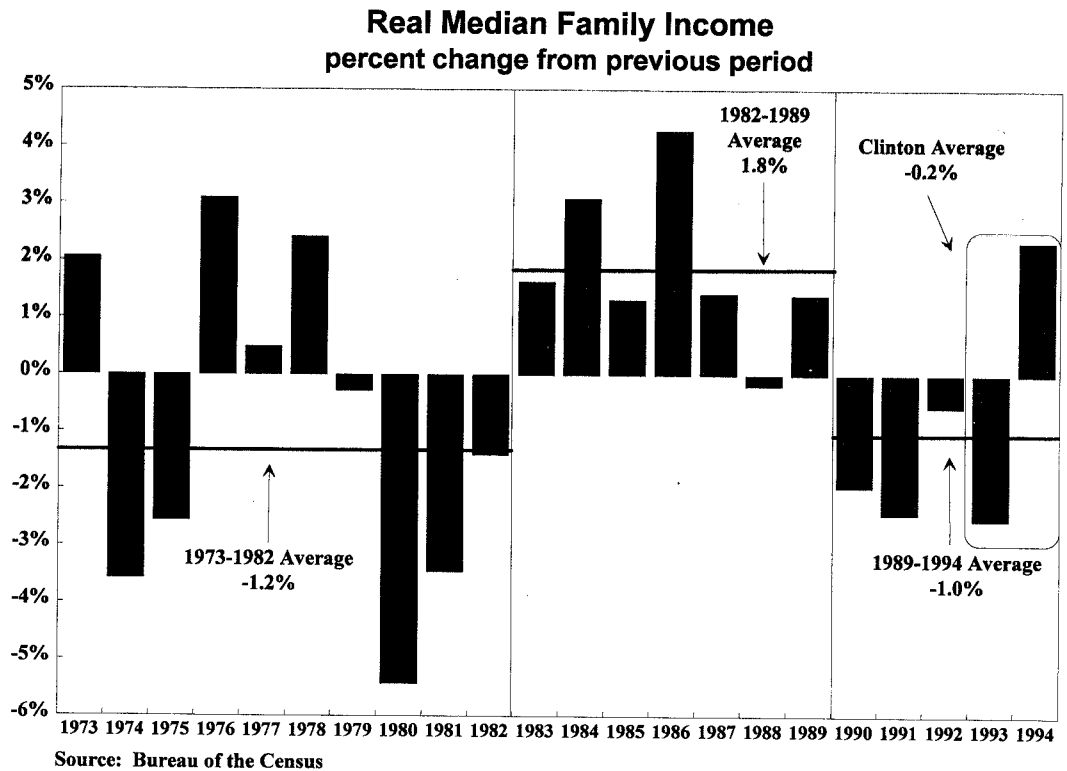
INCOME DATA

BETTER OR WORSE OFF?
IT DEPENDS ON THE POLICIES!

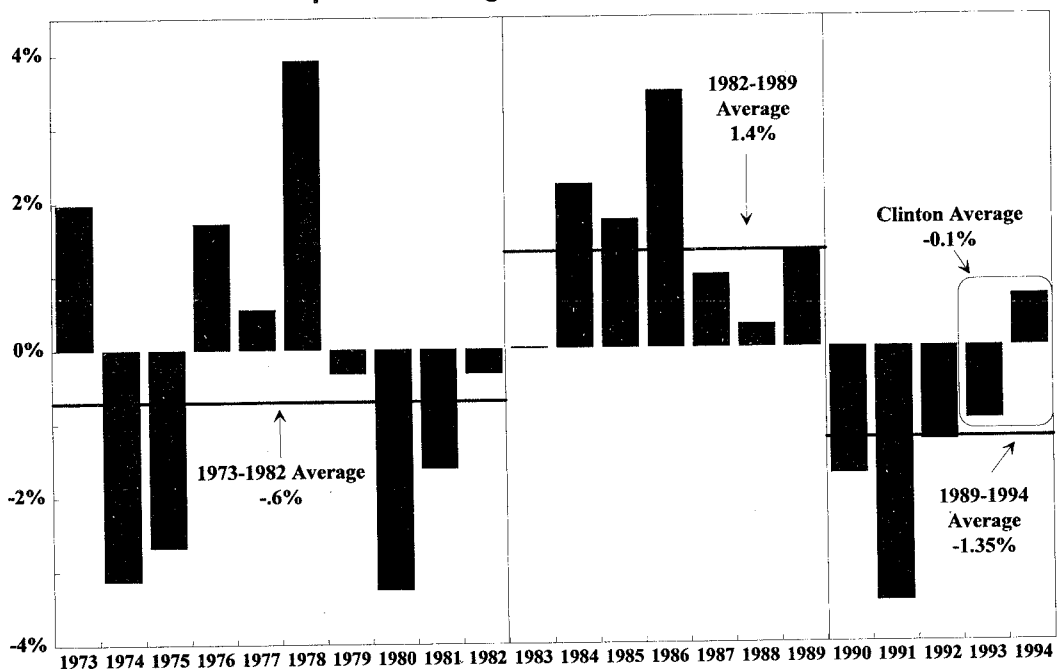
	Average real annual percent change					
	1973-82		*1982-89*		*1989-present**	
Measure of income						
Real median family income	-1.2	⇓	1.8	⇑	-1.0	⇓
Real median household income	-0.6	⇓	1.4	⇑	-1.35	⇓
Real income, low-income households (Upper limit of first quintile)	-0.7	⇓	1.5	⇑	-1.5	⇓
Real income, lower-middle-class households (Upper limit of second quintile)	-0.7	⇓	1.5	⇑	-1.7	⇓
Real income, middle-class households (Upper limit of third quintile)	-0.4	⇓	1.6	⇑	-1.0	⇓
Median real personal income, men	-1.7	⇓	1.4	⇑	-1.8	⇓
Median real personal income, women	0.4	*weak!*	3.4	⇑	-0.1	⇓
Real wages and salaries, per worker	-1.4	⇓	1.1	⇑	0.1	*weak!*
Real compensation, per worker	-0.8	⇓	1.1	⇑	0.3	*weak!*
Real disposable income, per person	0		2.8	⇑	0.7	*weak!*

*"Present" is 1994 for the first seven items in the table, as 1995 data will not be available until October 1996. The remaining three items are through 1995.

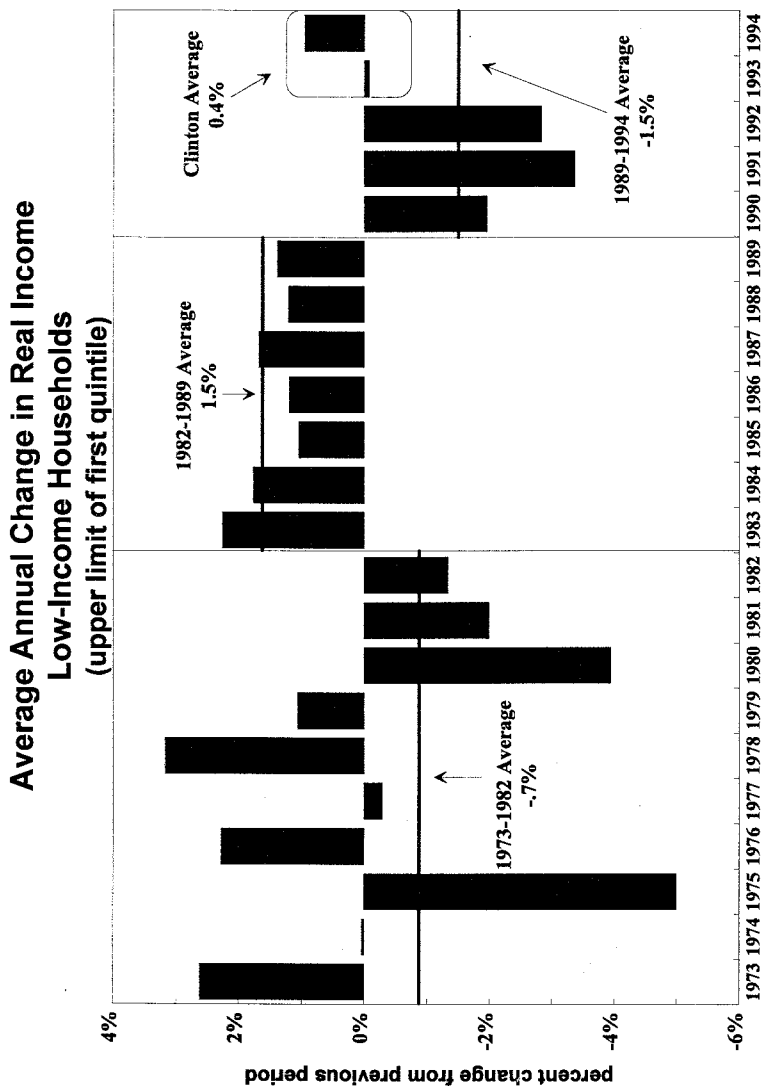
Source: Bureau of the Census, Bureau of Labor Statistics


Real Median Family Income
percent change from previous period
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
-4%
-5%
-6%
1982-1989
Average
1.8%
Clinton Average
-0.2%
1973-1982 Average
-1.2%
1989-1994 Average
-1.0%
1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994
Source: Bureau of the Census

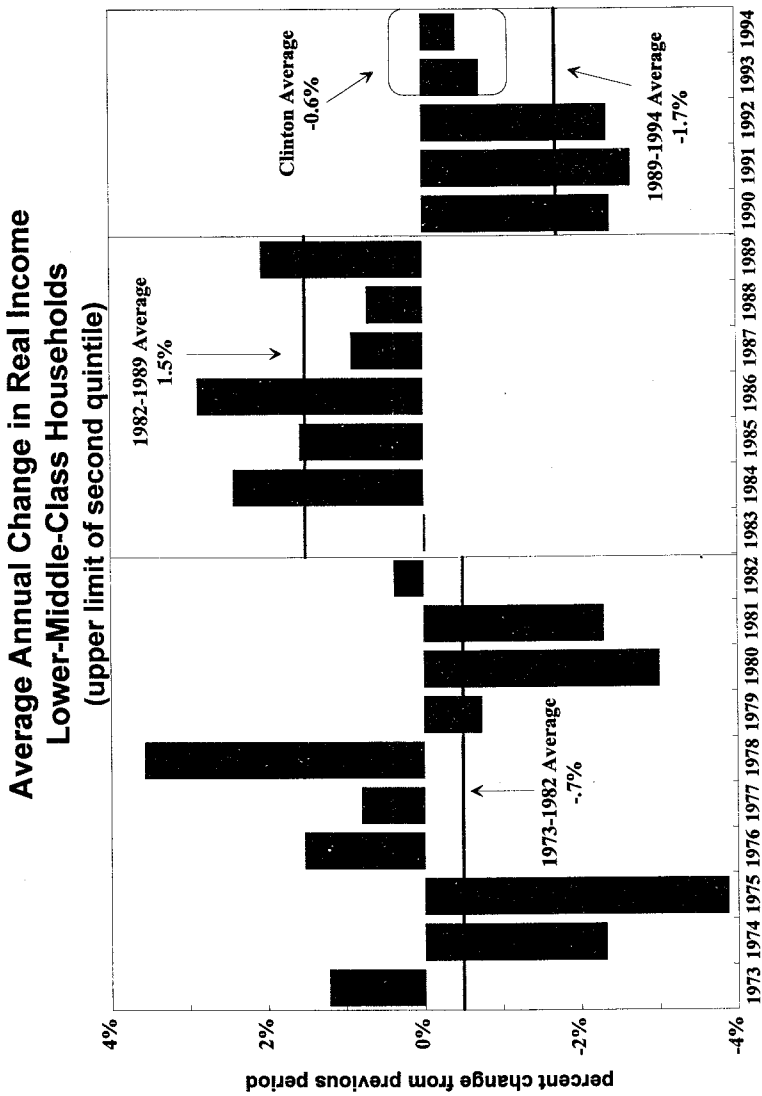
Real Median Income, All Households
percent change from previous period



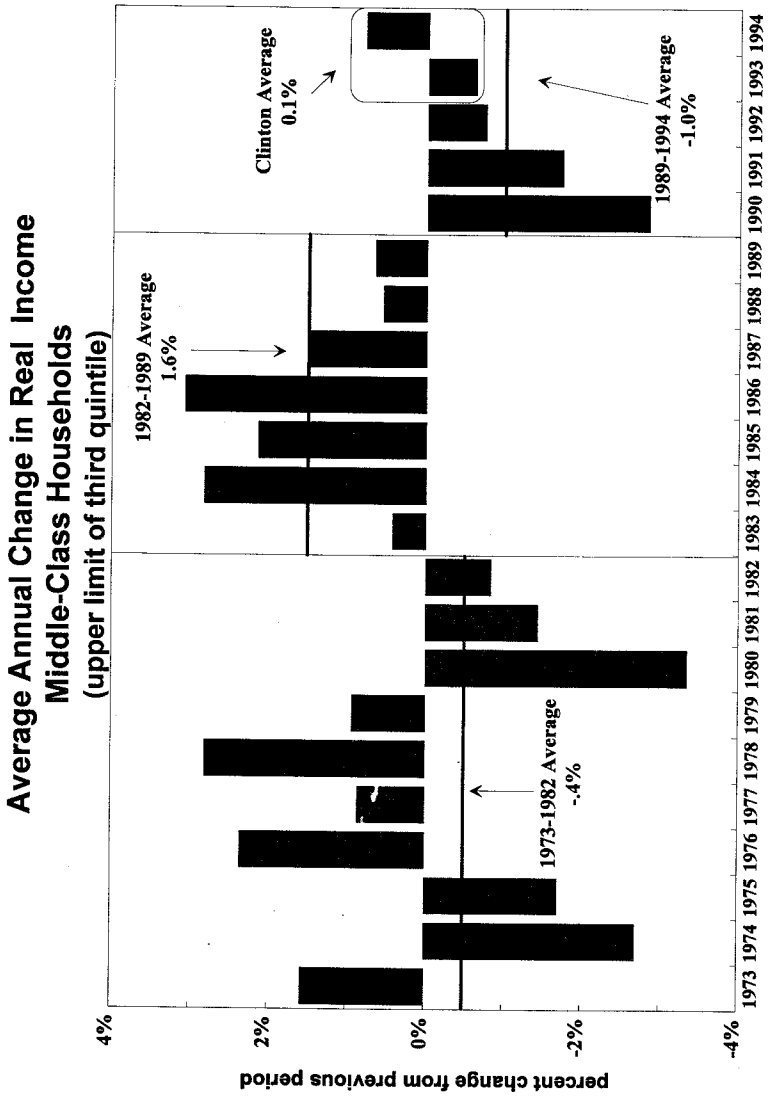
Source: Bureau of the Census



Source: Bureau of the Census

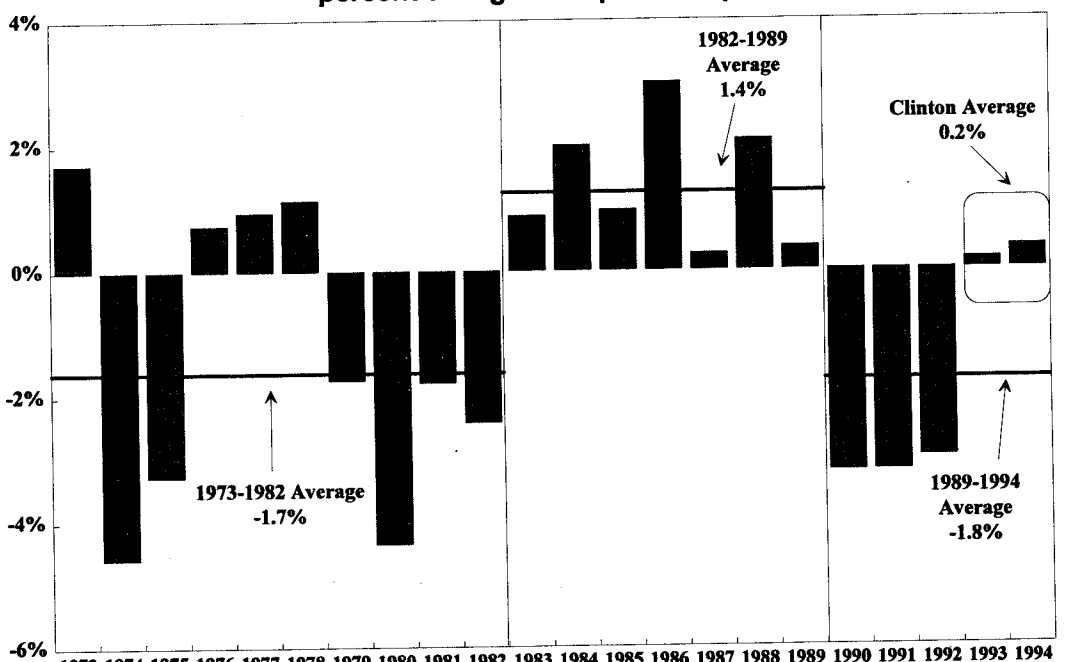


Source: Bureau of the Census

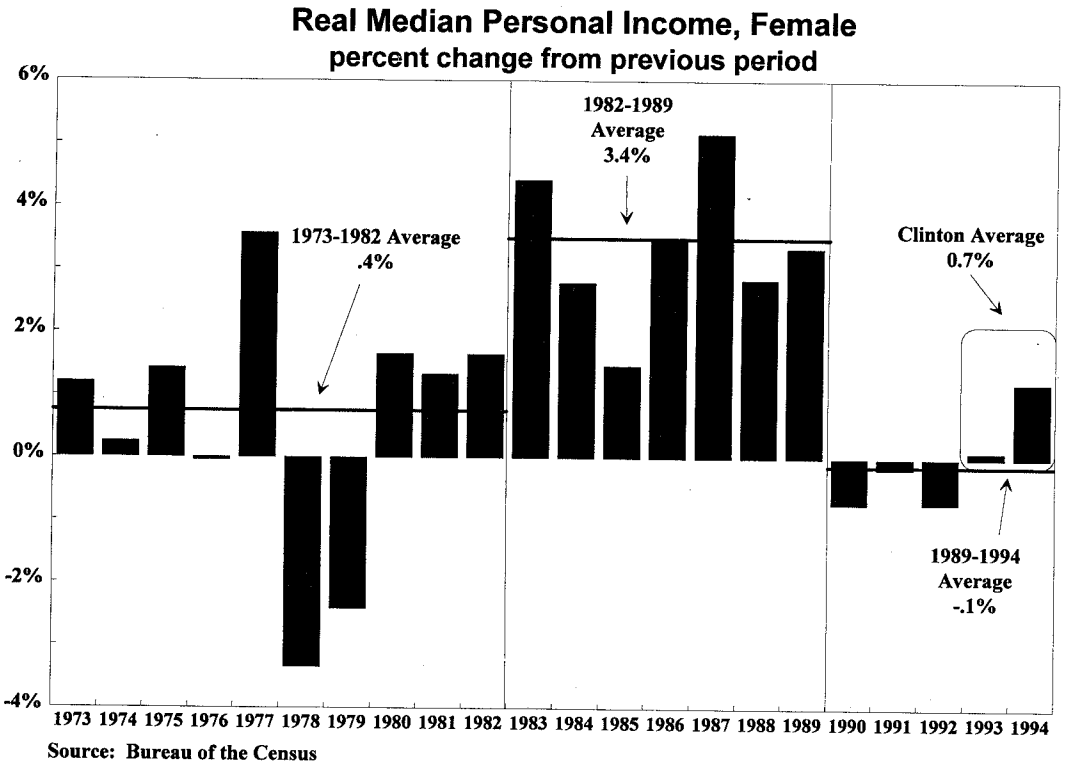


Source: Bureau of the Census

Real Median Personal Income, Male
percent change from previous period

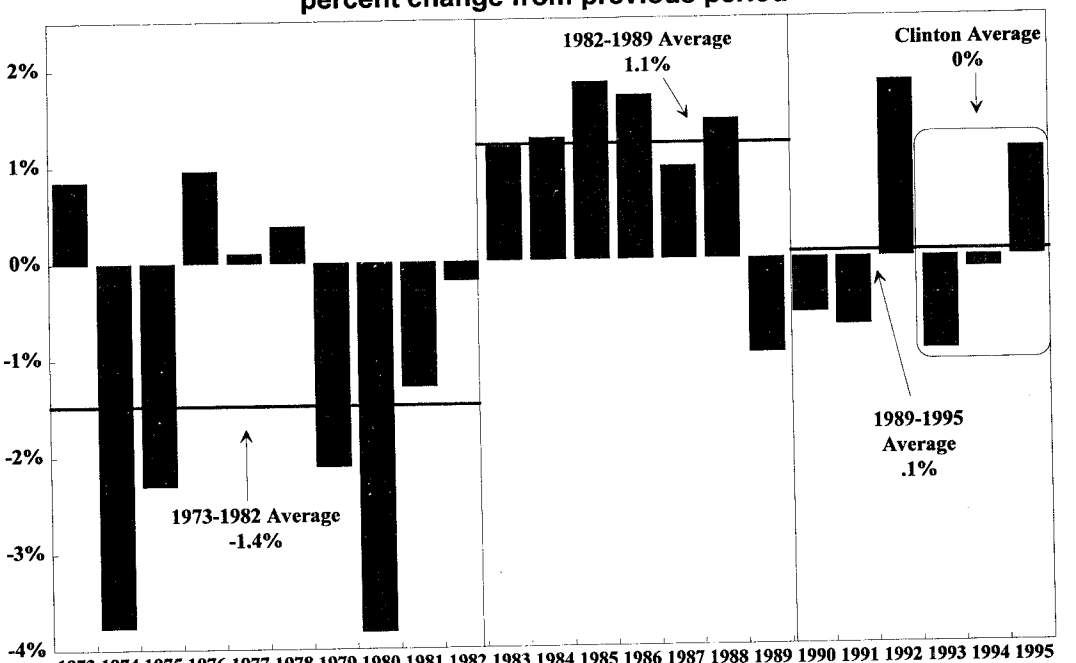


Source: Bureau of the Census



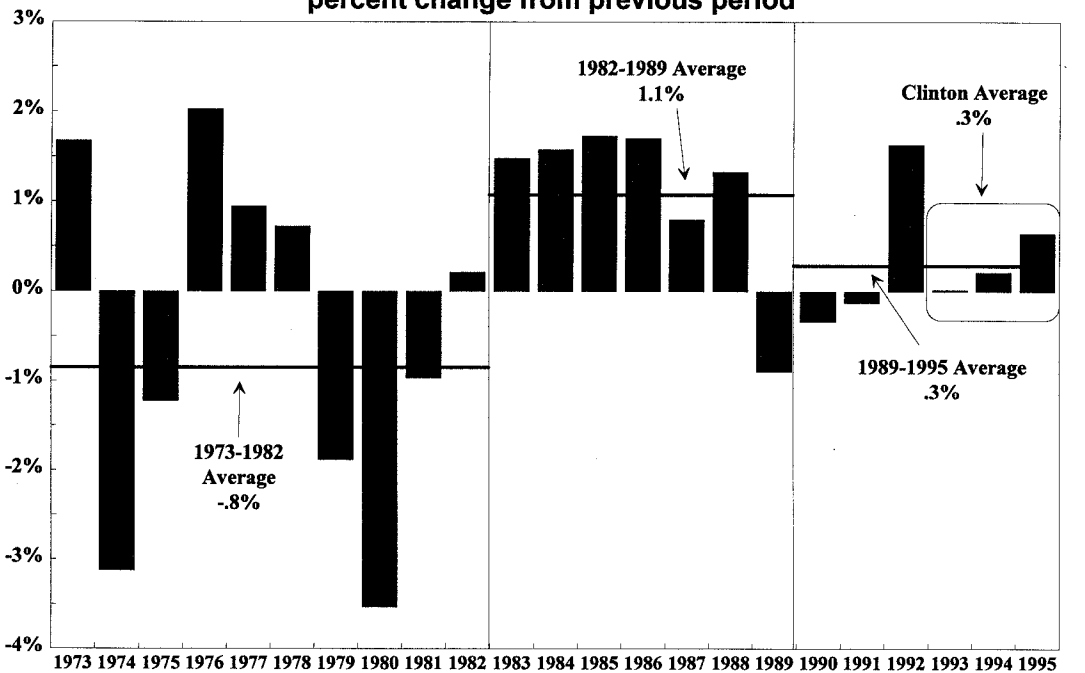
Source: Bureau of the Census

Real Wages and Salaries Per Worker
percent change from previous period

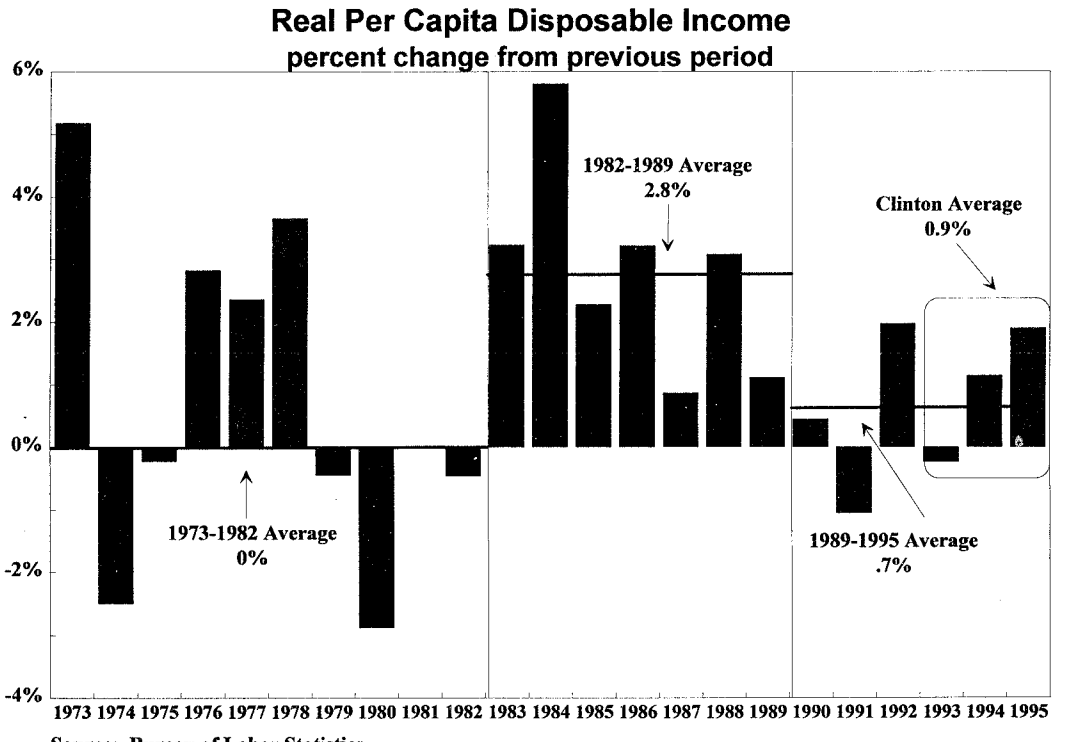


Source: Bureau of Economic Analysis

Real Compensation Per Worker
percent change from previous period



Source: JEC calculations based on data from the Bureau of Labor Statistics



Source: Bureau of Labor Statistics

Joint Economic Committee

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ISSUED BY
JEC MAJORITY STAFF
May 1996

Robert N. Mottice
Executive Director

JOB LOCK

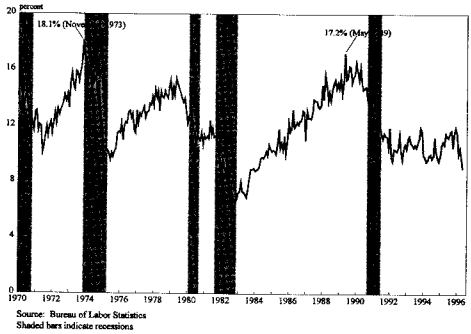
U.S. workers are anxious. Despite this, the Clinton administration recently released a report claiming the job market is not as bad as people think. The report, released by the President's Council of Economic Advisers, dismissed the issue of workplace anxiety.

But American workers show a tell-tale sign of high anxiety. What's that sign? Unlike the other economic expansions of the past 25 years, the share of unemployed workers who have left their jobs voluntarily has stagnated during the Clinton years.

This is a key indicator of worker anxiety. Why? Because when workers feel confident about the economy, many are willing to leave their jobs on their own in anticipation of finding something better down the road. For example, in the late 1980s, after a particularly long and strong expansion, the share of unemployed workers who had left their old jobs voluntarily hit a 16-year high.

By contrast, the anemic Clinton expansion has not given workers the same confidence. In fact, five years into a recovery and expansion, the share of unemployed workers who have left their jobs on their own is now 21% lower than at the end of the last recession! People fear losing their jobs, and don't like their prospects of finding new ones. The reason: Clinton's tax increases and big government have caused slow growth in employment and stagnating incomes. The result: workers are mired in "job lock."

VOLUNTARY JOB LEAVERS AS A PERCENT OF CIVILIANS UNEMPLOYED



Source: Bureau of Labor Statistics
Shaded bars indicate recessions

Prepared by Brian Wesbury, Chief Economist, and Phaedon Sinis, Associate Economist. (202) 224-5171.

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

INCOME MOBILITY AND ECONOMIC OPPORTUNITY

Second Edition

A JOINT ECONOMIC COMMITTEE REPORT

Reissued at the request of

Connie Mack, Chairman

August 1995

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104th CONGRESS

PREFACE TO THE SECOND EDITION

This Joint Economic Committee (JEC) Republican study, *Income Mobility and Economic Opportunity*, is the last of a series of JEC studies on income mobility which began in 1990. Sections of this study have appeared in a variety of publications, and a version has just been published in its entirety by W.W. Norton and Company in a new book entitled *Leading Economic Controversies of 1995.* In response to the interest this study has generated, the JEC is now issuing a second edition.

As Congress continues debate on elements of the "Contract With America," much discussion involves the real and imagined effects different policy options might have on Americans at different income levels. **It is important to remember, however, that the U.S. economy is characterized by a dynamism that creates an extraordinary degree of income mobility. This mobility severely diminishes the relevance of estimated income class effects as a determinant of policy.**

The debate on income equality is framed by historical data on income trends in recent decades. Unfortunately, this debate often seems to proceed on the assumption that household income is distributed as if by some central distributional entity. In reality, as Nobel Laureate F.A. Hayek pointed out, this notion of "income distribution" is highly misleading as a description of the outcome of a market economy. **There is no "income distribution" as such in a market economy**, nor any objective criteria on which to judge "distributional justice." Thus the whole concept of "income distribution" is based on an illusion. Furthermore, the critical role of income mobility is typically overlooked.

The high degree of income mobility in the United States is an essential reality all but ignored in the income "fairness" controversy of the late 1980s and early 1990s. In the many accounts of real and alleged changes in the incomes of different income classes over time, the fact that the composition of these groups had changed immensely was unduly neglected.

JEC research on this subject forced the reality of income mobility to the forefront of the debate. By demonstrating that stability in the membership of the income classes over time was illusory, it became evident that the portrayal of stratification badly distorted the fluid nature of the U.S. economy. Thus it became clear that the presumed stratification of income groups rooted in a theoretical abstraction, or conceptual model, is contradicted by reality. **The notion of quintiles as economic classes necessarily composed of mostly the same people over time is a mirage or illusion not reflected in the reality of income dynamics.** The changes in average income for a given quintile are meaningless and irrelevant to a majority of people who reside in this quintile temporarily.

The data on income mobility show that **during the 1980s there was considerable upward mobility** for those in the bottom to middle quintiles at the end of the previous decade. For example, **about 86 percent of the tax filers in the bottom quintile had exited over nine years, moving to a higher income quintile by 1988**. In other words, the grouping of people that was the bottom quintile in 1979 had ceased to exist as such by 1988. This is a good example of how the "bottom quintile" may appear stable as a theoretical abstraction, but does not exist in reality as a specific

group of people over any length of time. Another illustration is provided by the top 1 percent, most of whom had exited this percentile by 1988.

The data contained in this study were prepared by the U.S. Treasury Department for the JEC at the request of then-JEC Ranking Republican Member, Representative Dick Armey. This study was written by JEC senior economist Christopher Frenze and was first published in June 1992.

Fortunately, in recent years the significance of income mobility in the United States has become much better recognized. Simplistic portrayals of the U.S. economy as a kind of caste system, with rigidly articulated income strata, are much less common. A much more complicated, and interesting, economic reality is shown by the data on income mobility. The dynamism of the American market economy is reflected in the degree of income mobility and opportunity provided to Americans at all income levels.

Senator Connie Mack
Chairman

INCOME MOBILITY AND ECONOMIC OPPORTUNITY

"You could not step twice into the same river; for other waters are ever flowing on to you."
— Heraclitus, 540-480 B.C.

INTRODUCTION

Great attention has been given recently to changes over time in the average incomes of "quintiles," families or households ranked top to bottom by income and divided into fifths. However, such time line comparisons between rich and poor ignore a central element of the U.S. economy, which is the extent to which individuals move from one quintile to another. Figures on income mobility are more characteristic of the nature of our fluid society than comparisons of average incomes by quintile, which would only be statistically meaningful if America were a caste society where the people comprising the quintiles remained constant over time.

Unfortunately, while data on average income by quintile has been plentiful, however misleading, data on income mobility has been scarce. Until now.

This study is an analysis of newly available panel data based on income tax returns filed from 1979 through 1988, which were tabulated by the U.S. Department of the Treasury. The Treasury sample consists of 14,351 taxpayers filing returns in all of the above years. This sample tends to understate income mobility to the extent the movement of younger and older filers in and out of the population of taxpayers is missed by the requirement that returns be filed in all years. On the other hand, this understatement is at least somewhat offset at the low end of the income scale by the presence of an underclass which does not file tax returns year after year. For the purposes of this report, the bottom quintile consists of those who earn enough income to at least file income tax returns, if not to actually pay taxes.

Earlier studies of income mobility have demonstrated a startling degree of income mobility in as short a period as one year. However, as a January 1992 study noted[1], additional data over more extended periods were needed to draw more precise conclusions about income mobility over the longer term. This need has now been largely satisfied by the provision of longitudinal panel data from tax return files. However, much more data and research on income dynamics in coming years is needed.

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[1] JEC/GOP staff study, *Income Mobility and the U.S. Economy: Open Society or Caste System?*, released by Congressman Dick Armey, Ranking Republican, January 1992.

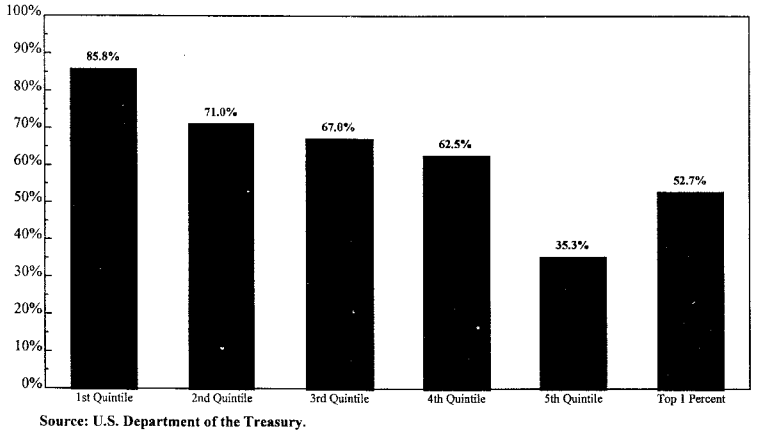
LEVEL OF INCOME MOBILITY BY QUINTILE

"All is flux, nothing stays still."
— Heraclitus

The new tax return data support the conclusion of earlier research which concluded that the degree of income mobility in American society renders the comparison of quintile income levels over time virtually meaningless. According to the tax data, 85.8 percent of filers in the bottom quintile in 1979 had exited this quintile by 1988. The corresponding mobility rates were 71 percent for the second lowest quintile, 67 percent for the middle quintile, 62.5 percent for the fourth quintile, and 35.3 percent for the top quintile.

Of those in the much discussed top 1 percent, over half, or 52.7 percent, were gone by 1988. These data understate income mobility in the top 1 percent to the extent mortality contributes to mobility and the diffusion of income. Graph 1 displays the income mobility of the various groups.

Graph 1 -- **PROPORTION MOVING TO DIFFERENT QUINTILES OR FROM TOP PERCENTILE, 1979-88**



Source: U.S. Department of the Treasury.

In all but the top quintile, at least 60 percent of filers exited their 1979 income quintile by 1988, with two-thirds or more exiting in the bottom three quintiles. Though much more stability was observed in the top fifth, over one-third had slipped downward to be replaced by others moving up. Even most of the top 1 percent had exited by 1988, to be replaced by others.

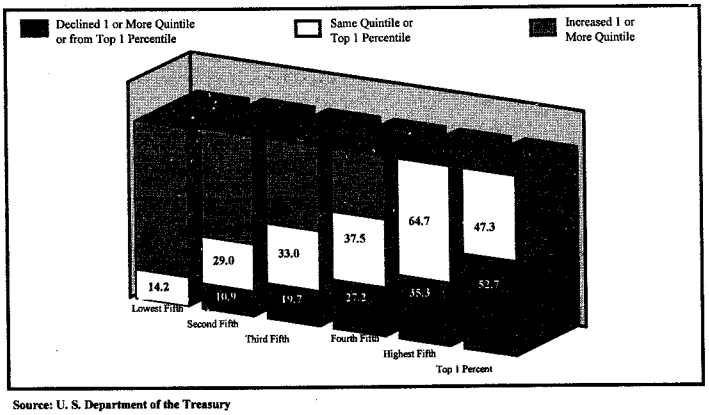
The very high degree of income mobility displayed above shows that the composition of the various quintiles changes greatly over time. A majority of filers have indeed moved to different quintiles between 1979 and 1988. Thus intertemporal comparisons of average wages, earnings, or private incomes of quintiles cannot provide meaningful measures of changes in the income of actual families and persons only temporarily in a given quintile or percentile. Quintiles may be a convenient way of presenting snapshots of income data for a group of people at a certain point in time. Nonetheless, the notion of a quintile as a fixed economic class or social reality is a statistical mirage.

DIRECTION OF INCOME MOBILITY

"Nothing endures but change."
— Heraclitus

Movement is important, but the direction of that movement is more important. While a strong argument can be made for a flexible and open market economy which presents opportunities to lower and middle income workers, instability alone is not necessarily a virtue. Graph 2 summarizes the income mobility data to display the direction of movement between 1979 and 1988. For example, in the third, or middle 1979 fifth, 47.3 percent had moved to a higher quintile by 1988, while 33.0 percent remained in this same quintile, and 19.7 percent fell into a lower quintile.

Graph 2 -- NET PROGRESS IN THE BOTTOM FOUR QUINTILES, 1979-88



Source: U. S. Department of the Treasury

Given the relative starting position, the very high mobility from the bottom quintile obviously reflects improvement. In addition, the upward movement in the second, third, and fourth quintiles is much larger than downward movement. For example, 60 percent of the second quintile had moved to one of the higher three quintiles by 1988. Over this same time, only 10.9 percent had fallen from the second into the lowest quintile.

In the long overdue debate over the significance of income mobility, some may argue that mobility would tend to reflect slippage, especially among the middle class. The data contradict this contention. Of those in the middle quintile in 1979, nearly half moved upward to the fourth or fifth quintiles by 1988. Overall, in the bottom four quintiles, net improvement was the rule, not the exception.

DETAIL ON INCOME MOBILITY, 1979-88

Table 1 displays the movement of filers from 1979 quintiles to their positions in 1988. Each row can be read across: of 100 percent of each 1979 quintile, the table shows their dispersion among the various fifths by 1988.

Table 1 -- **America on the Move**

		Percent in Each Quintile in 1988				
1979 Quintile	**Percent in Quintile in 1979**	**1st**	**2nd**	**3rd**	**4th**	**5th**
1st	100%	14.2%	20.7%	25.0%	25.3%	14.7%
2nd	100	10.9	29.0	29.6	19.5	11.1
3rd	100	5.7	14.0	33.0	32.3	15.0
4th	100	3.1	9.3	14.8	37.5	35.4
5th	100	1.1	4.4	9.4	20.3	64.7

Source: U.S. Department of the Treasury.

About 86 percent of those in the bottom quintile in 1979 had managed to raise their incomes by 1988 enough to have moved up to a higher quintile. The data show that these were not all grouped at the bottom at the second quintile. While 20.7 percent were in the second quintile, 25.0 percent had made it into the middle fifth, and another 25.3 percent into the second highest quintile. The 14.7 percent in the top quintile was actually higher than the 14.2 percent still stuck in the bottom fifth. **In other words, a member of the bottom income bracket in 1979 was more likely to move to the top income bracket by 1988 than remaining in the bottom bracket.**

In the second quintile, 71 percent had exited between 1979 and 1988. Though 29.0 percent still remained in the second quintile in 1988, 29.6 percent had moved up to the third quintile, 19.5 percent to the fourth, and 11.1 percent to the top quintile. Only 10.9 percent had moved down to the lowest quintile.

Of those in the middle quintile in 1979, 32.3 percent had moved to the fourth quintile and 15.0 percent to the fifth quintile by 1988. **Over this period, 47.3 percent had moved up, while 19.7 percent had moved down. The net effect of income mobility in the middle range clearly reflected net overall improvement.**

While the fourth quintile exhibited powerful income mobility, the top quintile is the most stable. However, all income mobility from the top quintile is by definition downward mobility. The share of this group dropping into lower quintiles was 35.3 percent, while 27.2 percent of the fourth quintile also dropped at least one quintile. Many of these with declining fortunes are still better off than many of those with upward mobility from a low quintile, however, the overall pattern is one of strong upward mobility from the lower quintiles, while income mobility from a high level often reflects economic reversals. Without income mobility, many in the top fifth would be better off, and the great majority of those in the lower quintiles would be worse off. Income mobility reflects improvement in the lower four quintiles, but this fact has been virtually ignored in public discussion of income trends.

While 35.3 percent fell from the top quintile into the fourth quintile or below, 40.0 percent of the bottom quintile had moved into the fourth or fifth quintiles by 1988. Of all of those in the bottom quintile in 1979, about two-thirds, or 65 percent, had moved to the middle or higher quintiles by 1988. These data demonstrate that the U.S. economy, not without problems over this period, still remains dynamic, open, and productive enough to permit most Americans in the bottom three-fifths to work their way up the economic ladder. What is needed are policies to ensure that this flexibility and opportunity are extended as widely as possible, especially to those who actually fall below the bottom fifth of taxpayers.

CONCLUSION

"Much learning does not teach understanding."
— Heraclitus

Currently there are two models of the American economy, one static, and the other dynamic. The first portrays the United States as a caste system and misapplies the characteristics of a permanent income strata to those only temporarily moving through income brackets. The alternative view portrays a much more complex and interesting social reality in which the composition of income classes are in constant flux. According to this latter point of view, simplistic generalizations about actual persons and families (or "the rich" and "the poor") cannot be drawn from data on a conceptual artifice which does not exist as such in reality.

The empirical data support the view of the market economy as a dynamic and open society which provides opportunity to those who participate. There is no evidence of stagnation, with the turnover rate in the most stable quintile -- the top fifth -- exceeding 35 percent. The turnover rates in the bottom four quintiles were at least 60 percent over the period, with most of this reflecting upward progress. Analysis which assumes or suggests stable composition of family or household income quintiles rests on invalid assumptions. It makes no sense to draw sweeping conclusions such as "the income of the bottom 20 percent of families fell" in a 15-year period when most of the people originally in that category have long since improved their standard of living enough to have moved up from the bracket entirely.

This study was prepared by JEC/GOP staff: Senior Economist Christopher Frenze (author); Edward Gillespie (editor); and Staff Assistant Nita Morgan (graphics).

ADDENDUM

INCOME MOBILITY AND PUBLIC POLICY

Many aspects of the current budget debate are new, while some mark a return to previous debates. One recurring theme is the effort of some analysts and journalists to root the budget issue in alleged family or household income trends, all too often in a simplistic way.

For over a decade advocates of larger government have sought to frame various elements of tax and budget issues by a model of our economy that suggests that the United States is a society characterized by rigid class stratification. According to this perspective, the starting point of policy analysis on tax and budget issues should be a review of changes in the average incomes of the various quintiles, or fifths of families or households over time. For example, changes in the average income of the bottom and top fifths during a 10- or 15-year period would be compared as a guide to policy-making. The average income gains of the top fifth were often a major focus, with the suggestion that the richest quintile was gaining faster at the expense of others.

However, the income definition for placement in the top fifth was rarely stated. This is understandable given the fact that the income definition for the top fifth is a surprisingly modest level of income, according to Census Bureau data. For example, in 1988, a household would need only $50,594 or more in income to merit placement in the top fifth, i.e., the rich. In other words, two working class spouses would together easily qualify for the exalted distinction of being in the top fifth. Moreover, the threshold for placement in the more rarified top 5 percent is also more modest than many might expect. In 1988, for example, an income over $85,640 qualified a household for placement in the top 5 percent, an income level easily achievable by two public school teachers. By 1993, the threshold for qualification in the top fifth had increased, but only to a relatively modest level of $60,545.

Thus the focus on income shares and the supposedly excessive income growth of the top fifth is undermined by the fact that many households with middle class income levels are defined as rich. This explains why the income definition of the top fifth is rarely mentioned, occasionally buried in an obscure footnote if disclosed at all. Many people at these income levels would be surprised to learn of their privileged status among the rich. When the income definitions are adequately considered, the class warfare argument loses much of its force.

Starting in 1990, a JEC research project was initiated to address this income issue by pushing the reality of income mobility to the forefront of the policy debate. A number of JEC studies on income mobility were released, the last one reprinted in an economics textbook in 1995. Though income mobility had been virtually ignored in the income and tax debate of the late 1980s and early 1990s, this has changed in recent years. The popular treatment of income, tax, and budget issues in the media and public debate has become less simplistic and relied much less on static treatment of income data.. Crude class warfare appeals have become much less credible as the facts about income mobility have become acknowledged.

The reality of income mobility has several important implications for the current budget debate. First of all, attempts to "distribute" the effects of tax and budget changes by income class cannot be accurate since the income classes themselves are not stable. For example, to attribute the effect of policy changes

to families classified by income level or quintile for the year 2002 is misleading because it ignores the fact that most of the people who would be in these groups in 2002 are in other groups now. One family, for example, might be in the lower income range now, middle income range in the interim period, and higher income range by 2002 as a result of normal life cycle changes in income, or other factors. How can a snapshot of income classes in 2002 capture the effects of policy changes implemented over a seven-year period in which this family is a member of all three income classifications? According to research by the Census Bureau, about one-third of all households are in different quintiles in an interval as short as one year. This indicates a significant enough volatility in income to render annual snapshots misleading unless conclusions based on them are very heavily qualified.

The artificial precision used in presenting the purported distributional effects of policy changes must be viewed as an attempt to mask a very crude procedure behind a pseudo-scientific facade. The reality is that the level of incomes in 1996 is unknown, the growth rate of income through 2002 is unknown, and the degree and direction of income mobility is unknown. The performance of the economy in the future in unknown, as is any information about future business cycles. Furthermore, the specific policies that will be adopted to implement the various budget plans are also unknown. In other words, most of the pertinent information needed to analyze the future impact of a budget plan on a family now in a particular income range does not exist. All of this has to be made up, and consequently the distributional analysis is little more than guesswork.

Income mobility is one of the major reasons distributional analysis based on annual snapshots will always be at least somewhat misleading. From a broader perspective, it is fascinating to consider how a static model of stratification could be superimposed to portray as a caste system what is in reality a very dynamic economic and social system. The stratification was assumed in the method, not discovered in the economy. This model of stratification misguided many policy-makers who were uninformed about the actual nature of the American economy. Fortunately, the current recognition of income and economic dynamics will help create the climate for a new policy direction for economic growth into the 21st Century.

Joint Economic Committee

May, 1995

U.S. SENATOR
Connie Mack
CHAIRMAN

ISSUED BY:
Connie Mack (FL), Chairman
Jim Saxton (NJ), Vice Chairman

ECONOMIC POLICY UPDATE

The Mirage of Economic Equality

"... there is no way of demonstrating that the wealth dispersion of other nations, given the variety of circumstances, including the high degree of income and wealth mobility in the U.S., is more or less "fair" than that of the U.S."

Some of the most contentious issues of recent years revolve around the notion of economic equality. An April 17, 1995 front page *New York Times* article, entitled "Gap in Wealth in U.S. Called Widest in West," is a recent illustration of the argument that wealth and income dispersion in the U.S. is inequitable. This article did not miss the opportunity to contend that Republican policies can be expected "to widen disparities between rich and poor." However, this simplistic perspective ignores a number of important problems.

These problems are usually skirted by those who use income and wealth dispersion data to favor more government, or oppose attempts to roll it back. For example, The *New York Times* article uses an international comparison of wealth dispersion to suggest that the U.S. is especially unequal, and that Republican policies will make it more so. The article also asserts that "the United States has become the most economically stratified of industrial nations."

Since there is no objective way to demonstrate that U.S. income or wealth dispersion is "inequitable," or even to objectively define what an equitable dispersion would look like, the wealth dispersion of other western nations is resorted to as the basis of comparison. Nonetheless, there is no way of demonstrating that the wealth dispersion of other nations -- given the variety of circumstances including the high degree of income and wealth mobility in the U.S. -- is more or less "fair" than that of the U.S. Instead, what is more important than relative international measures is whether the market economy in the U.S. provides the opportunity for low and middle class Americans to increase their wealth in absolute terms.

"All societies have unequal wealth and income dispersion, and there is no positive basis for criticizing any degree of market determined inequality."

As Nobel Laureate F.A. Hayek pointed out, judgements concerning economic inequality, equality and "fairness" are almost universally subjective. Aside from absolute equality favored by virtually no one, it is impossible to define meaningful or objective criteria to define what "fairness" or an appropriate degree of inequality might be, thus these kinds of notions are for Hayek a "mirage." For all practical purposes, these notions are subjective, aesthetic, and ideological. All the statistics on income and wealth on a domestic and

"... those who use wealth and income data to promote the inequality issue typically support measures that would only further concentrate government control over economic resources."

international basis cannot change the fact that there is no objectively meaningful standard on which to judge any market outcome as "unfair." For example, what objective criteria exist to determine when it is inequitable for those who work full–time, year–round, to have higher wealth or income than those who are unable or unwilling to work? All societies have unequal wealth and income dispersion, and there is no positive basis for criticizing any degree of market determined inequality. Moreover, wealth data are imperfect in a number of respects, such as the omission of pension assets and transfer programs.

Another irony is that the largest concentration of economic power is ignored by conventional measures of wealth. Government, through its direct and indirect control of economic resources, is the single most powerful economic force in the economy. Yet those who use wealth and income data to promote the inequality issue typically support measures that would only further concentrate government control over economic resources. Furthermore, the attempt to implement a policy goal which is undefinable expands the discretionary taxing and spending powers of government officials. The equal application of the law, as a check on the arbitrary power of government officials, is supplanted by granting more arbitrary political and economic power to government officials.

Most Recent Wealth Data Show Broad Gains

The April 17, 1995 *The New York Times* article follows a 1992 *New York Times* article on the Federal Reserve data which implied that during the 1980s, the top 1 percent gained at the expense of everyone else, complete with allusions to the 1920s Great Gatsby era. Both articles suggested that Republican policies could foster more inequity. Both articles refer to the Federal Reserve data on wealth, which present 1989 as the most recent year available. In addition, the most recent *New York Times* article argued that the Contract With America is expected to "widen disparities between rich and poor."

However, in addressing the issue this way, the trends in wealth during the 1980s in the United States are much more relevant than international comparisons of relative wealth shares. Increases in wealth reflect an increase in economic welfare, while declines reflect a decrease in economic welfare. This examination of changes in wealth stated in absolute terms as a reflection of economic welfare is straightforward and does not rely on normative opinions. This question can be examined using the available Federal Reserve data on changes in wealth in the U.S. between 1983 and 1989.

An examination of the trend in Federal Reserve wealth data for the U.S. during the 1980s does not support the argument that conservative fiscal policy has made the poor and middle class worse off.

Increase in Wealth Broadly Shared

What the data actually show is that the increase in wealth held by the top 10 percent increased about as fast as the wealth of the bottom 90 percent. This is why the wealth shares of the top 10 percent and bottom 90 percent were essentially unchanged between 1983 and 1989 (within standard error). For the most part, the increase in the share of the top 1 percent is offset by the decline in the share of the next highest 9 percentiles. Within the top 10 percent, the data show somewhat above average growth for the top 1 percent, with a decline of 5 percent in net worth for the others comprising the top 10 percent.

"What the data actually show is that the increase in wealth held by the top 10 percent increased about as fast as the wealth of the bottom 90 percent."

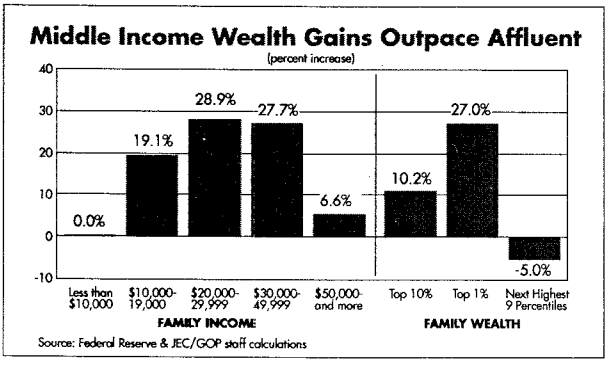
Moreover, it is essential to recall that the composition of these percentiles changes greatly over time. For example, the division of families among the top 10 percentiles is artificial because many are moving up to and down from the top 1 percent. Many of those with declines in net worth in the 90–98.9 percentiles in 1989 were in the much faster growing top 1 percent in at least one of the previous six years. The income mobility in each of the top 10 percentiles, with annual turnover of 30 percent and more, means that division of the top 1 percent from neighboring percentiles in order to draw sweeping conclusions about "the rich" is invalid. Changes in net worth by income class reveals an entirely different pattern from that described in *The New York Times*.

According to the Federal Reserve data, between 1983 and 1989 real net worth grew 6.6 percent in the category of families with incomes over $50,000 annually — the "wealthy" top quintile (see table and graph that follow). However, the average increase in wealth was 19.1 percent for families with incomes between $10,000 and $19,999; 28.9 percent for those between $20,000 and $29,999; and 27.7 percent for those between $30,000 and $50,000. These growth rates for the middle and low middle income range greatly outpace that of the over $50,000 category, a critical fact ignored by *The New York Times*. Robust increases in net worth are posted in the middle income range, but virtually none in that under $10,000.

Net Worth Grows Fastest for Middle Class (thousands of 1989 dollars, except as noted)

	Average Net Worth 1983	Average Net Worth 1989	Percent Change
All Families	$ 149.1	$ 183.7	23.2
Family Income			
Less than $10,000	30.0	30.1	—
$10,000–19,999	53.0	63.1	19.1
$20,000–29,999	69.5	89.6	28.9
$30,000–49,999	117.6	150.2	27.7
$50,000 and more (top 20 percent)	550.5	586.7	6.6
Family Wealth			
Top 1 Percent	4731.1	6010.5	27.0
Next Highest 9 Percentiles	593.2	563.7	-5.0

Source: Federal Reserve & JEC/GOP staff calculations



The evidence provided by the Federal Reserve demonstrates that increases in wealth were widely dispersed between 1983 and 1989, with the most rapid gains in the middle class. A selective presentation of data can be used to argue there was a surge in wealth held by the top 1 percent of wealth holders. However, a more complete review shows that this rate of increase was exceeded by the middle income range between $20,000 and $50,000. Moreover, many in the top 10 percent of wealth holders had significant declines in wealth, the only group so affected. This decline proves to be the major explanation for how the share of wealth held by the top 1 percent increased, while the share of the top 10 percent was unchanged within the margin of error.

Conclusion

The most recent Federal Reserve data do not show the rich gaining at the expense of everyone else during the 1980s, but broad gains in wealth. International comparisons on wealth dispersion have no bearing on U.S. policy because there is no way of saying any particular dispersion is superior to another, and because the focus on wealth shares glosses over mobility and the question of whether total and family wealth is decreasing, stagnating, or growing. Finally, the American political system can aim for civic equality under which the government applies the same rules for everyone, or equality of outcome under which government officials will have the arbitrary discretion to treat all citizens unequally and discriminate among them. The rule of law is only compatible with civic equality, and attempts to impose equality of outcomes undermines the rule of law and risks further intensifying citizen opposition to arbitrary exercise of government power.

Christopher Frenze
Majority Senior Economist

Chapter Two

Tax Policy

Principles of a Model Tax System

- Every taxpayer must be fully informed on exactly what is being taxed, how they are being taxed, and what their true tax liability is.

- Taxes should be as visible to the taxpayer as possible. Taxes act as the most important price mechanism for individuals to decide just how much government they are willing to pay for. "Hidden" taxes mask the true cost of government from taxpayers. All citizens should be accurately informed on their total tax liability and on how their tax dollars are being spent.

- Tax reform must not add new forms of taxation on top of the existing tax structure. This would only increase the level of complexity in the tax system and would likely lead to a higher tax burden.

- The tax system should explicitly treat all individuals equally under the law as intended by the Constitution. Deliberate differentiations of tax liabilities on the basis of the sources or uses of income should be avoided.

- The tax system should provide the same tax treatment for similar economic actions and transactions, rather than taxation based on the attributes of the taxpayer.

- Multiple layers of taxation should be avoided. Income should be taxed once and only once.

- The tax system should be as simple as possible. Complexity makes the system expensive, punitive, and results in an efficiency loss to the economy.

- The tax system should aim for neutrality in economic decision making, favoring neither consumption nor investment. The tax system should not interfere with the free will economic choices and decisions of individuals, households, or businesses. A low tax rate across a broad tax base creates the least distortions in the economy.

- Changes in the tax law intended to raise revenues should not be retroactive. All taxpayers must have confidence in the law as it exists when planning and entering into transactions.

- The U.S. tax code must be competitive with other industrialized nations. It should in no way impede the free flow of goods, services and capital across borders.

Joint Economic Committee

ISSUED BY
JEC Majority Staff
October 1996

U.S. SENATOR
Connie Mack
CHAIRMAN

Robert N. Mottice
Executive Director

ECONOMIC
POLICY
UPDATE

TAX LIABILITIES AND TAX CODE INDEXING

"Simply stated, a repeal of indexing is a tax increase."

One of the major accomplishments of recent federal income tax reforms has been to help eliminate the negative effects that inflation has on taxpayers. The introduction of indexing for key components of the tax code has helped prevent inflation from producing automatic tax increases and unintended changes in the distribution of the tax burden. While numerous federal tax reform and deficit reduction options continue to be debated, indexing should be preserved in order to protect all taxpayers from unlegislated tax burden increases due to inflation. Simply stated, a repeal of indexing is a tax increase.

"... when inflation accelerated, taxpayers were forced to pay higher taxes even though their real incomes did not increase."

The U.S. income tax was not originally designed to be immune from the effects of inflation. Thus when inflation accelerated, taxpayers were forced to pay higher taxes even though their real incomes did not increase. This punitive tax treatment was greatly magnified in the 1970s when inflation accelerated at double digit rates and more than 22 income tax brackets were in place--ranging from 14 percent to as high as 70 percent. Prior to President Reagan's 1981 and 1986 tax reforms, the unindexed income tax system with multiple tax brackets quickly increased the tax burden of all taxpayers by pushing them into higher tax brackets even when their real incomes and purchasing power were being eroded by inflation. Without indexing, any level of inflation in the economy would increase a taxpayer's tax liability and lower their after-tax purchasing power.

Prior to enacting several indexation adjustments to the income tax code, the portion of income paid to the government automatically increased while taxpayers' real incomes stagnated or declined. In other words, government was able to increase tax burdens and tax revenues without legislative action. Historically, "bracket creep," as this effect is called, could only be offset by periodic congressional action to increase the personal exemption, zero bracket amount, and bracket limits.

In order to protect taxpayers from the punitive tax burden effects of inflation, tax reforms enacted by Presidents Reagan and Bush specified that certain components of the individual income tax system will be indexed for inflation. Provisions originally contained in the Economic Recovery Tax Act of 1981 and later amended by the Tax Reform Act of 1986, and the Omnibus Budget Reconciliation Act of 1990 indexed key components of the income tax system.

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These components include:

"Without indexing, any level of inflation in the economy would increase a taxpayer's tax liability and lower their after-tax purchasing power."

- **the standard deduction,**
- **the additional standard deduction for the elderly,**
- **the additional deduction for the blind,**
- **the personal exemption,**
- **the dependent exemption,**
- **the earned income tax credit for low-income families (EITC),**
- **the income breakpoints for the various tax rate brackets,**
- **the income limitations on itemized deductions,**
- **and the income level above which the tax benefits of the personal exemptions are phased out.**

The inflation adjustments for any given tax year are based on the percentage amount by which the average Consumer Price Index for all urban consumers (CPI-U) for the twelve month period ending August 31 of the preceding year exceeds the average CPI-U during a specific twelve month base period. The base period varies depending upon the tax component under consideration.

Therefore, the inflation adjustments introduced into the code, in part protects taxpayers from paying higher tax on "illusionary" income gains due to inflation and helps to preserve their real after-tax purchasing power. Because of indexation, the real value of the personal exemption, the exemption for children, the standard deduction, the deductions for the blind and elderly, and the EITC for low-income families is protected from being eroded by inflation.

"The introduction of indexing has saved taxpayers billions of tax dollars by preventing their tax liability from rising simply because of inflation."

The introduction of indexing components of the income tax code has saved taxpayers billions of tax dollars by preventing their tax liability from rising simply because of inflation. Repealing the indexation now present in the tax code would have a dramatic impact on tax liabilities of all taxpayers. A recent Congressional Budget Report (August 1996) estimated that repealing indexing (except for the EITC) in 1997 would cost taxpayers an additional $215 billion over the next six years. This assumes a modest 3 percent annual inflation rate over the entire period. Of course, higher rates of inflation would cost taxpayers even more in increased tax liabilities. Suspending indexing for only one year (1997) would cost taxpayers an additional $61 billion over the next six years.

Amend or Repeal the Indexing of Income Tax Schedule
Increased Tax Revenue
(in $Billions)

	1997	1998	1999	2000	2001	2002	**Total (1997-2002)**
Suspend Indexing for One Year Only (1997)	$6.6	$9.5	$10.9	$11.6	$10.4	$11.6	**$60.6 Billion**
Repeal Indexing in 1997	$6.6	$16.4	$28.2	$41.3	$53.9	$68.2	**$214.6 Billion**

Source: Joint Committee on Taxation. (Assumes 3% annual rate of inflation)

"Repealing or suspending indexing would not burden all taxpayers equally and would cause distortions in the distribution of the tax burden."

Repealing or suspending indexing would not burden all taxpayers equally and would cause distortions in the distribution of the tax burden. Among families with the same income, the tax burden would be greater for lower-income families that rely on the standard deduction rather than itemized deductions. Without indexing, the burden on families with children would be greater than families without children because of the reduced value of the dependent exemption. The erosion of after tax income for the highest income families would be small because they receive little or no benefit from the personal exemption, and the bulk of them do not take the standard deduction.

The tax code reforms that allowed indexing began in various years and applied to various tax components. Most recently, the Tax Reform Act of 1996 adjusted the tax rate structure for inflation beginning in 1989 and the personal exemption amount was adjusted beginning in 1990. The base year value for indexation for the standard deduction (joint return) is $5,000 and the personal exemption base amount is $2,000.

The Effects of Indexation on Deductions, Exemptions and Tax Breakpoints

Year	Standard Deduction (Joint Return)	Personal & Dependent Exemption	15% Tax Rate Applies
1988	**$5,000**	**$2,000**	-
1989	$5,200	$2,000	$0-$30,950
1990	$5,450	$2,050	$0-$32,450
1991	$5,700	$2,150	$0-$34,000
1992	$6,000	$2,300	$0-$35,800
1993	$6,200	$2,350	$0-$36,900
1994	$6,350	$2,450	$0-$38,000
1995	$6,550	$2,500	$0-$39,000
1996	**$6,700**	**$2,550**	**$0-$40,100**

"... the tax burden would be greater for lower-income families."

As demonstrated in the table above, since 1988, indexing the code for inflation has raised the standard deduction for a joint return by $1,700 between 1988 and 1996. The personal exemption for individuals dependents has risen $550 since 1989. The level of taxable income at which the 15 percent tax rate applies has increased $9,150 from $30,950 in 1989 to $40,100 by 1996.

Without the indexing that has applied since 1989, the typical family would pay more than $1,300 more in federal income taxes in 1996.

Typical Family Example*

1996 Family Federal Income Tax Burden **with indexing**	$4,965.00
1996 Family Federal Income Tax Burden **without indexing**	$6,336.50
Difference in Tax Burden	**$1,371.50**

*Two-earner family with two dependent children, $50,000 total annual income. Tax liability calculated under current law vs. no indexation of code since 1988. (Joint Economic Committee)

"... the punitive tax burden effect is compounded each year the tax code is not indexed."

Tax Year 1997 Without Indexing

Consider what would happen to the typical two-earner family with $50,000 in income in 1996 if inflation was 3.5 percent in 1997 and indexing was repealed. In order for the family to maintain $50,000 in real income, they would have to earn $51,750. In other words, their income would have to rise by $1,750 just to maintain the same purchasing power that was eroded by inflation. The family's 1997 taxable income would increase by $1,750 and their tax burden would increase by $263 -- more than one-third or $90 due to the lack of inflation indexing. Without indexing, the family tax burden jumps from 9.9 percent of income to 10.1 percent in just one year. Simply stated, without indexing, this family would pay higher taxes even though their real income did not increase. And, the punitive tax burden effect is compounded each year the tax code is not indexed. With no indexing, the family would see more and more of their real income eroded by rising tax burdens every year.

"For the typical family unit, indexation of the code just since 1989 will offset more than $1,300 in tax liability on their 1996 tax return."

No Indexing in 1997
Typical Family Example*

	1996	1997 With Indexing, 3.5% Inflation	1997 No Indexing, 3.5% Inflation
Family Income	$50,000	$51,750	$51,750
Standard Deduction (Joint)	$6,700	$6,935	$6,700
Personal/Dependent Exemptions (4)	$10,200	$10,557	$10,200
Taxable Income	$33,100	$34,258	$34,850
Tax Liability	$4,965	$5,138 (up 3.5%)	$5,228 (up 5.3%)
Tax As Percent of Income	9.9%	9.9% (same)	10.1%
Tax Increase	--	**$173 (up 3.5%)**	**$263 (up 5.3%)**
"Bracket Creep" Extra Tax ($1997)	--	**$0**	**$90**

*Two-earner family with two dependent children filing joint return.

Conclusion

"Eliminating indexing would cost taxpayers $215 billion in extra taxes between 1997 and 2002."

Without indexing, inflation would cause the average income tax rate to increase without any legislative action and would erode all taxpayers' after-tax purchasing power. For the typical family unit, indexation of the code just since 1989 will offset more than $1,300 in tax liability on their 1996 tax return. At 3.5 percent annual inflation and no indexing, the typical family would pay nearly $400 in additional taxes by the year 2000 even with no real increase in income. According to the Congressional Budget Office, suspending indexation for just 1997 would cost taxpayers $61 billion over the next six years. Eliminating indexing would cost taxpayers $215 billion in extra taxes between 1997 and 2002. Under any tax reform or deficit reduction policy option, indexing should be preserved in order to continue the protection taxpayers now have from unlegislated and unintended tax burden increases due to inflation.

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For more information please call (202) 224-5171
Also available on the Internet at: "http://www.senate.gov/indexng.html

Joint Economic Committee Staff Report

STATE AND LOCAL TAXATION AND ECONOMIC GROWTH:

LESSONS FOR FEDERAL TAX REFORM

December 1995

EXECUTIVE SUMMARY

The experience of the states over the past third of a century provides a unique laboratory for investigating the effects of tax policy on economic growth. States vary widely in the method and magnitude by which they raise revenues, and this paper examines the resulting effects on economic well-being within states.

Through a comprehensive statistical analysis, this study concludes that higher state and local taxes had a distinct and significant negative effect on personal income growth over the period extending from 1960 to 1993. That is, when state and local taxes were raised, personal income growth slowed markedly. By the same token, states with lower taxes enjoyed substantially higher personal income growth.

Key findings include:

- Relatively low-tax states grew nearly one-third faster than high-tax states. This difference in growth rates translates into higher income of about $2,300 per person or $9,000 for a family of four for people living in low-tax states compared to those living in high-tax states.

- On average, an increase in state and local tax burdens equal to one percent of personal income lowered income growth by over three and a half percent. Since states raised tax burdens by an average of nearly two percent of personal income over this period, an average family of four lost almost $2,900 in income.

- Income taxes have a particularly adverse impact on income growth. Had a representative state kept its level of income taxation at the same share of personal income over the course of this study, personal income in that state would be over 30 percent greater today.

- Flat-rate income taxes are significantly more favorable to economic growth than progressive taxes. Personal income in flat-rate income tax states grew about 25 percent faster than did personal income in states with a progressive rate structure.

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Available on the Internet:
http://www.senate.gov/~jec/sta&loc.html

STATE AND LOCAL TAXATION AND ECONOMIC GROWTH: LESSONS FOR FEDERAL TAX REFORM

Taxes influence human economic behavior. While there is virtual unaminous agreement on this point among professional economists, disagreement exists over the extent and nature to which behavior is impacted by taxation. Most modern scholars, however, accept the proposition that taxation can impact on economic performance. Much of the evidence supporting that perspective relates to the fact that the United States has 50 individual states, each with its own tax structure and fiscal policy. There are 50 different observations of the impact that taxes have on economic growth, job creation, business formations, or other measures of economic performance.

Need for Study

Accordingly, there is a need to reassess the evidence flowing from the 50 "laboratories" provided by the fiscal experience of the states. Does the evidence support the view of "supply side" and other market-oriented economists that taxes have an important bearing on the economic performance of states, or is their impact relatively modest? Does it matter what type of taxes are levied? What does the literature suggest about the tax-economic performance relationship? These are a few of the questions that this study will address.

Relationship to the Federal Tax Debate

As important as state and local taxation is, however, it is dwarfed in magnitude by the federal tax system. Accordingly, the revision of the federal tax system that many Americans advocate is clearly the dominant public finance consideration of our times. However, the wealth of knowledge we have from the 50 "laboratories" at the state level can help guide us in revising the federal tax system.

Preview of Findings

Looking at the evidence from the state and local fiscal experience over the past several decades, the following conclusions seem warranted:

- The economic performance of states is negatively related to the overall amount of taxation: higher taxes mean lower growth, lower taxes mean higher growth;
- Income taxes are particularly debilitating in terms of economic performance relative to other forms of revenue;
- States, however, can significantly improve their economic performance by moving from a progressive to a flat rate income tax;
- Sales taxes are more benign in their impact on economic performance than income taxes;
- Federal grants in aid to state and local governments seem to have few if any positive economic effects on the area receiving funds;

In terms of policy implications at the federal level, to the extent improving economic performance is a goal, the state and local evidence supports moving to a relatively low marginal rate broad based income tax. The evidence supports flat tax proposals over ones that maintain significant rate progressivity. A low flat rate tax should increase the rate of economic growth, increasing incomes and job opportunities for Americans, and reduce the relative burden of government on the American people without reducing essential public services. While superfically the evidence also seems to support a move towards a national sales tax, closer examination reveals problems that make that approach to federal tax reform more problematic. State and local governments do not tax a large proportion of consumption, which makes the state evidence perhaps not totally relevant to the national scene. Moreover, cross-border effects of sales tax differentials at the state level suggest that a national sales tax would create some major administrative and enforcement problems. A federal sales tax would bring rates far in excess of anything observed historically, making the state and local evidence of limited value in assessing potential economic effects.

WHY TAXES MATTER: ECONOMICS AND HUMAN BEHAVIOR

Before looking at the results of previous research and presenting some new research findings, it is appropriate to understand why taxes potentially alter human behavior, leading to different outcomes from would exist in the absence of taxes. Why, for example, do many economists argue that taxes lead to significant reductions in the growth of incomes and jobs?

A majority of taxes imposed in the United States are imposed at the margin -- they impact on new or additional behavior. If an employee works overtime, she or he earns additional income -- and an additional federal and state income tax liability. If a consumer decides to buy a new car, he increases his consumption at the margin -- and the amount of sales taxes that he pays. The major exception to this principle is the real estate property tax imposed by local governments in all the states. A fixed cost on owners of capital resources, property taxes do not impact on marginal business or personal decisions as much in the short run. In the long run, however, all costs are variable, so property tax burdens impact marginally on business decisions. For example, increased property taxes reduce the attractiveness of owning property, lowering its market value. That, in turn, adversely affects the ability of firms to borrow and make new investments.

The imposition of a tax on additional economic activity tends, other things equal, to raise the costs of carrying out that activity relative to the benefits. This tends to reduce incentives to implement an economic action -- be it working, forming capital, or consuming. The "price", or cost, of the activity rises. By changing relative prices, taxes alter economic behavior, advserely when taxes are increased.

Using an extreme example makes the point. Suppose there is no income tax and the government decides to tax income earned at a 100 percent marginal rate. In other words, the government takes everything. People would simply stop working. An engineer might find his annual disposable income fall from $50,000 to zero. The same principle applies, although less drastically, if a previously existing tax rate were raised, so that take home pay falls from, say, $50,000 to $40,000.

It is true that there is what economists call an "income effect" and a "substitution effect." Higher income taxes lower the marginal benefits to working, leading people to substitute leisure, which is not taxed, for income, which is taxed. On the other hand, people facing reduced incomes might want to work harder to overcome the "income effect" of reduced after-tax earnings. The empirical evidence, however, suggests the substitition effect dominates, and that higher income taxes tend on balance to reduce activities that generate income.

Putting it differently, the Law of Supply suggests that the amount of resources that will be supplied varies directly with price. Taxes lower the after-tax "price" received by owners of factors of production, thereby lowering quantity supplied.

One other negative effect of taxes arises from the impact that taxes have on trade and exchange. It can be shown graphically that the imposition of, say, an excise or sales tax, will involve changing prices and quantitities produced, and that the revenue gains to government will be less than the loss of consumer and producer welfare from the reduction in trade (what economists call a "deadweight loss.") Intuitively, trade increases human satisfaction since both parties to trade are happy to make the exchange. Taxes that reduce trade (say by artifically raising prices) will reduce trade-related satisfaction or welfare.

The negative impact that taxes have on economies can be understood by using a different approach. By reducing individual incomes or raising prices of goods, taxes reduce the real command of the private sector over resources. Those resources that are not commanded by the private sector go to implement public sector programs. Resources are moved from the private to the public sector. If the productivity in the public sector is as high or higher than in the private sector, the economy should suffer no output loss, and perhaps will even grow more. If, however, public sector productivity is lower than that in the private sector, a resource shift to the public sector will lower overall productivity and output. If a private sector worker makes 10 widgets a day, while a public sector widget maker produces only six, the switching of one widget maker from the private to the public sector will result in the loss of four units of widget output per day.

The evidence is overwhelming that private sector activity on average is in fact more productive. The worldwide move to privitatization is a response to this reality. Three reasons for this are worth noting briefly. First, the private sector faces market disciplines not common in public sector activity. On the demand side, entrepreneurs win greater rewards if they satisfy customers who pay to buy their product. If prices rise for goods in short supply, the signalling device of the market motivates others to begin supplying goods that people seem to want. On the supply side, profits are increased if firms reduce costs, meaning they increase productivity. In government, those incentives are non-existent, and, indeed, there are sometimes perverse incentives that lead bureaucrats to try to increase their command over resources via bigger budgets without increasing their "output" of services or goods. In other words, they try to lower productivity.

Second, for most services that government provides, it is a monopoly or near-monopoly producer. There is only one provider of highway services, fire services, national defense services, or even, in many communities, educational services. The private sector, by contrast, is more likely to be characterized by competition, providing added incentives for suppliers to innovate, cut costs and be efficient.

Third, the accumulation of large revenues by governments leads to many attempts to use government to redistribute income. Much destructive behavior is unleased by using resources to attempt to change who gets the output, rather than create output. Public employees clamor for above-market level wages, business interests try to get tariffs erected to keep out foreign competition, other groups attempt to provide incentive-destroying welfare benefits to members of the population, etc.

For all of these reasons, taxes used to finance government activity tend to crowd out productive private sector behavior, replacing it with public activity that is, on average, less productive because of the nature of government and the lack of market based incentives. It is no surprise, then, that researchers have found overwhelming evidence that the economic performance tends to fall off when taxes are increased, a subject addressed more fully below.

WHAT MAKES A GOOD TAX?

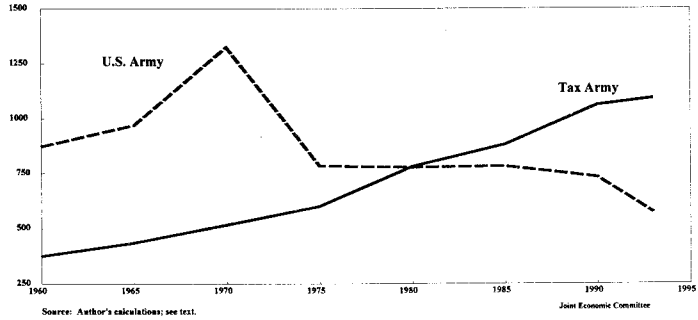
While there are strong theoretical and empirical reasons to believe that taxes are harmful to economic performance, not all taxes are the same in terms of their impact on economies or citizens. Economists have identified numerous criteria with which to evaluate taxes. Some of these criteria are somewhat controversial. To cite one example, some economists believe, other things equal, that a tax is improved if revenues from it increase at least proprtionately with changing incomes of the citizenry. The argument is made that this reduces the need to constantly change tax rates, tax bases, or levy new taxes. Others would argue, however, that a high revenue elasticity is not good, since it guarantees the government income without a vote of elected representatives. High revenue elasticity, according to this view, reduces accountability to the political process, and possibly promotes revenue-driven spending that is unproductive.

There are three criteria on which virtually everyone agrees in principle: a good tax is one that can be levied without enormous costs of administration; a good tax aims to be as neutral as possible with respect to resource allocation, and does not reduce economic growth by promoting allocative inefficiency; and a good tax tends to be fair. Bad taxes are administratively costly and complex, distort and reduce economic activity, and are widely viewed as unfair.

Resources devoted to tax collection, compliance, and administration are resources that could be used elsewhere. Much of the recent rise in discontent with the federal tax system arises because of its complexity. Conservative estimates are that it costs at least $70 billion a year to administer the federal income tax, and some put the estimates as much as three times higher.[1] Some three billion hours of human effort are expended annually filling out federal income tax forms -- the equivalent of 1,500,000 fulltime workers.

Moreover, a "tax army" of tax collectors, tax preparers, accountants, lawyers, etc. grows relentlessly, as Figure 3-1 shows. In that figure, the number of tax professionals is roughly estimated by taking one-half the accountants, one-fourth of the lawyers, and all the IRS employees. The tax army is much larger than the U.S. army. This may be an understatement, as it ignores tax preparation firms, most non-professional support personnel, etc. Adding in the 1,500,000 equivalent workers in form preparation, we expend nearly as many human resources preparing taxes as we do producing food.

Changing Personnel, Tax Army vs. U.S. Army, 1960-1993



Moreover, countless other adminstrative problems exist at the state and local level. A small army of tax assessors and appraisers determines the property tax base. High excise taxes lead to wholesale smuggling of cigarettes and other commodities between jurisdictions. Numerous studies show that cross-border purchases of goods to avoid taxes is extensive.

Good taxes do not distort the allocation of resources from what individual preferences and cost considerations dictate, as determined by market prices. If people spend more on housing and less on food because tax laws favor purchasing expensive houses, then the tax system is pushing people into spending patterns that differ from what their preferences reveal in the absence of taxation. Such a tax-induced change in human behavior violates the principle of tax neutrality and tends to lower economic welfare.

The violation of the principle of neutrality is particularly great at the federal level in the United States with respect to decisions to save and invest. The rate of personal savings out of disposable income is lower for Americans than citizens of virtually every other major industrialized nation in the world. In a de facto sense, marginal rates of taxation on income derived from savings sometimes exceed 100 percent. This is particularly the case where individuals make a long term financial investment. Because of persistent inflation, even at levels which we have come to regard as moderate, or even low, the real capital gains on the sale of an asset are often much smaller than the nominal gains that do not take account of the changing purchasing power of the dollar. Yet the tax system taxes nominal gains, which often are fictitious. Indeed, sometimes capital gains taxes have to be paid on investments that in any meaningful sense involved capital losses.

An even more fundamental problem is the fact that corporate earnings are taxed also at the individual level as dividends or capital gains, involving double taxation. Double taxation becomes triple taxation when the government taxes estates at the time of death. The pyramiding impact of these taxes increases the confiscatory nature of taxation of capital. On three separate occasions in the twentieth century, there were major reductions in federal income taxes -- the Mellon tax cuts of the 1920s, the Kennedy tax cuts of the 1960s, and the Reagan tax cuts of the early 1980s. All three

unleashed high rates of economic growth, because they reduced (although did not eliminate) the anti-growth/anti-neutrality provisions of the federal tax code.

One interesting feature of our 50 states is that there is wide variation in the types of taxation. Some emulate the federal income tax, with its attendant problems. Others use no income tax at all. Most states have sales taxes, but there are five exceptions. Do variations in tax systems between states mean the violation of the principle of tax neutrality also varies widely by state? If so, does that impact on state economic growth? We turn to those questions shortly.

A tax can be adminstratively simple and cheap to collect and be neutral in its economic impact but not be perceived to be fair. The classic example is a head or poll tax, the same dollar tax imposed on all citizens. Such a tax is highly regressive -- requiring a higher share of income at low income levels than at high income levels -- and thus violates many person's sense of what economists call "vertical equity." The imposition of the "community charge" by British Prime Minister Margaret Thatcher was similar to a head tax and widely considered the cause of her fall from power.

Many persons would say that a head tax violates the ability to pay principle of taxation. According to this principle, it is appropriate to tax the more affluent members of the population more than the poor because of the former group's greater "ability to pay." Many use this principle to call for highly progressive rates of taxation.

The concept of fairness cannot be scientifically measured or determined. What is fair to one person may be fair to another. Indeed, to many Americans being fair is treating everyone the same, except perhaps the most disadvantaged members of society. That view may be consistent with relatively proportional or flat rate taxation. Interestingly, one of the early founders of modern economics, John Stuart Mill, argued that a good case could be made to exclude a minimal amount of income (or other tax base) from taxation, but that taxation should be proportional after that point, similar to what proponents of flat rate income taxes advocate today.[2]

Since fairness is elusive to measure, perhaps the best indicator of the public's attitude on this issue is provided by polling data. For a generation, the Advisory Commission on Intergovernmental Relations (ACIR) has done rather extensive polling in which the public was asked: "Which do you think is the worst tax -- that is the least fair"? In the first poll, in 1972, 19 percent answered the federal income tax, compared with 45 percent that said the local property tax was the worst. The winner in recent years, by a wide margin, is the federal income tax, a tax that is one of the most progressive.[3] In the 1993 poll, 36 percent said the federal income tax was the worst. Adding another 10 percent who voted for state income taxes, some 46 percent said income taxes were the worst. By contrast, state sales taxes, which are typically somewhat regressive, ranked a distant third in the most recent poll, with only 16 percent citing them. Progressivity in rate structure does not seem to be too critical to most persons' notion of fairness.

Probably one reason the income tax is viewed is highly unfair is that it violates most people's concept of horizontal equity - a principle that holds that persons of similar economic means should pay similar amounts of tax. Because of the large amounts of deductions, exemptions, credits, surtaxes, and the like in the federal income tax code, individuals of similar income often pay widely varying amount of taxes. Homeowners pay less than renters; people with dividend income pay more than those with municipal bonds; persons in high tax states pay less federal tax than those in states

that minimize the state and local burden. Some people get the government to pay for most of their lunch, while others have to pay for their own food. All of this irritates people, particularly when the complexity of all the special provisions adds to the administrative costs of tax compliance.

In summary, good taxes are simple, economically relatively benign, and fair. The widespread perception that federal taxation, especially of income, fails to meet any of these criteria, is probably the underlying reason why the clamor for tax reform is growing in America. Our tax code is viewed as Bzyantine and unduly complex and expensive to administer; it has profoundly negative economic effects; and it is viewed as terribly unfair.

TAXES AND ECONOMIC PERFORMANCE: REVIEWING THE RESEARCH

Until a generation or two ago, economists often believed that taxes did not have a great deal of impact on economic behavior. For example, while the substitution effect of high income taxation might lead persons to stop working and enjoy more leisure (which is untaxed), the income effect of reduced paychecks would lead persons to work more. The two effects would roughly offset each other, so relatively high income tax rates would not have much economic impact.

One distinguished expert in the field of public finance, John F. Due, typified this thinking when he said, with reference to the impact of state and local taxes on business location, that studies "suggest very strongly that the tax effects cannot be of major importance."[4] As late as 1978, another economist made similar claims in an article surveying the literature on business location.[5]

Yet beginning in the early 1970s, economists increasingly took the view that "taxes matter" in a variety of ways. Much research anticipated the supply side revolution of the late 1970s and early 1980s that led to the 1981 Kemp-Roth bill enthusiastically promoted by President Ronald Reagan and, in modified form, approved by Congress in 1981 with bipartisan support.

Taxes and Economic Growth

Economists realized that state and local governments provided an excellent laboratory in which to evaluate tax policy, since there were 50 different states and thus 50 different tax systems. Perhaps the first empirical analysis into the question of state and local taxes on overall economic performance was performed by two economists at the Harris Bank and Trust in Chicago.[6] Robert Genetski and Young Chin used a simple regression model to show that economic growth was negatively correlated with changing rates of state and local taxation.

The Harris Bank study mirrored what numerous earlier studies found looking at specific areas or taxes. For example, A. James Heins discovered that there was an inverse relation between corporate income tax revenues in Illinois and state economic growth.[7] Arthur Laffer and associates found similar adverse effects between business taxes and economic growth in both Puerto Rico and Massachusetts.[8]

This author prepared an extensive study for the Joint Economic Committee in 1981 that replicated Genetski and Chin, but provided added detail.[9] Aside from tax variables, additional variables were introduced into the analysis for control purposes. For example, it was found that, other things equal, "States had a higher rate of economic growth the lower the growth in the burden of welfare expenditures."[10] A particularly interesting finding was that the study found that income and property taxes were more inimical to growth than sales taxes, and that progressivity within the income tax also, other things equal, tended to reduce growth.[11]

The findings of scholarly studies were supplemented by a variety of articles and books written for broader audiences.[12] The editorial page of the Wall Street Journal and the late columnist Warren Brookes were particularly important in spreading the view that "taxes matter."[13]

By the mid-1980s, this proposition was becoming standard wisdom within the economics profession, although with varying new nuances. L. Jay Helms, for example, said that the impact of taxes depended on how they were used, with expenditures on welfare, for example, having a negative impact.[14] A few years later, Mofidi and Stone reached similar conclusions.[15] Benson and Johnson showed that taxes had lagged negative effects, with the adverse impact being realized about three years after tax implementation.[16] Victor Canto and Robert Webb extended Helms's insight into the debilitating impact of tax-financed expenditures.[17] Still other studies confirmed the tax-growth relationship using other data sets or methodologies.[18]

The rate structure of taxation received some attention. In two studies, this author showed that there was a strong adverse relationship between the progressivity of state and local income taxes and economic growth, explicitly arguing that the state and local evidence supported a move to a flat rate federal income tax.[19] The negative effects of progressivity were described more fully by Hunter and Scott.[20] Both the Vedder and Hunter and Scott studies extended a pioneering observation by Romans and Subrahmanyam that tax progressivity reduced growth over a flat tax approach.[21]

Early studies by Marsden and Reynolds used international data to demonstrate that taxes were negatively correlated with economic growth.[22] Gerald Scully confirmed the tax-growth relationship in a study that looked at broader institutional factors in explaining growth differentials.[23] By the 1990s, numerous studies using ever more sophisicated econometric techniques and detailed international data sets confirmed the earlier finding. One National Bureau of Economic Research working paper reached what are now commonplace conclusions: "We find that a balanced-budget increase in government spending and taxation is predicted to reduce output growth rates."[24] Looking at the 24 major industrial nations belonging to the Organization of Economic Cooperation and Development (OECD) for the 1980s, two British economists concluded "We find robust and important effects suggesting that a large proportion of the divergence of economic performance through the 1980's can be explained by the supply-side effects of tax policy."[25] They were not alone in reaching that conclusion.[26]

Indeed, internationally, mainstream economists were reaching conclusions by the early 1990s that were very similar to those of early supply side economists of the late 1970s who were disparaged at the time by many mainstream economists. The conclusion of Dutch academic and government official Jariq van Sinderen is representative:[27]

> "Balanced budget reductions in taxes on wages and profits exert favorable effects on employment and growth. The relative impact depends on the specific government outlays and taxes which are cut back. In the long run, tax revenue decreases less than the amount of the intial tax reduction."

The latest word using international data was contained in a recent International Monetary Fund paper by Paul Cashin.[28] Using a combination of time series and cross section data on 23 OECD countries over the period 1971 to 1988, Cashin finds that each one percent increase in taxes as a percent of GDP lowers output per worker by about two percent. To be sure, he observes positive effects of spending from taxes, but in general the positive spending effects are only about one-half as large as the negative tax effects. That is approximately the same thing as saying that private sector expenditures are twice as productive as public sector ones.

Taxes and Other Measures of Economic Performance

The evidence suggests that taxes not only adversely affect economic growth, but other economic variables as well. The following propositions seem to be reasonably well documented by modern economic research:

- Businesses are less likely to locate in areas of high taxes;
- Job creation varies inversely with levels or changes in taxation, and unemployment varies positively with taxes;

Migration data suggest people move away from relatively high tax areas. The view that taxes do not matter in business location decisions began to be seriously questioned in the late 1970s. Grieson, Hamovitch and Morgenstern used econometric techniques in an important article in the Journal of Urban Economics, suggesting that taxes in fact did matter.[29] Bernard Weinstein, alone and with Robert Firestine, noted that high taxes forced up labor costs, as employers had to compensate employees for the burden of high taxes.[30] This observation was empirically verified a few years later in a National Bureau of Economic Research study.[31]

In the 1980s still more researchers, using more sophisicated models, confirmed the earlier findings.[32] One of the more interesting studies, however, used rather low tech procedures to reach similar conclusions. Robert Premus used a questionnaire approach with medium sized high technology firms, finding a strong indication that high tech firms consider taxes a major factor in business location.[33]

The research in the 1990s does not alter the now conventional wisdom that "taxes matter." To be sure, some offer qualifications. For example, Fox and Murray note that sensitivity to public policies, including taxes, varies considerably with industry and firm size.[34] Some of the more interesting recent evidence relates to locational choice of foreign multinational corporations.[35] One National Bureau of Economic Research study noted very high sensitivity of foreign investors to local taxes, concluding "that state taxes significantly influence the pattern of foreign direct investment in the United States."[36] Still another study written about the same time reached similar conclusions.[37]

The conclusions relating to business location are replicated with respect to migration. Studies by Cebula and by Browne in the 1970s demostrated that high local government taxation was a significant deterrent to in-migration of labor and thus a barrier to human capital formation within localities.[38] Reaching similar conclusions were Ecker and Syron.[39] For years, this author has cited evidence that shows that in the 1980s, people moved in large numbers into states with low or non-existent income taxes, while migrating out (net) of high income tax states. William Niskanen developed a model that demonstrates this relationship empirically, controlling for other factors.[40] A National Bureau of Economic Research demonstrated the importance of tax differentials in lifetime locational choice decisions in a still more sophisicated fashion.[41] Research on Canada shows similar sensitivity of migrants to taxes.[42]

Research has similarly showed that high taxes destroy jobs, or add to unemployment. Although they offer some caveats, Wasylenko and McGuire observed a negative correlation between taxes and metropolitan area employment growth between 1973 and 1980.[43] Looking at two different time periods in the 1960s and 1970s, Plaut and Pluta noted strong tax-induced adverse employment effects.[44] More recent evidence confirms these earlier studies. For example, Goss, Preston and Phillips think that earlier studies failed to fully control for other factors, thereby leading to an understatement of a strong negative relationship between taxes and employment growth.[45] In a forthcoming study by this author, it is suggested that state and local taxes tend, other things equal, to increase the long run rate of unemployment in states.[46]

The review of the literature above is meant to be illustrative, not exhaustive. Moreover, some topics are not even discussed. A study shows, for example, that high property taxes lower property values and thus the real wealth of the citizenry.[47] The overall evidence however is overwhelming: high taxes lower the growth of income and reduce employment opportunities, business investment and in-migration of human resources. Taxes do matter, and indeed, matter a good deal.

STATE AND LOCAL TAX SYSTEMS: A DESCRPTION AND TRENDS

Over the course of the twentieth century, state and local governments have grown enormously in size, necessitating increased revenues. This, in turn, has required new taxes and higher rates on existing taxes. Unlike the federal government, state and local governments are mostly constrained by balanced budget constitutional requirements that usually mean revenues rise roughly proportionally to expenditures. In recent decades, non-tax forms of revenue have become increasingly important to governments.

These trends are demonstrated in Tables 5-1 and 5-2. Turning first to Table 5-1, tax collections for state and local governments were more than 600 times larger in 1992 than 90 years earlier. Since considerable price inflation occurred over that time interval, it is necessary to correct for price trends. Using the Consumer Price Index, we observe that real (inflation-adjusted) tax revenues rose more than 45 fold between 1902 and 1992. Because of the likelihood that the Consumer Price Index overstates inflation, it is probable that actual real tax growth may be even greater.

TABLE 5-1

STATE AND LOCAL GOVERNMENT TAX COLLECTIONS: 1902 TO 1992*

Year	Tax Collections	Inflation-Adjustd Collections+	Taxes Per $1000 Personal Income
1902	$860	$12,745	$47.78
1927	$6,087	$51,900	$76.47
1940	$7,810	$82,446	$99.74
1950	$15,914	$97,861	$69.95
1960	$36,117	$180,829	$90.07
1970	$86,795	$331,521	$107.38
1980	$223,463	$401,477	$98.64
1992	$555,610	$586,895	$107.80

* Numbers in first two columns are in millions of dollars.
+ Adjusted using the Consumer Price Index; in 1994 dollars.
Source: U.S. Department of Commerce, author's calculations.

The compounded annual rate of growth of real tax revenues over the 90 years was 4.44 percent a year -- well beyond the rate of growth in personal income. In 1902, state and local tax payments absorbed less than $48 of every $1000 in personal income; by 1992, that share had over doubled, going to nearly $108 of each $1000 in income. The growth was rapid and fairly steady from 1902 to 1940. Tax revenues rose in both nominal and real terms in the 1940s, but there was a considerable decline in state and local tax payments in relation to personal income. This presumably reflects two factors. First, high unanticipated inflation meant that the tax base grew less rapidly than incomes, particularly in this era before heavy reliance on income taxation. Second, huge increases in federal taxation and spending during World War II may have crowded out state and local efforts to some extent.

The growth in tax revenues accelerated in the 1950s and 1960s before slowing down in real but not nominal terms in the 1970s during another burst of inflation along with the beginnings of a tax revolt in several states. Growth resumed in the 1980s, and at the present the state and local tax burden is at or near a historic high.

Table 5-2 includes non-tax general revenues that state and local governments obtain from their own sources. Federal grants, insurance and pension payments, utility and liquor store revenues are excluded. Fees, charges, and interest income of government are included. During the first half of the century, non-tax sources constituted 10-15 percent of general revenues, but now reach 30 percent. In some jurisdictions, most notably California, the growth in non-tax revenues has soared because of constitutional tax limitations. Looking at general revenues (less federal grants), state and local governments took roughly a nickel of each dollar received in 1902, but more than 15 cents in 1992, easily an all-time record.

TABLE 5-2

STATE AND LOCAL GENERAL REVENUES FROM OWN SOURCES, 1902 TO 1992

Year	General Revenues*	Real General Revenues*+	% From Non-Tax Sources	Revenue Per $1000 Personal Income
1902	$979	$14,509	12.2%	$54.39
1927	$7,155	$61,006	14.9%	$89.89
1940	$8,664	$91,461	9.9%	$110.65
1950	$18,425	$113,302	13.6%	$80.99
1960	$43,530	$217,944	17.0%	$108.56
1970	$108,898	$415,945	20.3%	$134.73
1980	$299,293	$538,020	25.3%	$133.45
1992	$743,399	$844,411	30.0%	$153.94

* In millions of dollars.
+ In 1994 dollars, deflated using the Consumer Price Index.
Source: U.S. Department of Commerce, author's calculations.

The type of taxes used by state and local governments have changed considerably over time. Early in this century, state and local governments obtained the overwhelming majority of their tax revenues from property taxes. During the Great Depression of the 1930s, many states enacted sales taxes and some introduced income taxes as well. Even so, as Table 5-3 indicates, at the middle of the century property taxes still provided nearly half of all tax revenues.

TABLE 5-3

CHANGING IMPORTANCE OF MAJOR STATE AND LOCAL TAXES: 1902 To 1992

	Percent of Total Tax Revenues Raised By Tax			
Year	Property	Sales	Income	Other
1902	82.1%	3.3%	0.0%	14.6%
1927	77.7%	7.7%	2.7%	11.9%
1950	46.2%	32.4%	8.7%	12.7%
1970	39.3%	34.9%	16.7%	9.1%
1992	32.1%	35.3%	25.0%	7.6%

Source: U.S. Department of Commerce, Bureau of the Census, and author's calculations

During the past forty years, the relative importance of property taxes has declined. The key word is "relative." Property taxes by any measure did not decline, but the growth in state and local government was essentially financed by expanding other forms of taxes, especially income taxes. Sales taxes rates have risen, so their relative importance has grown slightly, but the big shift has been towards income taxation.

However measured, state and local governments are absorbing larger amounts of the incomes of Americans, whether they be measured in nominal or real dollars, or even as a proportion of total income. The consequences of state and local fiscal policies, then, have grown over time simply because state and local government is relatively larger than earlier in our history.

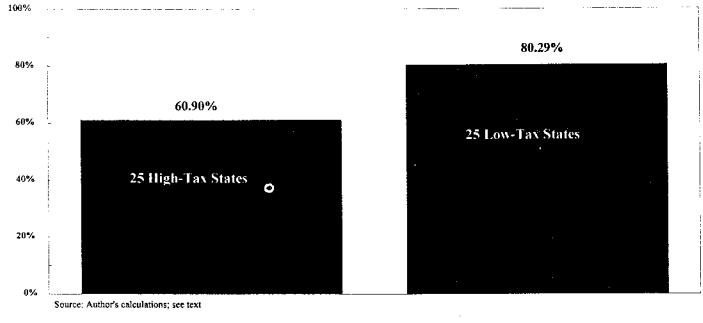
As the evidence that follows shows, these fiscal trends have probably introduced some drag on American economic growth. There is evidence that, other things equal, higher tax burdens mean lower growth. In addition, however, the shift to income forms of taxation have likewise probably reduced the growth rate, as income taxes are by many indicators the worst of all taxes from a growth perspective.

STATE AND LOCAL TAXES AND ECONOMIC GROWTH: SIMPLE EVIDENCE

Most of the studies relating taxes to economic performance that were cited earlier use moderately to very sophisicated statistical techniques to evaluate various forms of evidence. Such methodologies usually do an excellent job of controlling for other, non-tax factors that might explain economic performance, thus increasing the accuracy in the observed relationship between taxes and economic change. At the same time, these statistical studies are relatively difficult for the average person to understand. Accordingly, the use of some rather simple descriptive statistics helps evaluates the relationship between taxes and economic growth.

Since the impact of taxes on economic behavior takes time to be realized, and since the effects may accumulate over time, it is probably best to look at the tax-economic growth relationship over a relatively long time horizon. That also reduces the impact of regionally-specific short-term economic booms or busts that occur. Accordingly in Figure 6-1, we took the 25 states with the highest measured state and local tax burden over the period 1965-92, and calculated the average rate of growth in income per capita in real terms. We then did the same thing for the 25 states with the lowest measured state and local tax burden.[48]

Figure 6-1
Real Per-Capita Income Growth, High and Low Tax States, 1965-1993



Source: Author's calculations; see text

Note that the relatively low tax states grew nearly one-third faster than the high tax states. Since the average state in 1965 had per capita income of $11,899 in 1993 dollars, the difference between a 60 and 80 percent growth rate translates into a difference of about $2,300 per person, or over $9,000 for a family of four. The evidence suggests that residents of above average tax states suffered very materially from the fiscal actions of their state of residence.

In Table 6-1, the data are classified by quintiles in terms of average tax burden. Also, both the mean and median value were calculated for each group. Note that for both statistics, the 10 states with the lowest tax burden had the highest rate of income growth per capita, with income growth increasing with falling tax burden, with one exception. The lowest tax states grew anywhere from 12 to 28 percentage points more than the highest tax states, depending on the statistical measure of central tendency used.

TABLE 6-1
Economic Growth Experience Of States, Classified By Tax Burdens From 1965 To 1993

Average Tax Burden*	Median Growth, Real Per Capita Income	Average Growth, Real Per Capita Income
10 Highest Tax States	63.46%	67.96%
10 Next Highest Tax States	56.53%	58.33%
10 Middle States	71.86%	67.51%
10 Next Lowest States	72.62%	72.02%
10 Lowest Tax States	91.84%	79.51%

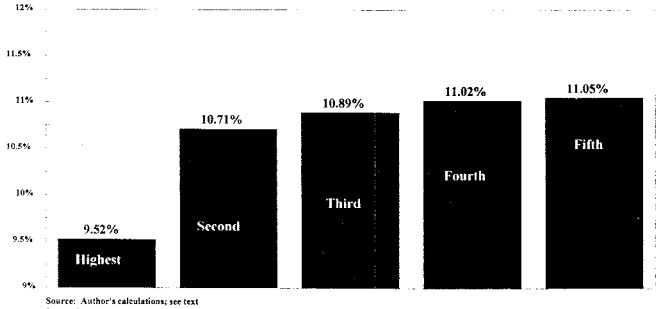
* For years 1965 to 1993.
# Average of state and local taxes per $1000 personal income in fiscal years 1965 and 1992.
Source: U.S. Department of Commerce, author's calculations

The low tax states included some of the fastest growing states in the Union from a per capita income perspective, including, for example, Virginia, Tennessee, Alabama, Georgia and New Hampshire. By contrast, none of the high tax states grew nearly as fast as these states. To be sure, the correlation between taxes and growth was far from perfect. Illinois and Ohio, for example, had relatively low taxes and also below average rates of economic growth. In short, "taxes matter," but it is not true that "taxes alone matter."

Another approach would be to categorize the states by their rates of economic growth. In Figure 6-2, note that the mean tax burden rises consistently as the growth experience worsens. The 10 states with the lowest growth rates had, on average, a 16.1 percent higher tax burden than the 10 states with the highest rate of economic growth.

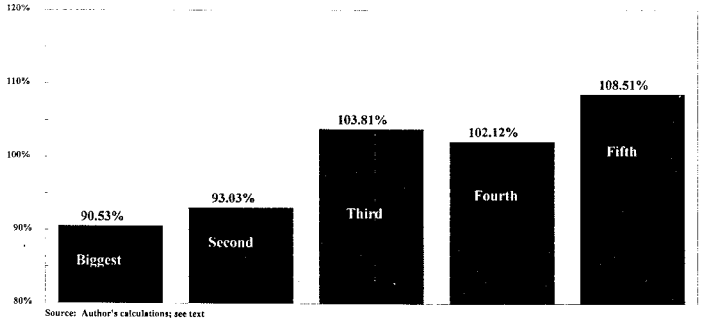
In Figure 6-3, two changes are made. First, we look at a slightly longer time horizon, 1960 to 1993. Second and more important, we look at the change in the tax burden over that entire time period rather than the average tax burden. The proposition here is that a high tax state can help itself by lowering its real tax burden, even if its burden after the tax cut is still fairly high relative to other states.

Figure 6-2
Tax Burden of States By Quintile of Per Capita Income Growth, 1965-1993



Source: Author's calculations; see text
State and local taxes as a % of personal income; average of figures for 1965 and 1992
"Highest" represents the 10 states with the highest growth rate from 1965-1993.
"Second" represents states ranked 11th to 20th in growth performance, etc

Figure 6-3
Per Capita Income Growth By Rate of Growth in Tax Burden, 1960-1993



Source: Author's calculations; see text

* "Biggest" refers to states with largest increase in state and local tax burden from 1960 to 1992; "second" refers to states ranked 11th to 20th in tax increase, etc.
Per capita income figures are in constant dollars.

Note that the states that cut their tax burden the most (New Hamsphire, Mississippi, South Carolina, Louisiana, North Dakota, Kansas, Tennessee, Nevada, Colorado and Vermont) had an average growth in real per capita income than was nearly 20 percent large than the states that increased their tax burdens the most (Alaska, Delaware, New York, Connecticut, New Jersey, Pennslyvania, Kentucky, Hawaii, Wyoming, and Nebraska). The differential growth between these two groups is substantial, amounting to about $2,000 a person by 1993.

Note also that quintile rankings show a fairly close negative correlation between the magnitude of tax changes and the rate of economic growth. Thus the second quintile in terms of tax increases grew a little faster than the top quintile, while the fourth quintile grew a little less than the bottom quintile (the group of states that actually reduced taxes in most cases).

Four Case Studies

For many readers, the reference to broader statistical aggregates is less interesting than individual case studies. Using the data on tax burdens in 1960 and 1992 and the growth experience from 1960 to 1993, there are many examples of specific states losing ground to similar states because of their inappropriate tax policy. Four examples follow.

The champion taxer of the large states is New York. Its tax burden was already above average in 1960, but it was raised an extraordinary 42.2 percent in the one-third of a century following 1960. Its neighbors, Pennsylvania, New Jersey and Connecticut - all raised their tax burdens too, yet less than New York. New York had a much higher average tax burden than its neighbors in 1960 - and the differential widened. The result? New York's rate of per capita income growth was less than any of these neighbors. New Jersey's income, below New York's in 1960, was above by 1990. Connecticut's per capita income exceeded New York's by two percent in 1960 - but by 14 percent by 1993.

Moving west and south, compare Kentucky and Tennessee. In 1960, Kentucky had an aggregate tax burden (as measured by state and local taxes as a percent of personal income) that was 12 percent lower than Tennessee's. It also had higher per capita income than its neighbor to the south. Over the next one-third of a century, the aggregate tax burden in Kentucky was increased by an extraordinary 38 percent. By contast, in Tennessee, the aggreage tax burden actually fell slightly. Kentucky was in the top quintile of states in terms of tax increases, while Tennessee was in the bottom.

The results were striking. Over the 33 years, the rate of economic growth was over 20 percent higher in Tennessee than in Kentucky. By 1993, per capita income was nearly eight percent higher in Tennessee. Lower taxes meant higher growth.

The Kentucky and Tennessee example points out the pernicious impact of progressive income taxes. Kentucky had a progressive income tax, while Tennessee had the "ultimate flat rate tax" -- no tax at all. With inflation, Kentuckians were pushed into higher tax brackets. Without voting, politicians in Kentucky inflicted higher taxes on their constituents. That did not happen in Tennessee.

Moving further West, compare Idaho and neighboring Montana. In 1960, per capita income was about 10 percent higher in Montana. The tax burden was also slighter higher in Montana than in its western neighbor. Over the next third of a century, Idahoans increased their tax burdens only very slightly, while Montanians had a much larger aggregate tax increase, greatly widening the already existing tax differential between the two states. What happened to incomes? They rose much more in Idaho, so that by 1993, per capita income in Idaho exceeded than in Montana, previously the considerably more affluent state.

The impact of tax differentials shows up in other statistics as well. For example, in 1960, more people lived in Montana than Idaho. By 1993, the population of Idaho exceeded that of Montana by 31 percent. It appears that people literally fled relatively high tax Montana for its relatively lower cost neighbor to the West.

People love the sun, and the nation's premier competitors for tourists wanting a sunny climate are California and Florida. What is the fiscal history of these two states? Throughout the period, the aggregate tax burden was higher in California than in Florida. Moreover, the differential widened over time, as the aggregate tax increases in California , despite property tax rollbacks following from Proposition 13, were larger than in Florida.

The result? By any measure, economic progress was greater in Florida. Real per capita income rose 118 percent in Florida - well above the national average. By contrast, in California, it rose less than 66 percent - substantially below the national average. In 1960, California had a dramatically higher per capita income than its eastern rival, exceeding Florida by 39 percent. Today, the differential in nearly gone (less than five percent). Also, population growth and migration have been greater in Florida than in California.

Again, Florida has no income tax, while California has a highly progressive income tax. Inflation pushed income taxes up in California, absorbing more of the populace's income and serving as a drag on the rate of economic growth. High taxes, low growth, and highly progressive income taxes, and doubly slow growth.

STATE AND LOCAL TAXES AND GROWTH: ECONOMETRIC FINDINGS

The simple descriptive statistics comparing different tax and growth situations can be criticized on the grounds that they do not take account of other, non-fiscal factors that might play a role in explaining economic behavior. Accordingly, in this section, rather simple but compelling econometric evidence is presented that demonstrates that "taxes have mattered" over the past third of a century in the United States.

While some modern studies have used highly complex multiequation models, the findings are typically similar to what is obtained using single equation ordinary least squares regression procedures. That is the methodology used here, as it can be understood at least in part by the intelligent layperson for whom this study is directed.

Let us look at the relationship between the rate of economic growth in the 50 states (called GROWTH in the statistical results below) and two fiscal variables: the level of state and local taxation as a percent of personal income in fiscal year 1960, denoted TAX60, and the change in that tax burden from 1960 through 1992 (again, as a percent of personal income), denoted TAXCHANGE. The variations in GROWTH are considerable, ranging from slightly over 60 percent in Delaware to nearly 151 percent in South Carolina. In the regression results below, the numbers in parentheses are t-statistics:

(1) GROWTH = 160.81 - 5.61 TAX60 - 6.35 TAXCHANGE,
(5.39) (1.87) (3.20)

$\bar{R}^2$ = .145, F-Statistic = 5.15.

The null hypothesis that there is a negative statistical relationship between taxes and economic growth is confirmed for both variables at least at the five percent level of significance using a one-tailed test. In other words, we are 95 percent confident (even 99 percent in the case of the tax change variable) that the true relationship between each of the tax variables and economic growth is negative (higher taxes, lower growth).

The findings suggest that an increase in state and local tax burdens equal to one percent of personal income would lower growth by about six percentage points from 1960 to 1993 (e.g., from 90 percent to 84 percent). That is true of both tax variables. Since the typical state in 1960 had personal income per capita of over $11,000 (in 1993 dollars), the results suggest a state that raised their taxes fairly considerable (say equal to two percent of personal income) would have had over $5,000 less income for an average family of four by 1993 compared to the state that did not change its tax levels at all.

Looking at actual tax burdens and growth rates, it is possible to estimate the impact that taxes had in explaining growth differentials. For example, Pennsylvania grew nearly 94 percent compared with less than 61 percent for Delaware. The findings suggest that about one third of that differential is tax-related. On the other hand, New York (85 percent growth) and New Hampshire (112 percent) followed radically different tax policies (New York raised its taxes dramatically, while New Hamphsire lowered its tax burden), and the findings show all the differential (and a bit more) is explainable by tax policy. Similarly, Indiana modestly outperformed Illinois (79 vs. 74 percent growth), and the differential is virtually entirely explainable by bigger tax hikes in Illinois.

The model above suffers from several limitations. It only explains about one-seventh of the total variation in economic growth, and it excludes other variables that might be important. Controlling for these other factors conceivably could wipe out the observed tax-growth relationship. Accordingly, a large number of control variables were introduced into the model. Also, there are significant problems involved in including Alaska, and arguably Hawaii in the regression equations. Aside from the geographic isolation of these states from the mainland, Alaska's tax numbers are severely distorted because of the treatment of oil revenues from the North Slope. Alaska's total state and local taxes as a percent of personal income increased several standard deviations more than any other state, and by standard outlier tests it is appropriate to exclude it. It is unique in its ability to export a huge portion of its tax burden to other states. In the regression below, the data set is confined to the 48 contigous states.

In Table 7-1, four additional variables are introduced into the model for control purposes: UNION, measuring the percent of the nonagricultural labor force in labor unions at midperiod (1974); SUNSHINE, the percent of the days of the year the sun shines in a leading city in the state, or an average of several cities; WAGES, a measure of average worker wage payments from four different dates within the time period, indexed to average 100 for all states; and UNEMPLOYMENT, the average annual unemployment rate for the first 32 years of the time period (1960 through 1991).

TABLE 7-1

State And Local Taxes And Economic Growth, 1960-1993: Results*

Statistic or Variable	Regression Coefficient	T-Statistic
Constant	308.90	10.54
TAX60	-3.65	-1.83
TAXCHANGE	-3.64	-1.97
UNION	-0.74	-1.65
SUNSHINE	-1.08	-3.64
WAGES	-1.10	-5.01
UNEMPLOYMENT	3.81	1.74
F- Statistic	18.10	
$\bar{R}^2$	.685	

*Dependent variable is the growth in real personal income per capita, 48 contiguous states; ordinary least squares regression analysis is used.
SOURCE: Author's calculations; see text.

The model now is far more robust statistically, explaining over two-thirds of the variation in economic growth between the states. The tax variables maintain their expected negative signs, and remain statistically significant at the five percent level using the appropriate one-tail test.

The magnitude of the impact of taxes on growth has been reduced by about 40 percent by the inclusion of the control variables, but still the tax-growth relationship remains potent. For example, compare North and South Carolina, both very fast growing states. South Carolina grew over five percentage points faster, however. Why? The fact that North Carolina raised its average tax burden nearly three times as much as its neighbor to the South can explain about two-thirds of the differential. Ohio had less growth than either of its large midwestern industrial neighbors (Michigan and Indiana). Yet it raised its taxes more than these states, and the model suggests that act explains a significant part of the growth differential (about one-third of it in the case of Indiana, one-fourth in the case of Michigan).

At the same time, it is not true that "taxes alone matter." Pennsylvania outgrew Ohio despite raising its taxes more, for example. The reasons relate to factors other than taxes. For example, the model found that high wage, highly unionized states tended to grow less than those with less unionization and lower wage levels. For no clear reason, sunshine and growth were statistically significantly negatively correlated. Taxes are relevant and important, but not exclusively important. They are, however, controllable by public policy whereas some other variables, notably the sunshine, are not.

To test to see if the tax-growth relationship was solid, an exercise in what econometricians call "sensitivity analysis" was performed. More than a dozen variations of the model were explored, some introducing new control variables (e.g., variables measuring the degree of manufacturing, energy or farm orientation of the state, a variable measuring the age of the state, even a variable

measuring political liberalness). Other models used all 50 states or even the 50 states plus the District of Columbia. In every single case, the expected negative relationship between both tax variables and the rate of economic growth was obtained, and in most instances for both tax variables the results were statistically signficant at least at the five percent level. The sensitivity analysis increased confidence that there is in fact a strong and statistically significant negative relationship between tax levels and tax changes and the rate of economic growth.

Population Change

When people discuss whether an area is growing, they typically think of population change. California rates low on growth in per capita income over time, but relatively high on growth as measured by population change. Most variations in the rate of population change reflect migration. Some people think migration is the ultimate measure of the attractiveness or success of an area. If an area is rapidly gaining population through migration, it is a sign that people like the area, and believe it has a relatively high quality of life.

Accordingly, regression analysis was used to explain variations in population growth between the states from 1960 to 1993. That variation was enormous, much more than for per capita income growth. Population growth was an extraordinary 387 percent in Nevada, but was actually negative in West Virginia. Again, several non-tax variables are introduced for control purposes, including two used before (WAGES and SUNSHINE), and one measuring the importance of farming (the percent of farm receipts as a percent of personal income in 1975, or FARM), and one measuring the importance of the production of fuels (mineral production as a percent of personal income in 1980), or ENERGY.

TABLE 7-2

Taxes And Population Change, 1960-1993: Regression Results*

Statistic or Variable	Regression Coefficient	T-Statistic
Constant	-362.099	-4.30
TAX60	-2.170	-0.36
TAXCHANGE	-13.255	-2.44
SUNSHINE	6.133	7.49
WAGES	1.125	2.35
FARM	-2.439	-4.38
ENERGY	-0.002	-2.14
$\bar{R}^2$	.602	
F-Statistic		12.86

*For 48 contiguous states.
SOURCE: Author's calculations; see text

The results, in Table 7-2, are quite interesting. Both tax variables have the expected negative sign, but the variable representing the initial tax level is not statistically significant at generally accepted levels. The variable measuring the change in tax burden, however, is highly significant in a statistically sense (at the one percent level using a one-tailed test), and supports the null hypothesis that, other things equal, people prefer areas where the tax burden is falling.

The results for the tax change variable are quite strong. Compare two otherwise identical states, one of which kept its taxes the same and the second raised its tax burden by two percent of personal income (from, say, nine to eleven percent). Suppose the state raising its taxes had 40 percent population growth. The model would predict population growth in the state holding the line on taxes would have population growth of more than 66 percent. If both states started with the same populations, the estimated 1993 population in the state maintaining lower taxes would be about 20 percent larger than in the tax raising state.

Looking at real illustrations, let us return to the example of Montana and Idaho used earlier. Idaho's population rose almost 65 percent, while Montana's increased only 24 percent. The model here suggests more than one-fourth of the difference between the two states is explainable by tax policy (the same is true with Washington and Oregon). Although both Minnesota and Wisconsin are high tax states, Wisconsin raised its taxes more. The differential tax change explains all the differential population growth (Minnesota 32 percent, Wisconsin 27 percent). The model predicts that had Illinois not raised its tax burden, its population growth would have more than doubled -- and Nebraska's would have tripled. If Florida had raised its taxes has much as New York (instead of slightly), its estimated 1993 population would have been more than two million less than the actual total of 13.7 million.

As before, use of sensitivity analysis reinforces the conclusion that changes in tax burdens are an important determinant of population growth. The general conclusion that emerges is that people alter their behavior in response to tax changes. As taxes go up, some people work and invest less, while others move. The evidence further confirms the basic proposition that increases in tax burdens are harmful to the growth and vitality of any area.

Moreover, a tax increase is a tax increase, whether imposed by federal, state, or local government. The rise in federal taxation over the past 60 years, then, may well be a significant factor in the lowering of the long-term slowdown in the rate of economic growth noted by some commentators.

Taxes and Total Personal Income Growth

Economies grow partly because of population growth, and partly because of "intensive economic growth" -- increases in output per capita. The statistical evidence above relates to both of the components of total income growth. However, it is possible to look directly at total personal income growth over time as it relates to taxes. This incorporates both population and per capita income effects. Because some studies have indicated that a short lag exists before the harmful effects of taxes are apparent, a two year lag is also introduced (taxes are related to income change two years later.) The control variables used are altered slightly as well. Table 7-3 shows the result for the 48 contigous states. Both tax variables have the expected negative sign, and the one representing the change in tax burden is statistically significant at the five percent level. Moreover, it shows a

powerful relationship between tax change and income change. Taxes lower per capita income, and they lower population growth, so the impact on personal income is doubly significant.

TABLE 7-3

Taxes And The Growth Of Total Real Personal Income, 1962-1994*

Statistic or Variable	Regression Coefficient	T-Statistic
Constant	-65.94	-0.54
TAX60	-0.76	-0.08
TAXCHANGE	-17.56	-2.13
UNION	-2.48	-1.90
SUNSHINE	6.41	5.02
FARM	-4.15	-4.95
ENERGY	-1.38	-2.24
$\bar{R}^2$	.594	
F-Statistic	12.47	

*Data are for 48 contiguous states.
SOURCE: Author's calculations; see text.

Compare New York and New Hampshire. The Empire State's real personal income only slightly more than doubled from 1962 to 1994, while New Hampshire's nearly tripled (110.3 vs. 186.3 percent). The statistical results suggest that this differential is entirely explainable by the fact that New York raised its average tax burden dramatically, while New Hampshire lowered its burden. Kansas grew faster than neighboring Iowa, and again the differential is explainable by the fact Iowa raised its tax burden, unlike Kansas.

EVALUATING ALTERNATIVE TAX AND NON-TAX FUNDING OPITONS

While it is clear that taxes have a negative effect on economic performance, as a practical matter all governments must fund their operations. Should the government resort to taxation or alternative means of raising revenues? If taxes are chosen, which taxes are best? If an income tax is used, should it have a flat or progressive rates?

Tax vs. Non-Tax Sources of Revenue

State and local governments have two other major sources of revenue besides taxes, along with several other options available on a short-term or emergency basis. As to regular sources of funding, first, they receive financial grants from the federal government. Second, they can levy fees or user charges, including lottery operations. In addition, of course, they earn some revenues from interest on investments. As to revenue sources of a one time nature, states sometimes rely on the sale

of assets. Also, despite balanced budget amendments, most states temporarily can meet expenditure demands in part by either drawing down cash balances (often in "rainy day funds") or even by borrowing.

The statistical model developed previously can be modified to evaluate the impact of federal grants and fees and charges on economic growth. In particular, the change in "miscellaneous revenues" including fees and charges was calculated as a percent of personal income for the period 1960 to 1992 for state and local governments; a similar measure was calculated to measuring changing federal grants. Also, in some regressions the level of fees and government grants in 1960 were also included as variables.

More than a dozen regressions were run using different combinations of fiscal variables, including tax variables previously included. The various non-fiscal control variables were changed, as well sample size (e.g., including Alaska and Hawaii as opposed to excluding them). The findings can be summarized:

- In all regressions, the previously observed negative relationship between tax levels, tax change and economic growth held. In a majority of the regressions, the observed relationship was statistically significant at least at the 10 percent level, and often at the five percent level.

- In over 90 percent of the regressions, the expected negative relationship between fees and charges and the rate of economic growth was confirmed, and in a majority of cases the relationship was statistically significant at the five percent level. However, the observed relationship between the initial (1960) fee burden and economic growth was far more tenuous, with none of the findings being statistically significant.

- There is no discernible relationship between the magnitude of federal grants received and the rate of economic growth. In 13 regressions examining the relationship between changes in federal grants (as a percent of personal income) and economic growth, in 6 of them the expected positive relationship was observed, while in 7 of them (one of them statistically significantly different from zero at the five percent level), a negative relationship held -- higher grants meant lower growth.

On the basis of these statistical findings, it would appear that state and local governments that raise fees and charges in order to avoid tax increases will not significantly alter economic performance. While the findings with respect to fees and charges are on balance slightly less robust than those for taxes, the evidence suggests that raising fees and charges would have similar negative effects on growth.

The findings with respect to government grants is particularly revealing. While getting funds from Washington may have political appeal, the economic impact is negligible, and may actually be more negative than positive.

Does the Type of Taxation Matter?

Once a government decides that expenditure considerations make a change in the aggregate tax burden desirable, does it matter which type of tax is changed? The model used in Table 7-3 was modified, substituting changes in four specific types of taxes for the aggregate tax change variable incorporated in that table. As before, the change in the tax burden as a percent of personal income was used to define tax change. The taxes examined were the individual income tax, general sales taxes, selective sales taxes (excises), and property taxes.

An extremely powerful and statistically significant negative relationship was observed between changes in individual income tax burdens and the rate of personal income growth. This is particularly important since, on net, the increase in income tax burdens equalled roughly all the total increase in tax burden (other taxes cumulatively stayed about the same as a proportion of personal income).[49] Indeed, the results suggest that if state and local income individual income tax burdens in 1992 had remained at their 1962 level as a percent of personal income, personal income growth from 1962 to 1992 would have averaged about 60 percent more. Since the average real personal income growth was about 189 percent, the results suggest that if state and local income tax burdens had not risen, personal income growth would have been over 30 percent greater than actually occurred.

A negative relationship was also observed between the two forms of consumption taxes (general sales and selective sales) and the rate of real personal income growth, but the results were not statistically significant at conventional levels of confidence nor were the estimated relationships suggestive that higher sales taxation strongly impacted growth. The observed relationship between changing property taxes and economic growth was actually positive but both statistically insignificant and weak.

The conclusion from the state and local data is that policymakers can improve the rate of economic growth by moving towards lower taxes on income. It might seem that a growth oriented fiscal strategy would be to move towards substituting a national sales tax for the existing income tax. There are a number of reasons, however, for believing that strategy is flawed, as will be discussed in detail below.

Flat Rate Vs. Progressive Income Taxes

Income taxes take many forms. In some states, virtually all income is taxed, but marginal rates are low and the same at all income levels. The tax is only modest progressive. Examples would include Illinois and Pennsylvania. A few states have a very small tax base, but fairly high flat rates on the remaining income. Good examples are New Hampshire and Tennessee, which tax only so-called unearned income (investments). Massachusetts is an example of a state that emulates Illinois and Pennsylvania in taxing most income at a flat rate, but follows Tennessee in placing a higher rate on investment income. Some states have nominally fairly sharply progressive income taxes that are in fact nearly flat rate taxes, since the top rate applies at very low income levels. Oklahoma is a good example, with rates ranging from 0.5 to 7.0 percent for those who do not deduct their federal income taxes, yet with the top rate applying for a typical family at about $25,000 income. In Utah, the top rate, 7.2 percent, applies to a family of four making more than about $15,000 annually.

Then there are states with classic highly progressive income taxes. Good examples include California, Iowa and Ohio. In all three states, the top marginal rate is at least 10 times the lowest rate, and apply at relatively high income levels. California's top rate of 11 percent is fully 10 percentage points below the lowest rate. A few states achieve similar progressivity by tying their tax to the federal income tax liability; Vermont is the classic example here.

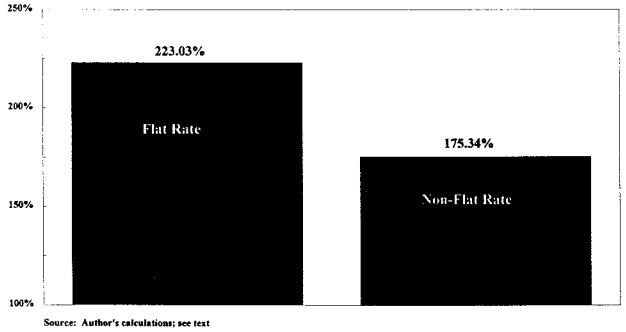
At the other extreme are states such as Florida, Texas, Washington and South Dakota that have absolutely no income tax whatsoever. They are the "ultimate flat rate tax" states. The pattern of taxes then, is richly varied across the land, providing good opportunity to evaluate alternative income tax structures.

The expectation is that progressivity in rate structures should have a negative impact on economic activity. Human behavior is determined at the margin -- it is the tax rate on extra or additonal income that influences decisions whether to work overtime, invest monies in a business venture, etc. High marginal tax rates lower the incentives to work, save, and invest more than lower marginal tax rates. Thus, one would predict that states with a broad-based income tax with flat rates at relatively low rates would do better than states with marginal tax rates that rise significantly with income.

In evaluating the effect of the progressivity of income tax rate structure, emphasis was again placed on the growth of total personal income, as that measure incorporates both the effects of migration and intensive economic growth from rising income per capita. As a first step, 14 states were identified that had flat tax rates for all or nearly all of the period 1962 to 1994. In many cases, the flat rate was zero - there was no income tax (e.g., Texas and Florida). In other cases (e.g., Illinois, Michigan and Pennsylvania), for most of the period the state had a flat tax with a positive rate. A few states (e.g., New Hampshire and Tennessee) had a zero rate for work related income, and a positve flat rate for property income.

Figure 8-1

Growth in Real Personal Income, Flat Rate and Non-Flat Rate States: 1962-1994



Source: Author's calculations; see text

Figure 8-1 shows that the average growth in real personal income from 1962 to 1994 was more than one-fourth higher in the 14 flat rate states than in the 36 states that had progressive rate structures for all or part of the period. Over time, a greater proportion of the nation's output (and the income derived from that production) came in states that chose not to increase income tax rates as individual incomes rose. Economic vitality was greater in the flat rate states.

The simple observation above, however, may have occurred by chance. It is possible that flat rate states had other attributes (e.g., sunshine, low unionization, etc.) that explain their high growth. Accordingly, a more sophisicated statistical analysis seems appropriate.

Table 8-1 reports the results of a ordinary least squares regression model that incorporates two tax variables. First, an average income tax burden is estimated by taking that burden at the beginning of the period as a percent of personal income, and doing the same thing for 1992, near the end of the period, and then averaging the two values. Second, the range of marginal income tax rates was examined for each state for four representative years within the period: 1968, 1980, 1987 and 1994 (December 31). The average of the four years was taken as a measure of flatness. Thus if a state had a range from 2 to 6 percent on the tax in each year, the value assigned to that state would be four (six minus two). By contrast, a flat rate state would be assigned the value of zero.

TABLE 8-1

Flatness Of Income Tax Rates And Personal Income Growth, 1962-94*

Statistic or Variable	Regression Coefficient	T-Statistic
Constant	30.39	0.34
AVEINCOME TAX	-19.14	-3.81
TAXRANGE	-7.26	-3.01
UNION	-3.62	-3.38
SUNSHINE	5.76	4.95
FARM	-4.21	-5.91
FUEL	-1.99	-3.59
$\bar{R}^2$	.675	
F-Statistic	17.26	

*48 Contiguous states.
SOURCE: Author's calculations; see text.

As reported earlier, several other control variables were introduced: UNION, the percent of nonagricultural employees in labor unions in mid-period (1974); SUNSHINE (percent of days a year the sun shines); FARM (agricultural receipts as a percent of personal income in mid-period); and FUEL (receipts from fuel production, a measure of energy orientation, as a percent of personal income in 1980). Incorporating these various variables into the model allows us to evaluate the flat rate-income growth relationship holding these other factors constant. The results reported are for the 48 contiguous states.

The model is extraordinarily robust, explaining more than two-thirds of the total variation in real personal income between the states. Every variable is statistically significant at the one percent level. As expected, personal income growth was, other factors held constant, significantly lowered by increases in the average income tax burden. As reported above, income taxes were found to be detrimental to growth.

Of greatest interest was the finding that increases in the range of marginal income tax rates was strongly negatively related to personal income growth. To put the estimated relationship in perspective, let us compare two states with identical income tax burdens and otherwise economically the same. One, however, had a flat rate tax of 4 percent, while the second had a progressive rate structure ranging from 1 to 7 percent throughout the period. Suppose the progressive rate state had real income growth of 180 percent (near the average of all states). The model predicts that income growth in the flat rate state would have been over 223 percent, nearly one-fourth higher. The results suggest that moving to a flat rate in the income tax can have dramatic long run growth effects, even where the initial move is "revenue neutral." In the longer run, government revenues are also higher with the flat rate tax, given the powerful income effects that flatness has and the positive relationship of tax revenues to income.

One caveat. The measure of flatness is imperfect -- simply the range from the lowest to the highest rate. In some states, the indicated range is more nominal than real, since virtually all taxpayers are at the top or near the top of the range in terms of marginal income. Trying to devise a more perfect measure of relative flatness of rates, however, is extremely difficult, given differences between the states in the definition of income, differences that have changed over time.

Turning to real world examples, Iowa and Kansas both had progressive income taxes throughout the period, but Iowa's was consistently more progressive. Kansas's real personal income grew 108.5 percent, while Iowa's grew 93.8 percent. If the estimates in Table 8-1 are correct, this differential is entirely explainable by the difference in rate structure, independent of the amount of revenue that the income taxes rose.

Going to the Northeast, Massachusetts' growth (127 percent) far outdistanced New York's (88.5 percent). Again the differential is entirely explainable by the fact that while both states levied state income taxes, the Empire State's tax was highly progressive, while Massachusetts consistently had a flat rate, albeit one that at times was at a relatively high level.

It would be hard to find two states more similar than North and South Dakota. Yet South Dakota's real personal income growth of 105 percent far outdistanced its neighbor to the north, which grew less than 77 percent, the lowest growth in the union. Why? South Dakota had no income tax (a zero rate flat tax), whereas North Dakota had a high progressive rate structure.

Finally, compare our two premier Sun Belt tourist states, California and Florida. California had a highly progressive tax, whereas Florida again had a zero rate flat tax. California growth of 192 percent pales in comparison to Florida's 457 percent. The regression result in Table 8-1 suggests that more than one-fourth of that huge differential is explainable by the fact that California taxed income and Florida did not. In addition, however, more than another one fourth of the differential is explainable by the fact that California had a highly progressive rate structure as opposed to a flat tax. Collectively, a majority of the California-Florida income differential is explained by income taxation in California.

As before, sensitivity analysis was performed to see if the results were fragile, that is highly susceptible to changes in specification in the model. Consistently, negative relationships were observed between the variable measuring rate variability and the rate of personal income growth. Indeed, replicating Table 8-1 but including Alaska and Hawaii in the regression actually strengthened the observed relationship. The expected negative relationship between the rate and income tax burden variables are also observed where the dependent variable is income growth per capita, although the results are far less robust.

To conclude, states put themselves in double jeopardy by enacting progressive rate individual income taxes. The income tax itself has negative growth effects, but those effects are compounded by the fact that progressivity in the rate structure very materially worsens the climate for growth in incomes and output.

Cross Border Effects of Consumption Taxation

While the evidence suggests that partial relief from the debilitating impact of income taxes can be obtained by moving to a flat rate system, why not simply abolish income taxes and increase sales taxes? Why have none of the states moved to substitute their income tax with a higher sales tax?

While several factors may be at work, a major administrative problem with sales taxes is that they are susceptible to avoidance and/or evasion if rates rise too high. Numerous studies suggest that the "cross border elasticity of demand" may be as high as five or six for products sold near state borders.[50] In other words, if the price of good A is five percent higher in State A than in nearby State B because of sales or excise taxes, the evidence is sales of the product in State A may be 25 to 30 percent lower as a consequence of the tax. It is no coincidence that Oregon, without a sales tax, has a ratio of retail sales to disposable income that is over 20 percent higher than the Nation as a whole, and far higher than its four neighbors that all impose general sales taxes.[51]

This becomes relevant to the national tax reform debate. A significant national sales tax would almost certainly lead to a very significant decline in retail sales in states bordering on Canada and Mexico, as well as some erosion elsewhere from tourists and others attempting to avoid high American taxes. The impact would not be inconsequential. For example, roughly 30 percent of Americans live in a state bordering on a foreign country. When the tax-induced price differentials grow large enough, organized smuggling could well bring further erosion of the tax base to interior parts of the country.

POLICY IMPLICATIONS FOR THE NATIONAL TAX REFORM DEBATE

As the narrative above suggests, the 50 states have had widely divergent tax systems over time and place. No two states have identical structures of taxation. Accordingly, we have observed historically 50 different approaches to financing government -- and 50 different experiences of economic change. How do these experiences inform the growing debate as to how to reform the federal income tax system?

In deciding the relevance of the experience of the states, the political process has to decide what national economic goals have priority. The historical evidence suggests that there has been a slowdown in the rate of economic growth in the United States. If one reads historical treatments of the American economy written in the 1970s, they suggest that the long term rate of annual economic growth in the United States is about 3.5 or 3.6 percent.[52] Yet the current conventional wisdom is that the sustainable rate of economic growth is about 2.5 percent a year.[53]

The compound interest effects of the difference between 2.5 and 3.5 percent economic growth are difficult to overstate as Table 9-1 demonstrates. The national output in 2005 with the higher growth rate would be more than 10 percent higher than with the existing 2.5 percent norm. But that differential would climb over 21 percent in 20 years, and to over 47 percent in 40 years. Per capita income would literally be thousands of dollars higher within a decade with 3.5 percent growth, allowing the nation greater affluence and less poverty. Accordingly, the economic growth effects of taxation legitimately may be considered a major consideration in the debate over federal tax reform.

Table 9-1

Impact On Total Output: 2.5 vs. 3.5 Percent Annual Growth Rate

Year	GDP in Year With 2.5 Percent Annual Growth	GDP in Year With 3.5 Percent Annual Growth	Percent Differential
1995	100.0	100.0	0.0
2005	128.0	141.0	10.2
2015	163.9	199.0	21.4
2035	268.5	395.9	47.8

1995=100
SOURCE: Author's calculations.

Flat Rate Proposals

The most discussed congressional proposals to reform the federal tax system involve substituting a flat or near-flat rate tax for the existing tax which has a rate structure of from 15 to nearly 40 percent. Some of the so-called flat tax proposals in fact maintain graduated rate structures, and thus are best considered modifications of the existing tax. Yet other proposals in both houses of Congress would truly initiate a flat rate tax, typically with generous exemptions that would remove lower income Americans from the tax rolls.

Many Americans favor the flat tax approach because it would remove enormous amounts of complexity from the tax system, saving taxpayers perhaps two billion hours or more of time in tax preparation, and also freeing literally hundreds of thousands of participants in the "tax army" to work in more worthwhile pursuits. Others favor the flat tax because of a feeling it is fair, treating everyone the same except the poor, who are freed of the obligation of paying income taxes. By expanding the tax base, the flat tax to many people is a fairer tax in that it promotes horizontal equity-requiring persons of similar economic circumstance to pay the same amount to the federal government.

This study, however, provides another rationale for supporting flat rate taxes. The evidence from the states is that flat rate taxes promote the growth of income and output. If a nation is picking between two income taxes raising the same amount of money, the evidence from the states suggests that the flat rate tax will generate more income growth over the long term which, in turn, would allow the nation to ultimately lower its tax burden, reduce its deficit and then its national debt, increase government services, or a combination of the above.

In short, the state evidence is supportive of moving towards a true flat rate tax. The evidence also supports the proposition that the nation should try to minimize its federal income tax burden. While going to a flat tax in a revenue neutral fashion would be a very positive development, the evidence from the states suggests that a long term goal should be to reduce the income tax burden, to the extent a major goal is the maximization of economic growth.

A National Sales Tax

The evidence from the states appears also to support moving towards a national sales tax. Consumption taxation seems to have a less harmful effect on economic growth than income taxation. Yet there are a number of reasons why the lessons of the states are less useful in evaluating the efficacy of a national sales tax than a flat rate income tax.

The nation already has income taxes at both the federal and state level, and typically those taxes are defined very similarly. Indeed, most states use federal adjusted gross or taxable income as the starting point in calculating the state tax. By contrast, there is no national sales tax, and the tax base varies considerably between the states on general sales taxes. Virtually no state taxes a wide variety of consumption items, such as legal, medical and educational services. Many do not even tax food.

Virtually all discussion of federal consumption taxes involves either a national sales tax to replace the income tax or a value added tax to be imposed in addition to existing taxes. With a minor partial exception for Michigan, the states have no experience with value added taxes. With respect to sales taxes, the highest sales tax collections in fiscal year 1992 in relation to personal income were in Louisiana, where revenues were undoubtedly augmented by unusually large tourist inflows. Louisiana collected sales tax revenues equal to 4.25 percent of personal income. The current federal individual income tax equals between nine and ten percent of personal income. Thus any national sales tax that replaces the income tax would have to have a much larger tax base and considerably higher tax rates than imposed by any of the states at the present time.

Thus no federal sales tax would be anything like existing state sales taxes in terms of magnitude or base. Inspection of state sales tax rates and revenues suggests that a federal tax that emulated the states with respect to the tax base would have to have a rate of about 20 percent, well over double any state experience. At those high rates, the problems of tax evasion and avoidance discussed above become very significant. Attempts to lower that rate by base expansion would raise severe equity issues. The nation might hesitate, for example, to impose a federal sales tax of, say, 15 percent, on, open heart surgical procedures where a patient died, or on college tuitions, or on wheelchairs.

With the sales tax, proposed federal legislation is so far out of the range of state and local experience that interpolating from that experience would be injudicious and inappropriate. While it is possible that a federal sales tax that is radically larger and broader than current state and local taxes might have relatively benign economic effects, it would be highly speculative to assert that based on the state and local experience. By contrast, with respect to state and local income taxes, the rates imposed are well within the relevant federal experience, so the historical empirical evidence from the states are relevant to the current policy debate. The evidence is clear, moving to a flat rate income tax would be consistent with higher rates of growth in income and output.

CONCLUSION

The experience of the American states and their localities tell us that taxes matter, and, indeed, they matter a great deal. While governments cannot control the sunshine, the availability of natural resources, or a variety of other factors, they can control the taxes that they levy. State and local governments that have maintained low taxes have grown faster than jurisdictions that have had relatively high tax burdens. Income taxes are particularly debilitating to the growth of incomes and output.

The empirical evidence is also clear, however, that a state with high progressive income taxes can improve its economic performance by lowering the overall tax burden and moving to a flat rate structure. This lesson is instructive to the current federal concern over the tax system. To the extent that the growth in income is a national economic objective, the evidence of the states supports a move to a federal flat rate income tax.

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ENDNOTES:

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19. Richard K. Vedder, "Federal Tax Reform: Lessons from the States," Cato Journal, Fall 1985; "Tithing for Leviathan: The Case for a Pure Flat Rate Tax," in Dwight Lee, ed., Taxation and the Deficit Economy (San Francisco: Pacific Institute for Public Policy Research, 1986).

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53. Some writers have lamented the growth slowdown of the recent past. See in particular Robert L. Bartley, "Giving Up on Growth?" Wall Street Journal, September 13, 1995, p.12.

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

Robert N. Mottice
Executive Director

ECONOMIC POLICY UPDATE

Issued By
JEC Majority Staff
September 1996

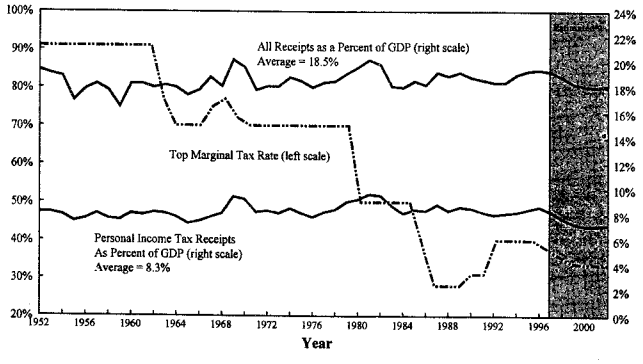
TAX CUTS, ECONOMIC GROWTH, AND TAX REVENUE

If the economy grows faster in response to lower tax rates, then a tax cut will "cost" less than expected. The extent of this economic "feedback" is at the heart of the long-running debate about tax cuts — a debate recently reignited by new proposals to cut tax rates by 15 percent across-the-board.[1]

The 19 Percent Truism

History clearly shows that a 15 percent cut in marginal tax rates would not cause a large loss in revenue. Since the early 1950s, federal receipts have hovered closely around 19 percent of gross domestic product (GDP). Remarkably, this trend has persisted regardless of whether the top tax rate has been as high as 91 percent or as low as 28 percent (Figure 1). Similarly, revenue from the personal income tax has averaged just over 8 percent of GDP.

Figure 1
Federal Receipts as a Percentage of GDP



*Assumes loss of $551 billion in tax revenue, converted into share of GDP

Sources: Department of the Treasury; JEC calculations

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Tax Cuts and Economic Growth

Presidents Kennedy and Reagan both passed dramatic tax cuts, reducing marginal tax rates on incomes. After each tax cut, America enjoyed its most robust periods of postwar economic growth. The Kennedy tax cut lowered the top tax rate from 91 percent to 70 percent — leading to a growth rate of 5.1 percent (1964-1967). The Reagan tax cuts dropped the top rate from 70 percent to 28 percent — leading to a growth rate of 4 percent (1983-1989).

Figure 2
Revenue After Kennedy Tax Cuts

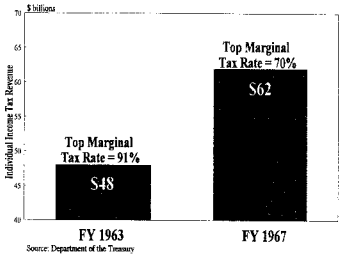
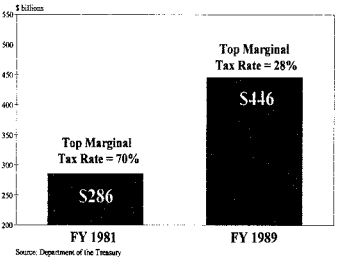


Figure 3
Revenue After Reagan Tax Cuts



Tax Cuts and Tax Revenue

In 1964, Congress passed the tax cut plan originally put forth by President Kennedy. Despite reduced rates (70 percent down from 91 percent), income tax revenue rose — from $48 billion in 1963 to $62 billion in 1967. Factoring out inflation still resulted in a revenue hike of 18 percent (Figure 2).

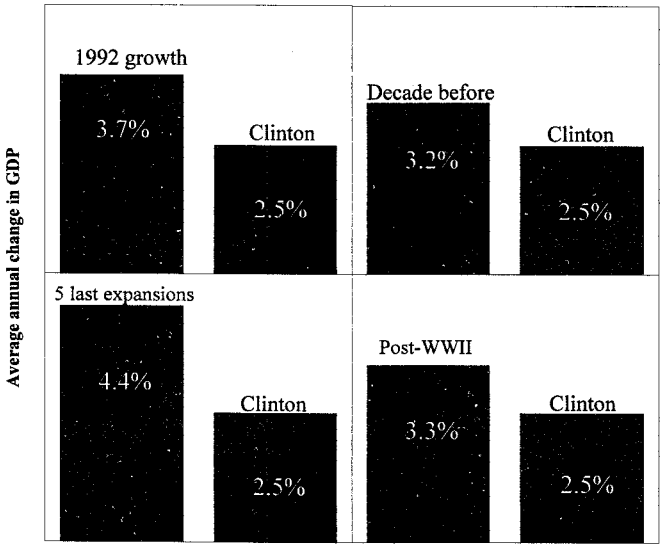
In 1981, the last budget year before President Reagan took office, federal revenue from the personal income tax totaled $286 billion. During his two terms, Ronald Reagan cut taxes across-the-board, including chopping the top tax rate from 70 percent to 28 percent. In 1989, Reagan's last budget year, the individual income tax took in $446 billion. Even factoring out inflation, a total increase in real revenue of 14 percent was produced (Figure 3).

Dole's Tax Cut

The Joint Committee on Taxation estimates that former Senator Robert Dole's proposed tax cut would mean $551 billion less revenue through 2002, assuming no extra economic growth.[2] Despite the historical record to the contrary, Figure 1 shows what would happen to tax receipts as a share of GDP if the government lost all of this $551 billion, with absolutely no economic feedback into federal revenue (i.e., lowering taxes as a share of GDP).

But if Robert Dole's tax cut, like tax cuts in the past, causes even a small increase in economic growth then much of the supposed cost of the tax cut would be offset. Is higher economic growth unrealistic? Definitely not. The economy has grown at an anemic 2.5 percent rate since Bill Clinton took office. By contrast, it grew at faster rates in the year before he took office, the decade before, in the last five expansions and in the entire post-World War II era (Figure 4).[3]

Figure 4
Clinton's Growth Gap

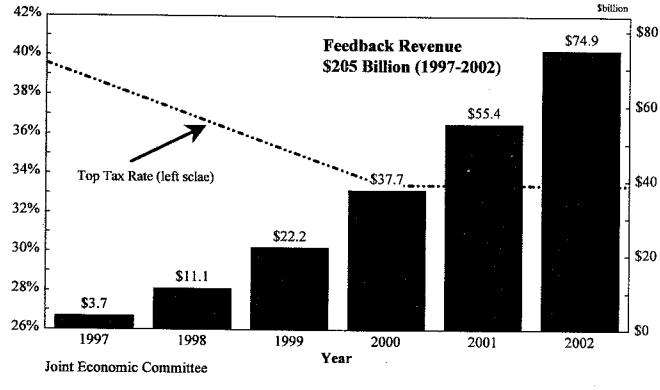


Sources: Department of Commerce; NBER; and JEC calculations

The Feedback Effect

Cutting marginal tax rates by 15 percent across-the-board and reducing the tax burden on capital gains will increase the incentive to work, save and invest. Even if tax relief only gradually gets America back to the conservative 3.2 percent growth rate of the decade before Clinton, the feedback effect would be sizeable, amounting to $205 billion – 37 percent of the tax cut (Figure 5).[4]

Figure 5
Feedback Revenue from Tax Relief



Is 37 Percent Feedback Too Low?

A 37 percent feedback is well within the range of bipartisan agreement about the economic effects of tax cuts. From 1975 to 1983, the Congressional Budget Office (CBO) was headed by Alice Rivlin, who also recently served as Clinton's budget director. In a 1978 report, CBO opined that the Kemp-Roth tax cut would produce a 24 percent revenue feedback in its first year, 52 percent after five years.[5] A special 1982 CBO study on the feedback effect of tax cuts suggested that economic growth would make up for as much as one-third to one-half of supposed revenue losses.[6]

Economists can debate about how much economic growth we should expect from tax cuts. But, in the final analysis, even small increases in economic growth can have dramatic effects on revenue. An economic growth rate that gradually reaches its pre-Clinton level of 3.2 percent can offset 37 percent — $205 billion — of the static revenue loss from a proposal to cut taxes by $551 billion. This would leave Americans with both a lower tax burden and a higher standard of living.

Prepared by Joint Economic Committee:
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Also available on the Internet at: "http://www.senate.gov/~jec/taxcuts.html"

ENDNOTES

1. Senators Spencer Abraham, Connie Mack, and Robert Bennett have proposed a 15 percent across-the-board cut in personal income tax rates. Former Senator Robert Dole has proposed $548 billion in tax relief which includes a 15 percent across-the-board cut in personal income tax rates, reducing capital gains tax rates, providing a $500 per-child tax credit, expanding Individual Retirement Accounts, and lowering taxes on Social Security benefits.

2. The Joint Committee on Taxation (JCT) estimates former Senator Robert Dole's proposed tax cuts would total $551.3 billion over six years (1997-2002). The 15 percent across-the-board cut in personal income tax rates would comprise $411.2 billion (75 percent) of the total tax relief. JCT, #96-1, 229; August 8, 1996.

3. Joint Economic Committee, Economic Policy Update: *"Clinton's Growth Gap,"* May, 1996.

4. Since the proposed 15 percent cut in marginal tax rates is phased in over three years, the estimated real GDP growth rate is boosted by approximately 0.2 percentage points per year in 1997, 1998, 1999 and 2000 and thereafter held at 3.2 percent per year. The estimate of the baseline GDP growth rate comes from the *"Mid-Session Review of the 1997 Budget,"* Office of Management and Budget; July, 1996.

5. Congressional Budget Office: *"An Analysis of the Roth-Kemp Tax Cut Proposal,"* October 1978.

6. Congressional Budget Office Special Study: *"How Changes in Fiscal Policy Affect the Budget: The Feedback Issue;"* June 1982.

Joint Economic Committee

August 1995

U.S. SENATOR
Connie Mack
CHAIRMAN

ISSUED BY:
Connie Mack (FL), Chairman

ECONOMIC
POLICY
UPDATE

CUTTING TAXES: FUNDAMENTAL TO WELFARE REFORM

"...if helping poor families is the goal, cutting taxes is the right policy."

What general tax policy is most beneficial to poor families? Should taxes be raised on the rich and the resources transferred to the poor, or should taxes be lowered so that the economy provides jobs to those in need of them? A look at the effects of recent tax policy shows that, if helping poor families is the goal, cutting taxes is the right policy.

The incomes of the poorest families increase, and fewer families suffer under poverty, after taxes are cut. On the other hand, tax increases lead to both a decline in the incomes of poorer families and more families subsisting in poverty.

THE EFFECTS OF TAXATION UPON POOR FAMILIES

Whenever there is debate about cutting taxes, those who oppose them usually argue that the proposed tax cuts will act as "welfare" for those with higher incomes who do not need tax relief.

Countering that dogma is the common-sense reality that lower marginal tax rates will act as an incentive for entrepreneurial innovation as well as an encouragement for people to work harder (since they receive more benefit from their work). These effects will help the economy grow, and the economic strength will serve to help all who participate in the economy, both rich and poor.

"The record of tax policy in recent decades confirms the idea that tax increases hurt, and tax cuts help, the incomes of families in poverty."

The arguments concerning tax increases are similar in nature. Those favoring tax increases argue that the tax cuts of the 1980s made the poor become poorer, and that taxes should be raised to make the distribution of income more "equitable."

Those who oppose tax increases believe that higher tax rates will dampen new business creation, act as a disincentive to work harder and a deterrent to productivity expansion, and therefore will make the economy suffer.

What does the evidence show about the effects of changes in taxation upon the incomes of families who most need help? The record of tax policy in recent decades confirms the idea that tax increases hurt, and tax cuts help, the incomes of families in poverty.

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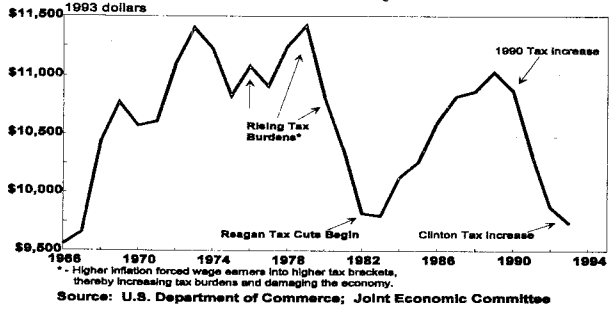
INCOMES OF POORER FAMILIES ROSE UNDER KENNEDY AND REAGAN TAX CUTS

"The increases in tax rates have hurt the economy and the poorest families have made less in real terms than previously."

After the Kennedy tax cut of the early 1960s, the average real income of the poorest 20 percent of families moved higher (12.7 percent higher from 1966 to 1969 alone - see Chart 1). After the Reagan tax cuts, the real incomes of the poorest 20 percent of families again rose (12.6 percent from 1983 to 1989). In the periods during and after which tax burdens rose (following the inflation of the 1970s and the Omnibus Budget Reconciliation Act of 1990), the poorest families suffered. The increases in tax rates have hurt the economy and the poorest families have made less in real terms than previously. The poorest 20 percent of families lost 13.9 percent of their incomes (in real terms) from 1973 to 1982, and, since 1990, the poorest 20 percent have lost 10.4 percent through 1993, the latest year for which the data are available. It will only be a matter of time before we see that the Clinton tax increase has had a similar effect upon these poor families.[1]

CHART 1

MEAN INCOME OF FAMILIES IN THE LOWEST INCOME QUINTILE



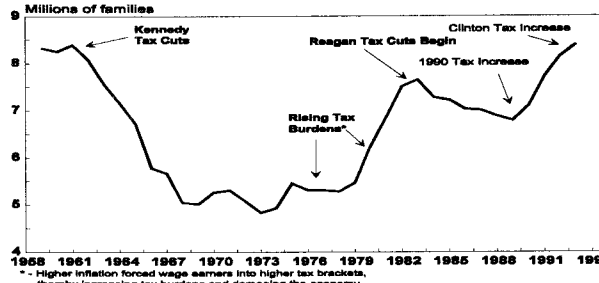
* - Higher inflation forced wage earners into higher tax brackets, thereby increasing tax burdens and damaging the economy.

Source: U.S. Department of Commerce; Joint Economic Committee

"The tax cuts helped the economy grow, and, with that growth, fewer families had to live in poverty."

The statistics on families in poverty tell the same story. Before the Kennedy tax cuts, over eight million families lived in poverty (see Chart 2). That number fell below five million prior to the 1970s, but then the phenomenon of "bracket creep" set in. As inflation drove wage earners into higher tax brackets, (even though their real incomes had not increased), the economy stagnated. The number of families in poverty steadily rose during that time, and peaked at 7.65 million in 1983 (12.3 percent of all families).

CHART 2
FAMILIES IN POVERTY



* - Higher inflation forced wage earners into higher tax brackets, thereby increasing tax burdens and damaging the economy.

Source: U.S. Department of Commerce; Joint Economic Committee

" If the goal is to help the poor and neediest members of our society, the prescription is tax cuts. "

That 1983 peak came just after the government began phasing in the Reagan tax cuts (and before their true economic impact could be felt). The Reagan tax cuts increased incentives to work and create business activity. Eighteen million new jobs were added. The tax cuts helped the economy grow, and, with that growth, fewer families had to live in poverty.

The numbers of families living in poverty fell continuously during the Reagan boom of the 1980s, and by the end of the '80s, there were almost 1,000,000 fewer poverty-stricken families. Also by 1989, only 10.3 percent of families were in poverty, and that percentage was falling. However, after the 1990 tax increase, the number of families living in poverty once again began to grow, and now approximately 8.4 million families live in poverty (12.2 percent of all families).[2]

CONCLUSION

The data show a clear message: If taxes are raised, those who take that action should realize that they will be hurting the poor, the people who cannot afford to be hurt. If the goal is to help the poor and neediest members of our society, the prescription is tax cuts.

Contact: Jeff Given, Economist, Joint Economic Committee, (202) 224-5171.

Endnotes:

[1] Bureau of the Census, Housing and Household Economic Statistics Division.

[2] Bureau of the Census, Economic and Statistics Division, "Income, Poverty, and Valuation of Noncash Benefits: 1993."

II

104TH CONGRESS
2D SESSION

S. 1988

To amend the Internal Revenue Code of 1986 to provide for individuals who are residents of the District of Columbia a maximum rate of tax of 15 percent on income from sources within the District of Columbia, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JULY 24, 1996

Mr. MACK (for himself, Mr. LIEBERMAN, Mr. ABRAHAM, Mr. LOTT, Mr. HATCH, and Mr. BENNETT) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1986 to provide for individuals who are residents of the District of Columbia a maximum rate of tax of 15 percent on income from sources within the District of Columbia, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "District of Columbia Economic Recovery Act".

SEC. 2. SPECIAL RULES FOR TAXATION OF INDIVIDUALS WHO ARE RESIDENTS OF OR INVESTORS IN THE DISTRICT OF COLUMBIA.

(a) IN GENERAL.—Subchapter A of chapter 1 of the Internal Revenue Code of 1986 (relating to determination of tax liability) is amended by adding at the end the following new part:

"PART VIII—SPECIAL RULES FOR TAXATION OF INDIVIDUALS WHO ARE RESIDENTS OF OR INVESTORS IN THE DISTRICT OF COLUMBIA

"Sec. 59B. Limitation on tax imposed on residents of the District of Columbia.
"Sec. 59C. Taxation of capital gains sourced in the District of Columbia.

"SEC. 59B. LIMITATION ON TAX IMPOSED ON RESIDENTS OF THE DISTRICT OF COLUMBIA.

"(a) GENERAL RULE.—If a taxpayer elects the application of this section, the net income tax of an individual who is a resident of the District of Columbia for the taxable year shall not exceed the limitation determined under subsection (b) for such year.

"(b) LIMITATION.—

"(1) IN GENERAL.—The limitation determined under this subsection is the sum of the following amounts:

"(A) 15-PERCENT RATE.—15 percent of so much of District-sourced income as exceeds the exemption amount.

"(B) AVERAGE RATE.—An amount equal to the average rate of the non-District-sourced adjusted gross income.

"(2) DISTRICT-SOURCED CAPITAL GAINS.—

"For exclusion from tax of capital gains, see section 59C.

"(c) DEFINITIONS.—For purposes of this section—

"(1) RESIDENT OF DISTRICT OF COLUMBIA.—An individual is a resident of the District of Columbia for the taxable year if—

"(A) such individual used a residence in the District of Columbia as a place of abode (and was physically present at such place) for at least 183 days of such taxable year, and

"(B) such individual is subject to the District of Columbia income tax for such taxable year.

"(2) NET INCOME TAX.—The term 'net income tax' means—

"(A) the sum of regular tax liability and the tax imposed by section 55 (determined without regard to this section), reduced by

"(B) the aggregate credits allowable under part IV (other than section 31).

"(3) EXEMPTION AMOUNT.—The term 'exemption amount' means—

"(A) $30,000 in the case of a joint return or a surviving spouse,

"(B) $15,000 in the case of—

"(i) an individual who is not a married individual and is not a surviving spouse, and

"(ii) a married individual filing a separate return, and

"(C) $25,000 in the case of a head of a household.

"(4) AVERAGE RATE.—The term 'average rate' means the percentage determined by dividing—

"(A) the sum (determined without regard to this section) of the taxpayer's regular tax liability and the tax imposed by section 55, by

"(B) the taxpayer's taxable income.

If the percentage determined under the preceding sentence is not a whole number of percentage points, such percentage shall be rounded to the nearest whole number of percentage points.

"(5) REGULAR TAX LIABILITY.—The term 'regular tax liability' has the meaning given to such term by section 26(b).

"(d) DISTRICT-SOURCED INCOME.—For purposes of this section, the term 'District-sourced income' means adjusted gross income reduced by the sum of—

"(1) non-District-sourced adjusted gross income,

"(2) the deduction allowed by section 170, and

"(3) the deduction allowed by section 163 to the extent attributable to qualified residence interest (as defined in section 163(h)).

"(e) NON-DISTRICT-SOURCED ADJUSTED GROSS INCOME.—For purposes of this section, the term 'non-District-sourced adjusted gross income' means gross income of the taxpayer from sources outside the District of Columbia reduced (but not below zero) by the deductions taken into account in determining adjusted gross income which are allocable to such income.

"(f) SOURCES OF INCOME.—For purposes of this section—

"(1) RETIREMENT INCOME AND OTHER INCOME NOT SOURCED UNDER SUBSECTION.—The source of any income not specifically provided for in this sub-

section shall be treated as from sources within the District of Columbia.

"(2) PERSONAL SERVICES.—

"(A) IN GENERAL.—Compensation (other than retirement income) for services performed by the taxpayer as an employee, and net earnings from self-employment (as defined in section 1402)), shall be sourced at the place such services are performed.

"(B) SERVICES PERFORMED IN WASHINGTON-BALTIMORE AREA TREATED AS PERFORMED IN THE DISTRICT OF COLUMBIA.—Services performed in the Washington-Baltimore area shall be treated as performed in the District of Columbia.

"(C) INDIVIDUALS PERFORMING 80 PERCENT OF SERVICES WITHIN WASHINGTON-BALTIMORE AREA.—If, during any taxable year, at least 80 percent of the hours of service performed by an individual are performed within the Washington-Baltimore area, all such service shall be treated for purposes of this paragraph as performed within the District of Columbia.

"(D) WASHINGTON-BALTIMORE AREA.—For purposes of this paragraph, the term

'Washington-Baltimore area' means the area consisting of—

"(i) the Washington/Baltimore Consolidated Metropolitan Statistical Area (as designated by the Office of Management and Budget), and

"(ii) St. Mary's County, Maryland.

"(3) INTEREST.—

"(A) IN GENERAL.—Interest received or accrued during the taxable year shall be treated as from sources outside the District of Columbia.

"(B) EXCEPTION FOR SMALL AMOUNTS OF NON-DISTRICT-SOURCED INTEREST.—Interest which would (but for this subparagraph) be treated as from sources outside the District of Columbia shall be treated as from sources in the District of Columbia to the extent the amount of such interest does not exceed $400.

"(C) EXCEPTION FOR INTEREST PAID BY DISTRICT OF COLUMBIA BUSINESSES AND RESIDENTS.—

"(i) BUSINESSES.—In the case of interest paid during a calendar year by a debtor which was required to file (and

filed) a franchise tax return with the District of Columbia for the debtor's taxable year ending with or within the prior calendar year, an amount equal to the D.C. percentage (as shown on such return) of such interest shall be treated as from sources within the District of Columbia. The preceding sentence shall apply only if such percentage is furnished to the taxpayer in writing on or before January 31 of the year following the calendar year in which such interest is paid.

"(ii) OTHERS.—Interest shall be treated as from sources within the District of Columbia if the interest is paid during a calendar year by a debtor—

"(I) which was required to file (and filed) an income tax return with the District of Columbia for the debtor's taxable year ending with or within the prior calendar year, and

"(II) which is not required to file a franchise tax return with the District of Columbia for such taxable year.

"(D) SPECIAL RULE FOR DETERMINATION OF D.C. PERCENTAGE FOR NEW BUSINESSES.—Interest shall be treated as from sources within the District of Columbia if the interest is paid during a calendar year by a debtor which was required to file (and filed) a franchise tax return with the District of Columbia for such debtor's taxable year ending with or within such calendar year, but which was not required to file such a return for such debtor's prior taxable year.

"(4) DIVIDENDS.—

"(A) IN GENERAL.—Dividends received or accrued during the taxable year shall be treated as from sources outside the District of Columbia.

"(B) EXCEPTION FOR SMALL AMOUNTS OF NON-DISTRICT-SOURCED DIVIDENDS.—Dividends which would (but for this subparagraph) be treated as from sources outside the District of Columbia shall be treated as from sources in the District of Columbia to the extent the amount of such dividends do not exceed $400.

"(C) EXCEPTION FOR DIVIDENDS PAID BY CORPORATION ENGAGED IN BUSINESS IN THE

DISTRICT OF COLUMBIA.—In the case of dividends paid during a calendar year by a corporation which was required to file (and filed) a franchise tax return with the District of Columbia for the corporation's taxable year ending with or within the prior calendar year, an amount equal to the D.C. percentage (as shown on such return) of such dividends shall be treated as from sources within the District of Columbia. The preceding sentence shall apply only if such percentage is furnished to the taxpayer in writing on or before January 31 of the year following the calendar year in which such dividends are paid.

"(D) SPECIAL RULE FOR DETERMINATION OF D.C. PERCENTAGE FOR NEW BUSINESSES.—Dividends shall be treated as from sources within the District of Columbia if the dividends are paid during a calendar year by a corporation which was required to file (and filed) a franchise tax return with the District of Columbia for such corporation's taxable year ending with or within such calendar year, but which was not required to file such a return for such corporation's prior taxable year.

"(5) DISPOSITION OF TANGIBLE PROPERTY.—Income, gain, or loss from the disposition of tangible property shall be sourced to the place such property is located at the time of the disposition.

"(6) DISPOSITION OF INTANGIBLE PROPERTY.—

"(A) IN GENERAL.—Income, gain, or loss from the disposition of intangible property shall be treated as from sources outside the District of Columbia.

"(B) EXCEPTION.— If any portion of the most recent income received or accrued by the taxpayer before such disposition which was attributable to such property was from sources within the District of Columbia, a like portion of the income, gain, or loss from such disposition shall be treated as from sources within the District of Columbia.

"(7) RENTALS.—Rents from property shall be sourced at the place where such property is located.

"(8) ROYALTIES.—Royalties shall be treated as from sources outside the District of Columbia.

"(9) INCOME FROM PROPRIETORSHIP.—

"(A) IN GENERAL.—In the case of a trade or business carried on by the taxpayer as a pro-

prietorship, income from such trade or business (other than income which is included in net earnings from self-employment by the taxpayer) shall be treated as from sources outside the District of Columbia.

"(B) EXCEPTION FOR DISTRICT OF COLUMBIA BUSINESSES.—If the taxpayer is required to file (and files) a franchise tax return with the District of Columbia for the taxable year, subparagraph (A) shall not apply to an amount equal to the D.C. percentage of such income.

"(10) INCOME FROM PARTNERSHIP.—

"(A) IN GENERAL.—In the case of a taxpayer who is a partner in a partnership, income from such partnership (other than income which is included in net earnings from self-employment by any partner) shall be treated as from sources outside the District of Columbia.

"(B) EXCEPTIONS.—

"(i) Subparagraph (A) shall not apply to a partnership which was required to file (and filed) a franchise tax return with the District of Columbia for the partnership's taxable year ending with or within the tax-

payer's taxable year to the extent of the D.C. percentage of the taxpayer's distributive share of the partnership income.

"(ii) Subparagraph (A) shall not apply to a partnership which was not required to file a franchise tax return with the District of Columbia for the partnership's taxable year ending with or within the taxpayer's taxable year to the extent of the taxpayer's distributive share of partnership income which is not (as determined under this subsection) from sources outside the District of Columbia.

"(11) INCOME IN RESPECT OF A DECEDENT; INCOME FROM AN ESTATE.—Income in respect of a decedent, and income from an estate, shall be sourced at the place where the decedent was domiciled at the time of his death.

"(12) INCOME FROM A TRUST.—Income (other than retirement income) from a trust shall be treated as from the same sources as the income of the trust to which it is attributable.

"(g) DEFINITIONS RELATING TO SUBSECTION (f).—For purposes of subsection (f)—

"(1) RETIREMENT INCOME.—The term 'retirement income' has the meaning given such term by section 114(b)(1) of title 4, United States Code (determined without regard to subparagraph (I) thereof).

"(2) D.C. PERCENTAGE.—The term 'D.C. percentage' means the percentage determined by dividing—

"(A) the net income taxable in the District of Columbia (as shown on the original return for the taxable year), by

"(B) total net income from all sources (as shown on such return).

The preceding sentence shall be applied based on amounts shown on the original applicable District of Columbia franchise or income tax return.

"(h) SECTION NOT TO APPLY TO ESTATES AND TRUSTS.—This section shall not apply to an estate or trust.

"(i) ELECTION.—The election provided in subsection (a) shall be made at such time and in such manner as the Secretary may by regulations prescribe. Any such election shall apply to the first taxable year for which such election was made and for each taxable year thereafter until such election is revoked by the taxpayer.

"(j) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

"SEC. 59C. EXCLUSION OF CAPITAL GAINS SOURCED IN THE DISTRICT OF COLUMBIA.

"(a) EXCLUSION.—

"(1) GENERAL RULE.—Except as provided in paragraph (2), in the case of a taxpayer who is an individual, gross income shall not include any qualified capital gain recognized on the sale or exchange of a District asset held for more than 3 years.

"(2) EXCEPTION FOR CERTAIN GAIN OF NONRESIDENTS.—In the case of a taxpayer who is not a resident of the District of Columbia for any taxable year, gross income shall not include 50 percent of the qualified capital gain recognized on the sale or exchange of residential rental property (within the meaning of section 168(e)(2)(A)) which is a District asset held for more than 3 years and which is not taken into account under section 1202.

"(b) DISTRICT ASSET.—For purposes of this section—

"(1) IN GENERAL.—The term 'District asset' means—

"(A) any District stock,

"(B) any District business property,

"(C) any District partnership interest, and

"(D) any principal residence (within the meaning of section 1034).

"(2) DISTRICT STOCK.—

"(A) IN GENERAL.—The term 'District stock' means any stock in a domestic corporation if—

"(i) such stock is acquired by the taxpayer on original issue from the corporation solely in exchange for cash,

"(ii) as of the time such stock was issued, such corporation was a District business (or, in the case of a new corporation, such corporation was being organized for purposes of being a District business), and

"(iii) during substantially all of the taxpayer's holding period for such stock, such corporation qualified as a District business.

"(B) REDEMPTIONS.—The term 'District stock' shall not include any stock acquired from a corporation which made a substantial stock redemption or distribution (without a bona fide

business purpose therefor) in an attempt to avoid the purposes of this section.

"(3) DISTRICT BUSINESS PROPERTY.—

"(A) IN GENERAL.—The term 'District business property' means tangible property if—

"(i) such property was acquired by the taxpayer by purchase (as defined in section 179(d)(2)),

"(ii) the original use of such property in the District of Columbia commences with the taxpayer, and

"(iii) during substantially all of the taxpayer's holding period for such property, substantially all of the use of such property was in a District business of the taxpayer.

"(B) SPECIAL RULE FOR SUBSTANTIAL IMPROVEMENTS.—

"(i) IN GENERAL.—The requirements of clauses (i) and (ii) of subparagraph (A) shall be treated as satisfied with respect to—

"(I) property which is substantially improved by the taxpayer, and

"(II) any land on which such property is located.

"(ii) SUBSTANTIAL IMPROVEMENT.—For purposes of clause (i), property shall be treated as substantially improved by the taxpayer if, during any 24-month period beginning after the date of the enactment of this section, additions to basis with respect to such property in the hands of the taxpayer exceed the greater of—

"(I) an amount equal to the adjusted basis at the beginning of such 24-month period in the hands of the taxpayer, or

"(II) $5,000.

"(C) LIMITATION ON LAND.—The term 'District business property' shall not include land which is not an integral part of a District business.

"(4) DISTRICT PARTNERSHIP INTEREST.—The term 'District partnership interest' means any interest in a partnership if—

"(A) such interest is acquired by the taxpayer from the partnership solely in exchange for cash,

"(B) as of the time such interest was acquired, such partnership was a District business (or, in the case of a new partnership, such partnership was being organized for purposes of being a District business), and

"(C) during substantially all of the taxpayer's holding period for such interest, such partnership qualified as a District business.

A rule similar to the rule of paragraph (2)(B) shall apply for purposes of this paragraph.

"(5) TREATMENT OF SUBSEQUENT PURCHASERS.—The term 'District asset' includes any property which would be a District asset but for paragraph (2)(A)(i), (3)(A)(ii), or (4)(A) in the hands of the taxpayer if such property was a District asset in the hands of all prior holders.

"(6) 10-YEAR SAFE HARBOR.—If any property ceases to be a District asset by reason of paragraph (2)(A)(iii), (3)(A)(iii), or (4)(C) after the 10-year period beginning on the date the taxpayer acquired such property, such property shall continue to be treated as meeting the requirements of such paragraph; except that the amount of gain to which subsection (a) applies on any sale or exchange of such property shall not exceed the amount which would be

qualified capital gain had such property been sold on the date of such cessation.

"(c) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) QUALIFIED CAPITAL GAIN.—Except as otherwise provided in this subsection, the term 'qualified capital gain' means any long-term capital gain recognized on the sale or exchange of a District asset held for more than 3 years.

"(2) CERTAIN GAIN ON REAL PROPERTY NOT QUALIFIED.—The term 'qualified capital gain' shall not include any gain which would be treated as ordinary income under section 1250 if section 1250 applied to all depreciation rather than the additional depreciation.

"(3) DISTRICT BUSINESS.—The term 'District business' means, with respect to any taxable year, any individual, partnership, or corporation if for such year either—

"(A)(i) at least 50 percent of the total gross income of such individual, partnership, or corporation is derived from the active conduct of a trade or business in the District of Columbia,

"(ii) substantially all of the use of the tangible property of such individual, partnership, or corporation (whether owned or leased) is within the District of Columbia, and

"(iii) at least 35 percent of the employees of such individual, partnership, or corporation are located in the District of Columbia, or

"(B) at least 50 percent of the employees of such individual, partnership, or corporation are located in the District of Columbia.

"(d) TREATMENT OF PASS-THRU ENTITIES.—

"(1) SALES AND EXCHANGES.—Gain on the sale or exchange of an interest in a pass-thru entity held by the taxpayer (other than an interest in an entity which was a District business during substantially all of the period the taxpayer held such interest) for more than 3 years shall be treated as gain described in subsection (a) to the extent such gain is attributable to amounts which would be qualified capital gain on District assets (determined as if such assets had been sold on the date of the sale or exchange) held by such entity for more than 3 years and throughout the period the taxpayer held such interest. A rule similar to the rule of paragraph (2)(B) shall apply for purposes of the preceding sentence.

"(2) INCOME INCLUSIONS.—

"(A) IN GENERAL.—Any amount included in income by reason of holding an interest in a pass-thru entity (other than an entity which was a District business during substantially all of the period the taxpayer held the interest to which such inclusion relates) shall be treated as gain described in subsection (a) if such amount meets the requirements of subparagraph (B).

"(B) REQUIREMENTS.—An amount meets the requirements of this subparagraph if—

"(i) such amount is attributable to qualified capital gain recognized on the sale or exchange by the pass-thru entity of property which is a District asset in the hands of such entity and which was held by such entity for the period required under subsection (a), and

"(ii) such amount is includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-thru entity acquired such asset and at all times thereafter be-

fore the disposition of such asset by such pass-thru entity.

"(C) LIMITATION BASED ON INTEREST ORIGINALLY HELD BY TAXPAYER.—Subparagraph (A) shall not apply to any amount to the extent such amount exceeds the amount to which subparagraph (A) would have applied if such amount were determined by reference to the interest the taxpayer held in the pass-thru entity on the date the District asset was acquired.

"(3) PASS-THRU ENTITY.—For purposes of this subsection, the term 'pass-thru entity' means—

"(A) any partnership,

"(B) any S corporation,

"(C) any regulated investment company, and

"(D) any common trust fund.

"(e) SALES AND EXCHANGES OF INTERESTS IN PARTNERSHIPS AND S CORPORATIONS WHICH ARE DISTRICT BUSINESSES.—In the case of the sale or exchange of an interest in a partnership, or of stock in an S corporation, which was a District business during substantially all of the period the taxpayer held such interest or stock, the amount of qualified capital gain shall be determined

without regard to any intangible, and any land, which is not an integral part of the District business.

"(f) CERTAIN TAX-FREE AND OTHER TRANSFERS.—For purposes of this section—

"(1) IN GENERAL.—In the case of a transfer of a District asset to which this subsection applies, the transferee shall be treated as—

"(A) having acquired such asset in the same manner as the transferor, and

"(B) having held such asset during any continuous period immediately preceding the transfer during which it was held (or treated as held under this subsection) by the transferor.

"(2) TRANSFERS TO WHICH SUBSECTION APPLIES.—This subsection shall apply to any transfer—

"(A) by gift,

"(B) at death, or

"(C) from a partnership to a partner thereof of a District asset with respect to which the requirements of subsection (d)(2) are met at the time of the transfer (without regard to the 3-year holding requirement).

"(3) CERTAIN RULES MADE APPLICABLE.—Rules similar to the rules of section 1244(d)(2) shall apply for purposes of this section."

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (1) of section 55(c) of such Code is amended by adding at the end the following: "Such regular tax shall be determined without regard to section 59B."

(2) The table of parts for subchapter A of chapter 1 of such Code is amended by adding at the end the following new item:

"Part VIII. Special rules for taxation of individuals who are residents of or investors in the District of Columbia."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after the date of the enactment of this Act.

SEC. 3. EXPENSING OF ENVIRONMENTAL REMEDIATION COSTS WITHIN THE DISTRICT OF COLUMBIA.

(a) IN GENERAL.—Part VI of subchapter B of chapter 1 of the Internal Revenue Code of 1986 is amended by adding at the end the following new section:

"SEC. 198. EXPENSING OF ENVIRONMENTAL REMEDIATION COSTS WITHIN THE DISTRICT OF COLUMBIA.

"(a) IN GENERAL.—A taxpayer may elect to treat any qualified environmental remediation expenditure which is paid or incurred by the taxpayer as an expense

which is not chargeable to capital account. Any expenditure which is so treated shall be allowed as a deduction for the taxable year in which it is paid or incurred.

"(b) QUALIFIED ENVIRONMENTAL REMEDIATION EXPENDITURE.—For purposes of this section—

"(1) IN GENERAL.—The term 'qualified environmental remediation expenditure' means any expenditure—

"(A) which is otherwise chargeable to capital account, and

"(B) which is paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

"(2) SPECIAL RULE FOR EXPENDITURES FOR DEPRECIABLE PROPERTY.—Such term shall not include any expenditure for the acquisition of property of a character subject to the allowance for depreciation which is used in connection with the abatement or control of hazardous substances at a qualified contaminated site; except that the portion of the allowance under section 167 for such property which is otherwise allocated to such site shall be treated as a qualified environmental remediation expenditure.

"(c) QUALIFIED CONTAMINATED SITE.—For purposes of this section—

"(1) IN GENERAL.—The term 'qualified contaminated site' means any area within the District of Columbia—

"(A) which is held by the taxpayer for use in a trade or business or for the production of income, or which is property described in section 1221(1) in the hands of the taxpayer, and

"(B) which contains (or potentially contains) any hazardous substance.

"(2) TAXPAYER MUST RECEIVE STATEMENT FROM ENVIRONMENTAL AGENCY.—An area shall be treated as a qualified contaminated site with respect to expenditures paid or incurred during any taxable year only if the taxpayer receives a statement from the appropriate agency of the District of Columbia in which such area is located that such area meets the requirements of paragraph (1)(B).

"(3) APPROPRIATE AGENCY.— For purposes of paragraph (2), the appropriate agency of the District of Columbia is the agency designated by the Administrator of the Environmental Protection Agency for purposes of this section. If no agency is designated under the preceding sentence, the appropriate agency shall be the Environmental Protection Agency.

"(d) HAZARDOUS SUBSTANCE.—For purposes of this section—

"(1) IN GENERAL.—The term 'hazardous substance' means—

"(A) any substance which is a hazardous substance as defined in section 101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, and

"(B) any substance which is designated as a hazardous substance under section 102 of such Act.

"(2) EXCEPTION.—Such term shall not include any substance with respect to which a removal or remedial action is not permitted under section 104 of such Act by reason of subsection (a)(3) thereof.

"(e) DEDUCTION RECAPTURED AS ORDINARY INCOME ON SALE, ETC.—Solely for purposes of section 1245, in the case of property to which a qualified environmental remediation expenditure would have been capitalized but for this section—

"(1) the deduction allowed by this section for such expenditure shall be treated as a deduction for depreciation, and

"(2) such property (if not otherwise section 1245 property) shall be treated as section 1245

property solely for purposes of applying section 1245 to such deduction.

"(f) COORDINATION WITH OTHER PROVISIONS.—Sections 280B and 468 shall not apply to amounts which are treated as expenses under this section.

"(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(b) CLERICAL AMENDMENT.—The table of sections for part VI of subchapter B of chapter 1 of such Code is amended by adding at the end the following new item:

"Sec. 198. Expensing of environmental remediation costs within the District of Columbia."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to expenditures paid or incurred after the date of the enactment of this Act, in taxable years ending after such date.

SEC. 4. FIRST-TIME HOMEBUYER CREDIT FOR DISTRICT OF COLUMBIA.

(a) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1986 (relating to nonrefundable personal credits) is amended by inserting after section 22 the following new section:

"SEC. 23. FIRST-TIME HOMEBUYER CREDIT FOR DISTRICT OF COLUMBIA.

"(a) ALLOWANCE OF CREDIT.—In the case of an individual who is a first-time homebuyer of a principal residence in the District of Columbia during any taxable year, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to so much of the purchase price of the residence as does not exceed $5,000.

"(b) FIRST-TIME HOMEBUYER.—For purposes of this section—

"(1) IN GENERAL.—The term 'first-time homebuyer' means any individual if—

"(A) such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence in the District of Columbia during the 1-year period ending on the date of acquisition of the principal residence to which this section applies, and

"(B) subsection (h) or (k) of section 1034 did not, on the day before the close of such 1-year period, suspend the running of any period of time specified in section 1034 for such individual with respect to gain on a principal residence in the District of Columbia.

"(2) ONE-TIME ONLY.—If an individual is treated as a first-time homebuyer with respect to any principal residence, such individual may not be treated as a first-time homebuyer with respect to any other principal residence.

"(3) PRINCIPAL RESIDENCE.—The term 'principal residence' has the meaning given such term by section 1034.

"(4) DATE OF ACQUISITION.—The term 'date of acquisition' means the date—

"(A) on which a binding contract to acquire the principal residence to which this section applies to is entered into, or

"(B) on which construction or reconstruction of such principal residence is commenced.

"(c) CARRYOVER OF CREDIT.—If the credit allowable under subsection (a) exceeds the limitation imposed by section 26(a) for such taxable year reduced by the sum of the credits allowable under this subpart (other than this section and section 25), such excess shall be carried to the succeeding taxable year and added to the credit allowable under subsection (a) for such taxable year.

"(d) SPECIAL RULES.—For purposes of this section—

"(1) ALLOCATION OF DOLLAR LIMITATION.—

"(A) MARRIED INDIVIDUALS FILING JOINTLY.—In the case of a husband and wife who file a joint return under section 6013, the $5,000 limitation under subsection (a) shall apply to the joint return.

"(B) MARRIED INDIVIDUALS FILING SEPARATELY.—In the case of a married individual filing a separate return, subsection (a) shall be applied by substituting '$2,500' for '$5,000'.

"(C) OTHER TAXPAYERS.—If 2 or more individuals who are not married purchase a principal residence, the amount of the credit allowed under subsection (a) shall be allocated among such individuals in such manner as the Secretary may prescribe, except that the total amount of the credits allowed to all such individuals shall not exceed $5,000.

"(2) PURCHASE.—The term 'purchase' means any acquisition, but only if—

"(A) the property is not acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under section 267 or 707(b) (but, in applying section 267 (b) and (c) for purposes of this section, paragraph (4) of section 267(c) shall be

treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants), and

"(B) the basis of the property in the hands of the person acquiring it is not determined—

"(i) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or

"(ii) under section 1014(a) (relating to property acquired from a decedent).

"(3) PURCHASE PRICE.—The term 'purchase price' means the adjusted basis of the principal residence on the date of acquisition."

(b) CONFORMING AMENDMENT.—The table of sections for subpart A of part IV of subchapter A of chapter 1 of such Code is amended by inserting after the item relating to section 22 the following new item:

"Sec. 23. First-time homebuyer credit for District of Columbia."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to purchases after the date of the enactment of this Act, in taxable years ending after such date.

○

District of Columbia Economic Recovery Act
Mack-Lieberman
Senate Version

House version:	*Senate version:*
Personal Income: D.C. Residents are taxed at a single 15% rate for all income earned within the Washington-Baltimore MSA	***Personal Income:*** There is no change in the Senate version.
Standard Deductions: Increases the current standard deductions to: $15,000 for single filers $25,000 for head of household filers $30,000 for married filers	***Standard Deductions:*** No change in Senate version
Other Deductions: Maintains the current Mortgage and Charitable deduction provisions.	***Other Deductions:*** No change in Senate version
Business Income: Business income is taxed at the current federal rate - there is no change in the rate	***Business Income:*** Senate version also makes no changes in the business income provisions
D.C. Resident Capital Gains: There is no capital gains on investments made by District residents on activities occurring within the District.	***D.C. Residents Capital Gains:*** There is no change from the House version. D.C. residents have no capital gains on investments made within the District
Non-D.C. Resident Capital Gains: There is no provisions for capital gains relief for non D.C. residents.	***Non D.C. Residents Capital Gains:*** There is a zero capital gains rate for all business investments made within the District of Columbia. ***Single family home investment is treated at the current rate*** (this was done to limit accelerated property value rates)
First Time Home Buyers Provision: No first time home buyer provision	***First Time Home Buyers Provision:*** Establishes a $5,000 first time home buyers tax credit for the purchase of a residence within the District of Columbia
Brown Fields Provision: No Brown fields provisions	***Brown Fields Provision:*** Adds a brown Fields provision that allow immediate expensing of environmental clean up to new purchasers. Currently only existing property owners are allowed to expense the cost of environmental clean up.
Hold Harmless Provision: Allows DC residents to choose between the incentives offered in the DCERA and remain under the current federal income tax systems	***Hold Harmless Provision:*** No change in Senate version.

Long Term Changes in DC Population
1950
Approx. 800,000
District Residents
2000
Approx. 550,000
District Residents
Approx.
200,000
Residents
Lost

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

THE ABCs OF THE FLAT TAX

A review of the ABCs below provides a snapshot of how a flat tax would affect key aspects of the federal income tax system we now know. A flat tax...

A Would eliminate the individual and corporate **Alternative Minimum Tax (AMT)**. The AMT now forces select individuals and businesses to absorb the additional cost and complexity of calculating their taxes twice using two different methods. Estimates show that the cost of complying with the AMT may exceed the revenue it garners for Uncle Sam.

B Would **broaden** the tax **base** by eliminating the multitude of special deductions and exemptions that can be used only by a select few. A broader tax base would accomplish both a fairer distribution of the tax burden and a lower tax rate that creates the least distortions in the economy.

C Would end individual **capital gains** taxation that represents double taxation and hinders new investment by punishing people who save and invest. Joint Economic Committee research indicates that at least $1.5 trillion of capital is locked-up because individuals do not want to absorb high capital gains taxes.

D Would end the taxation of **dividends** that now represents double taxation of income. For example, after a corporation pays a 35% top tax rate on its income, when it disburses that income to individuals as dividends it is taxed again at a top rate of 39.6% -- a whopping combined tax of 60.7%.

E Would eliminate **estate** ("death") and gift taxation that represents punitive double taxation and unfairly transfers income from families to the government. The steep 55% top estate tax rate can force many families to liquidate or sell their businesses or farms just to pay the tax collector rather than being able to pass those belongings onto their next generation -- wiping a lifetime of hard work. The flat tax would also bring **equity** and **efficiency** to the tax system by levying the same tax rate on everyone and dramatically simplifying the code.

F Would establish **fairness** in the tax system. What could be more fair than having two people with the same income pay the same tax? The flat tax would explicitly treat all individuals equally under the law and everyone would face the same single tax rate. Can we say the tax system was fairer when the top rate was 28, 50, 70 or even 94 percent?

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104th CONGRESS

Would spur economic **growth** by ending the double taxation on savings and investment; eliminating individual capital gains taxation; lowering the tax rate and allowing investment to flow to its most constructive endeavors rather than into unproductive tax shelters. If tax reform fosters just a 0.5% increase in GDP growth, the typical American family after five years would have incomes of more than $3,000 higher then they would under current tax law.

Would do away with perplexing **holding period** calculations for stocks, securities and capital assets because individual capital gains are not taxed under a flat tax. Currently, individuals must keep detailed track of the duration of each and every investment to figure out the various tax treatment of long-term vs. short-term transactions.

Would allow **interest rates** to decline. Since individual interest income is not taxed under the flat tax, interest rates would drop to reflect the tax-free status of interest (similar to current municipal bonds that pay a much lower interest rate because they are tax free.) Consumers would benefit from lower interest costs on home mortgages, credit cards, auto loans, and other consumer credit.

Would no longer punish married couples filing a **joint return** with higher tax burdens. A single flat tax rate means a spouse's additional income could no longer push a family into a higher tax bracket and force them to pay the tax code's "marriage penalty."

Would eliminate the perplexing **Kiddie Tax**. Current tax law requires a child under age 14 to pay tax at his or her parents' highest marginal tax rate on the child's net unearned income (i.e., over a specified level) if that tax is higher than what the child would otherwise pay on it. The flat tax's single rate would put an end to this complexity.

Would minimize tax **loopholes** that unfairly allow only select individuals or interest groups to reduce their tax liability at the expense of others. Under the current code, for example, donating an art work can virtually wipe out the tax liability of a millionaire. Loopholes narrow the tax base and cause incentive-destroying tax rates to soar.

Would allow the lowest **marginal tax rate**. Uncle Sam's top marginal income tax rate on individuals has risen from 28% just a few years back to more than 40% today. The marginal tax rate determines how much after-tax money an individual keeps for each additional dollar earned and influences whether that individual works overtime, seeks out tax shelters, or goes fishing.

Would establish greater **neutrality** in economic decision making by not interfering with the free-will economic choices of individuals, households, and businesses. Multiple tax rates, double taxation and special loopholes are trademarks of the current tax system that prevent neutral treatment of how people choose to earn, save, invest or spend their money.

Would reverse the income tax rate hikes of the **Omnibus Budget Reconciliation Act of 1993 (OBRA'93)**. Signed into law by President Clinton on August 10, 1993, OBRA hiked the top marginal tax rates on corporations from 34% to 35% and boosted the top individual tax rate from 31% to 39.6%.

Would allow taxpayers to file a **postcard-size tax return** by streamlining and simplifying the tax code. A flat tax would also eliminate the complex **PEP** and **Pease** provisions in the current code that create a back-door tax increase on select individuals by phasing out personal exemptions and limiting itemized deductions.

Would eliminate the **qualified terminal interest property (QTIP)** provisions in the tax code. You know the tax system is too complex if rules begin with the letter **"Q!"**

Would eliminate the need for the **rollover provision** on the gain from the sale of a home by not taxing capital gains on an individual's home. Currently, taxpayers under the age of 55 must pay taxes on any capital gain from the sale of a home unless the owner uses that money (rolls-it-over) to buy a home of equal or greater cost within two years.

Would dramatically **simplify** the tax code. The IRS would no longer need to publish 480 different tax forms. Taxpayers would no longer have to wade through 1,378 pages of tax code and 6,439 pages of federal regulations. Analysis by the Tax Foundation estimates that a flat tax could reduce current income tax compliance costs from $140 billion to $8.4 billion.

Would condense numerous **tax rates** into one low **tax rate**. The current income tax code has multiple rates: 15%, 28%, 31%, 36%, 39.6%, and they even go higher because additional limits are imposed on certain individuals' deductions. These steeply graduated tax rates discourage work, entrepreneurial investment, and increased productivity by taking a larger and larger slice of someone's hard work or success.

Would reduce the tax evasion by the so-called **underground economy**. The current high marginal tax rates increase the value of cheating or not reporting income vs. the cost and risk of detection. If the flat tax reduced the top rate from 39.6% to 19%, it would cut in half the reward for cheating.

Here's one for the economist! The flat tax would replace the notion of **vertical equity** in the tax code with horizontal equity. Vertical equity supports redistributionist and egalitarian goals associated with graduated tax rates. It forces individuals to forfeit a greater and greater percentage of their income to the government if they increase their earnings. Conversely, a flat tax would support horizontal equity--meaning people under similar circumstances should bear equal tax burdens and every taxpayer should pay taxes in direct proportion to his or her income.

Would help put an end to the current class **warfare** mind set that ends up hurting all income groups with higher tax rates and slower economic growth. "Soak-the-rich" tax policy may score political points, but it's bad economics. Increasing tax rates more often results in lower federal revenues because people work less and invest in unproductive tax shelters to avoid the higher rates. Conversely, a single low tax rate would enhance equity and boost work incentives.

Would limit the number of **X-aminations** (OK, this one's a stretch) of tax returns because they would be far less complicated. Flat tax returns could be filed on a postcard-size form.

Would increase the after-tax **yield** for additional work, saving and investing by replacing today's steeply graduated tax rates with one low flat rate. Under a flat tax, people would pay taxes on their income when earned; however, if they then decide to save or invest this after-tax income, they wouldn't be doubly taxed as under the current system. That's because the flat tax would not tax the returns (interest and dividends) on individuals' savings or investments.

Would allow a **zero tax bracket** by exempting a given level of individual income before the tax would kick in (similar to today's standard deduction and personal exemption). A flat tax system with a personal exemption and a deduction for dependents would protect low-income individuals and families from facing high taxation.

Hopefully, the ABCs of a flat will help spell out the critical need for genuine tax reform.

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Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

Farewell, Tax Code

By Connie Mack

The newly released report by Jack Kemp's National Commission on Economic Growth and Tax Reform holds the promise of dramatic improvement in the well-being of all Americans. It provides the needed philosophical underpinning to construct a model tax system for our Nation and, hopefully, marks a milestone in saying farewell to the onerous tax code we've all come to know and hate.

The Commission's work reflects the growing consensus among economists, lawmakers, presidential candidates, and grassroots Americans that our current income tax system has become a tremendous obstacle to economic growth and our standard of living. The current tax code is beyond repair. It is unfair, complex, costly, and punishes hard work and investment. Simply stated, it is unfit to carry us into the 21st century and prevents us from ensuring a better future for ourselves, our children and grandchildren.

Perhaps the most significant aspect of the Commission's report is its timeliness. Today, as Congress and the Administration are struggling over tax relief as a component of a balanced budget agreement, the Commission's work implies that those tax cuts are absolutely critical. For decades, genuine tax reform has been hindered by a tax policy preoccupied with raising revenues to feed the federal government's insatiable appetite for spending. Fortunately, the Republican commitment to balance the budget through spending restraint will focus tax policy on economic growth. The Republican effort to improve savings and investment with capital gains tax relief, expanded savings incentives, and family tax relief would be a down payment on the pro-growth policies articulated in the Kemp Commission's findings.

The current tax system depresses the performance of our economy. It combines steep tax rates and punitive taxation of savings and investment with a multitude of loopholes, subsidies, credits and exemptions that can be used only by a limited number of taxpayers. Because of these high tax rates and selective deductions, investment decisions are all too often based on tax consequences instead of economic merit.

In part, this is why our economy has slowed from an average growth rate of 4 percent per year in the middle of this century to around 2.5 percent since the 1970s. This slowdown costs every person in America more than $10,000 a year! Tax reform guided by the Commission's principles would help reverse this growth gap and translate into a higher living standard for all Americans.

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A very important axiom outlined in the Commission's report is the importance of "neutrality" in a tax system. In other words, the tax code should not attempt to micro-manage individual behavior or the economy. Unfortunately, since its 1913 enactment, our income tax system has fallen prey to a multitude of unintended purposes including income redistribution, social engineering, and government intrusion into our saving, investing, and spending decisions.

Our complex and intrusive income tax system allows government to engineer behavior, jeopardizing not only economic growth, but individual liberty and the freedom of Americans to decide how best to use their own money. Currently, the federal government takes a huge chunk of people's income and then induces them to act in particular ways by giving them some of their own money back through deductions and credits.

As a democracy, we have the right to demand that our tax system work for us, not against us. The Kemp Commission's findings and recommendations provide the foundation to build a new tax system that will be equitable and will promote, not punish, economic growth. A low-rate flat tax would accomplish those goals admirably by allowing all taxpayers to keep more of their own money as they earn it and not interfering with our free economic choices.

Mere tinkering with the tax code will not correct the enormous problems ingrained in our current tax system. By embracing the ideas presented by Jack Kemp's Tax Reform and Economic Growth Commission, we'll be well on our way to constructing a new, model tax system that will improve the lives of all Americans.

Sen. Mack (R., Fla.) is chairman of the Joint Economic Committee.

Joint Economic Committee Report

THE FLAT TAX:

VITAL FOR AMERICA'S FUTURE

Senator Connie Mack, Chairman
July 1995

THE FLAT TAX
VITAL FOR AMERICA'S FUTURE

A TAX SYSTEM GONE AWRY

There is a large and growing consensus among economists, lawmakers, and taxpayers that our current income tax system has become a tremendous obstacle to economic growth. After eight decades of misuse by lawmakers, lobbyists, special interests, and income redistributors, our tax system is unfair, complex, costly, and punishes work, saving and investing. Simply stated, our onerous income tax system is unfit to carry us into the 21st Century, and prevents us from ensuring a better future for ourselves, our children and grandchildren.

Since its 1913 enactment, the income tax system has fallen prey to a multitude of unintended purposes including income redistribution, social engineering, and government micro-management of saving, investing, and spending decisions.

The only legitimate purpose of any tax is to provide revenue to cover the cost of government (see "Principles of a Model Tax System," page 3). Taxpayers should be able to clearly see the cost of government spending and thereby determine how much government they are willing to pay for. Unfortunately, since its 1913 enactment, the income tax system has fallen prey to a multitude of unintended purposes including income redistribution, social engineering, and government micro-management of saving, investing, and spending decisions.

We have the right to demand that our tax system be equitable, efficient, and supportive of our nation's greatest economic growth potential. Sadly, our current tax system treats individuals unfairly, exacts tremendous administrative and compliance costs, and hinders our economy from realizing its full productive potential. As a result, Americans' opportunity to better their standard of living is jeopardized.

NEW THINKING REQUIRED

Mere tinkering cannot correct the enormous problems now codified in our current tax system. Partial reforms have been tried repeatedly, with limited success at best. We must fundamentally rethink the manner in which income is taxed in order to construct a system that is equitable, efficient, and pro-growth. In order to achieve genuine tax reform, the blinders must be taken off, special interests must give way to overriding national concerns, politically motivated class warfare must stop, and the defenders of the status quo must get out of the way of positive change.

The flat tax system, pioneered by Professors Robert Hall and Alvin Rabushka of Stanford University, encompasses the new thinking and fundamental change that is needed to create a fair, simple, and pro-growth tax system.

WHAT IS A FLAT TAX?

A flat tax would levy a single tax rate on all income subject to tax. Income would be taxed once and only once. The complexity and unfairness resulting from hundreds of exemptions, credits, loopholes and deductions now prevalent in the tax system would be eliminated to make the single tax rate as low as possible. Only a personal allowance and dependent deduction would be permitted.

Can A Flat Tax Be Revenue Neutral?

Yes. Any flat tax system can be designed to bring in exactly the same amount of revenue as the existing federal income tax. The specific tax rate that would result in revenue neutrality would depend on the size and number of allowances (deductions) permitted, creating a direct tradeoff between deductions and the tax rate. The higher the allowances are set, the higher the tax rate would need to be to bring in the same amount of tax revenue as the current system.

The chart below shows a hypothetical set of flat tax rates and allowances that would result in revenue neutrality. This model, produced by the Congressional Budget Office shows that all federal income tax revenues could be fully replaced by a system with a flat tax rate of 13.1 percent and no deductions. Allowing total deductions for a family of four to reach $36,800 (more than double the amount allowed in 1995) would require a 19.9 percent rate.

Revenue Neutral Tax Rates for Alternative Allowances and Exemptions Under a Flat Tax

	Option 1	*Option 2*	*Option 3*	*Option 4*	*Option 5*
Standard Allowances					
Single	$13,100	$13,100	$ 6,550	$ 6,550	$0
Joint	$26,200	$26,200	$13,100	$13,100	$0
Head of Household	$17,200	$17,200	$ 8,600	$ 8,600	$0
Dependent Exemption	$ 5,300	$2,650	$ 5,300	$ 2,650	$0
Revenue Neutral Tax Rate	19.9%	19.4%	16.8%	16.3%	13.1%

Source: Congressional Budget Office, 1995.

PRINCIPLES OF A MODEL TAX SYSTEM

- ✓ **All taxpayers must be fully informed on exactly what is being taxed, how they are being taxed, and what their true tax liability is.**
- ✓ **Taxes should be as visible to the taxpayer as possible. "Hidden" taxes mask the true cost of government.**
- ✓ **The tax system should explicitly treat all individuals equally under the law. Deliberate differentiations in tax liabilities based on the sources or uses of income should be avoided.**
- ✓ **The tax system should provide the same tax treatment for similar economic actions and transactions rather than taxation based on the attributes of the taxpayer.**
- ✓ **Multiple layers of taxation should be avoided. Income should be taxed once and only once.**
- ✓ **The tax system should be simple. Complexity makes the system expensive, punitive, and results in an efficiency loss to the economy.**
- ✓ **The tax system should aim for neutrality in economic decision making. The tax system should not interfere with the free will economic choices and decisions of individuals, households, or businesses.**
- ✓ **A low tax rate across a broad tax base creates the least distortions in the economy. High marginal tax rates damage economic growth by reducing the incentives to work, save and invest.**
- ✓ **Changes in the tax law intended to raise revenues should not be retroactive. All taxpayers must have confidence in the law as it exists when planning and entering into transactions.**
- ✓ **The U.S. tax code must be competitive with other industrialized nations. It should in no way impede the free flow of goods, services and capital across borders.**

WHY DO WE NEED A FLAT TAX?

Problem. Our current tax system is **unfair**, often levying different tax burdens on people with the same incomes. For example, higher taxes are levied on some senior citizens with Social Security income. The tax code allows only certain individuals to take advantage of special tax loopholes and tax breaks, while others are forced to pay higher taxes.

Solution. The flat tax, with its single low-rate, would both ensure **that all taxpayers pay their fair share**, and eliminate special tax loopholes that can only be used by a select few.

Problem. Our current tax system is needlessly **confusing and complex.** It takes Americans six billion hours each year, at a cost of $200 billion, just to comply with the tax code.

Solution. The flat tax **eliminates confusion and complexity** by replacing hundreds of deductions and multiple tax rates with one low tax rate. Taxes could be filed on a form the size of a post-card, and all taxpayers would clearly see exactly how much income tax they are paying. The cost of complying with tax rules and regulations would be reduced tremendously for both individuals and government. These savings could be used to lower taxes even further.

Problem. The current tax code **punishes people who work hard or take risks** to improve their standard of living. Citizens automatically forfeit more of their money to taxes when they are pushed into higher tax brackets—cutting Uncle Sam in on a larger share of their earnings. Our current system's steep increases in tax rates crush work incentives and entrepreneurial spirit. Because of high tax rates, many people find themselves working longer and harder and ending up with nothing to show for it.

Solution. The flat tax would not punish hard work and success. Under the flat tax, the more you make, the more you pay. However, **Uncle Sam would not demand a disproportionately larger, punitive share of your income as you earn more.**

Problem. The current tax code **discourages saving and investing** by taxing these activities more than once. This can make it much more attractive and rewarding to consume rather than to save. As a result, the savings and investment needed for economic growth are eroded, and every American's chance for a higher income and improved standard of living is diminished.

Solution. The flat tax **eliminates double and triple taxation.** Americans, regardless of how they make their money, would pay taxes when their income is earned. However, the returns (interest and dividends) on after-tax income that is saved or invested would not be taxed yet again. All but those in the lowest income groups would pay taxes on their income, but they would pay once (and only once) at a single low rate. Unlike the current system, people who save and invest for their future would not be punished with higher taxes.

Problem. Because of current high tax rates and the tax code's multitude of deductions, **investment decisions are often based on tax consequences instead of economic merit.** This stifles economic growth.

Solution. A low-rate flat tax **would eliminate special subsidies, loopholes, and tax shelters,** allowing investment decisions to be based solely on their economic merit, not their tax consequences. Investment in unproductive tax shelters would shift to more productive endeavors and economic growth would improve.

Problem. The current tax code **allows government to micro-manage behavior,** jeopardizing individual liberty and the freedom of Americans to decide how best to use their own money. Currently, the government takes a huge chunk of people's income and then bribes them with their own money by giving some of it back with deductions and tax credits.

Solution. A low-rate flat tax would **allow taxpayers to keep more of their own money as they earn it,** and shield them from the changing whims of Uncle Sam. Simply stated, if individuals were given the lowest tax rate possible under a flat tax, their need for special deductions would be eliminated.

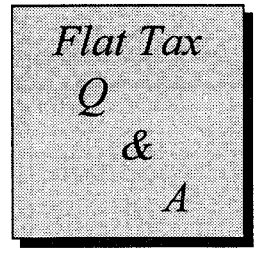
Problem. Tax rates are too high. Marginal income tax rates that were set at 15 and 28 percent just a few years ago, now reach as high as 45 percent. High marginal tax rates damage economic growth by reducing the incentives to work, save, and invest. Marginal tax rates largely determine whether people save or spend, invest prudently or seek out tax shelters, and work or just stay home.

Solution. Under a single, low-rate flat tax, **people could earn more without being pushed into higher tax brackets.** The savings from the efficiencies of a flat tax system would provide tax relief and encourage individuals to earn as much as they can without being penalized.

COMPARISON OF THE CURRENT INCOME TAX SYSTEM TO THE FLAT TAX

Current Tax System	Flat Tax
Imposes high tax rates that discourage work and entrepreneurial activity.	Allows individuals to earn as much as they can without being punished by the tax system.
Punishes saving and investing with high tax rates and double taxation.	Ends high tax rates and double taxation of savings and investment.
Unfairly levies different taxes on people with similar incomes. Special deductions and exemptions often are available to only a select few.	Treats everyone the same, with all taxpayers paying the same low tax rate. Eliminates special deductions and loopholes.
Drives investment into unproductive tax shelters.	Ends all tax shelters, allowing more productive investments.
Encourages spending more than saving by taxing savings and investment at least twice, sometimes three times.	Ends punitive taxation of savings and investment, leaving individuals free to decide whether to spend, save or invest.
Is overly complex with high administrative and compliance cost.	Ends complexity by eliminating the multitude of deductions, exemptions, and credits.
Redistributes income.	Promotes the creation of income and economic opportunity for all Americans.

FREQUENTLY ASKED FLAT TAX QUESTIONS



Q. Why do so many economists and policy makers want to replace our current income tax system with some type of consumption tax?

A. Consumption-based taxes largely exempt savings and investment from punitive taxation. This spurs capital formation, increased productivity, and economic growth. One of the most destructive elements of the current tax system is that it punishes saving and investing with high tax rates and double taxation. This punitive tax treatment makes it far more attractive to spend income than to save it.

Q. Would a good tax system punish consumption and reward savings and investment?

A. Not at all. People save and invest so they can consume at a later date. For example, individuals forgo current consumption to save for their retirement years. The flat tax system would not punish an individual's decision to spend, rather, it treats consumption and savings equally, leaving the tax system neutral with respect to an individual's decision to save or spend.

Q. In order to tax consumption, do we need to scrap the income tax system?

A. No. The flat tax would work within the income tax framework. Income can either be spent or saved, and every act of investment in the economy ultimately traces back to an act of saving. The flat tax is a consumption-based tax, because it provides an immediate 100 percent tax exclusion for new investment and exempts the returns on savings (interest and dividends) from taxation.

Q. How is double taxation eliminated under the flat tax?

A. Earnings on an individual's savings and investment (interest and dividends) would not be taxed, eliminating the double taxation that now occurs when both businesses and individuals pay taxes on the same income. Currently, companies pay corporate income tax on their earnings, and then individuals pay personal income tax on the interest and dividends they are paid from those same companies' earnings. The flat tax system would also eliminate the massive record keeping necessary for businesses, individuals and the government to track and report all interest and dividend payments made each year.

Q. Why is a single tax rate better than a progressive tax with higher rates?

A. Steeply graduated tax rates discourage work by taking a bigger and bigger slice of people's incomes as they earn more. Today's high tax rates largely result from the multitude of deductions, exemptions, and tax credits that allow certain individuals or businesses to pay little or no taxes, leaving other taxpayers to pick up the tab. All these deductions force incentive-destroying marginal tax rates up, while fostering complexity, creating inequities, and enhancing Uncle Sam's ability to micro-manage people's behavior. A single low tax rate would enhance equality and boost work incentives.

Q. Aren't there good reasons to allow certain deductions in the tax code?

A. Rarely. Rather than have the government take a big tax bite out of paychecks, and then bribe workers by giving them their own money back, a single low-rate flat tax would let people keep more of their own money as they earn it. Business owners, individuals and families could then decide for themselves how best to spend or invest their money without having to bend to the dictates of Uncle Sam. Having one tax rate, and eliminating the multitude of deductions, would end the special-interest tax break "free-for-all" that is largely to blame for the complexity, instability, unfairness, and social engineering prevalent in the existing tax code. The flat tax would finally end the misuse of the tax code that greatly reduces economic efficiency.

Q. Many previous attempts at tax reform promised simplicity that never materialized. Why will this effort be any different?

A. For the more than 80 percent of Americans who get the bulk of their income from salaries and wages, the flat tax system couldn't be simpler. These taxpayers could file a tax return the size of a post-card. Previous tax reform efforts preserved numerous costly and complex deductions and exemptions reserved for only a few. The flat tax would achieve simplicity because it would tax income only once, at one low-rate, and would finally eliminate special deductions, exemptions, and credits.

Q. Who will benefit under a flat tax system, businesses or individuals?

A. The flat tax is an integrated system that applies to both businesses and individuals. Both business and individual income would be taxed at the same tax rate. The flat tax's business tax is not just replacement for the existing corporate income tax. It covers all income from non-corporate businesses, such as,

Trying to judge the flat tax on the standards of the current tax system is one of the biggest mistakes committed when analyzing the flat tax.

partnerships and proprietorships, as well as interest income, which is currently taxed under the personal income tax system. First and foremost, you cannot equate the current corporate income tax to the flat tax's business tax. Likewise, you cannot compare the current individual income tax to the flat tax on wages and salaries. Trying to judge the flat tax on the standards of the current tax system is one of the biggest mistakes committed when analyzing the flat tax. Simply stated, the business tax is a comprehensive withholding tax on all types of income other than wages, salaries, and pensions. The benefit of this tax is that it taxes income once (at its source), and only once. Currently there is double taxation on corporate income: once when the company pays income tax and again when individuals are taxed on the company's after-tax payout of interest and dividends. Ending this punitive double taxation that will encourage saving and investment is vital to economic growth and an improved standard of living for all individuals.

Q. Is it fair to tax individuals at the same rate as corporations and businesses?

Remember, corporations do not pay taxes--people do.

A. *Remember, corporations do not pay taxes--people do. The current corporate income tax is borne by individuals who are the owners of corporations (shareholders), individuals who work for these corporations, and individuals who buy corporate products. Levying the same tax rate on businesses and individuals guarantees that all income is taxed and taxed fairly. The flat tax's business tax is designed to collect the tax that owners of a business owe on the income produced by the business. Corporate taxes can only result in reduced returns to shareholders, lower wages for employees, or higher prices for consumers. Unfortunately, there is no way to know the aggregate amount of corporate taxes an individual pays. In fact, the Joint Committee on Taxation does not calculate the individual's share of corporate taxes, thereby ignoring the burdens on individuals imposed by a tax that raised $150 billion last year. This has resulted in the inaccurate and misleading tax burden distribution tables that have been so often quoted by policy makers.*

Q. How is income taxed under the flat tax system?

A. *Under the flat tax, each firm pays a tax on the total income generated, less its investment in plant and equipment and wages paid to its employees. The workers then pay the tax on what they earn, making the flat tax an airtight integrated tax system.*

Q. Will the flat tax bring in the same amount of revenue as the current income tax system? In other words, would it be "revenue neutral?"

A. *Any flat tax system can be designed to be revenue neutral simply by setting the appropriate tax rate and amount of deductions that are allowed.*

Q. If the tax system is radically reformed and we preserve revenue neutrality, who will be the "winners" and "losers?"

A. Everyone will be a winner under a more simple and efficient tax system that eliminates the economic distortions that now hamper investment, productivity, and wage and job growth. The flat tax would better enable the economy to reach its full potential and afford all Americans a better standard of living.

The static income distribution models currently used by the Congressional Budget Office (CBO), Treasury and the Joint Committee on Taxation (JCT) cannot show the full benefits from this type of tax reform. Unfortunately, the defenders of the status quo will attempt to use faulty distribution numbers to discredit the flat tax. These models have been proven wrong time after time. If we look beyond the current static analysis and reform a tax system that we know is unfair and restricts economic growth, everyone will be better off.

The static income distribution models currently used by the Congressional Budget Office (CBO), Treasury and the Joint Committee on Taxation (JCT) cannot show the full benefits from this type of tax reform.

Q. What guarantee is there that the flat tax would improve economic growth?

A. The potential economic benefits from a low-rate flat tax aren't just wishful thinking. Lowering high marginal tax rates worked for Presidents Kennedy and Reagan and resulted in robust economic growth. This growth meant higher wages, more jobs and improved living standards for all income groups, as well as increased revenues for the Treasury.

Q. What deductions would be eliminated under a flat tax?

A. For individuals personal and dependent deductions would be allowed. Beyond that, people would be better off with a low single tax rate that lets them keep their own money as they earn it.

Today's system, with its high tax rates that combine with double and even triple taxation, can take more than half of someone's income. With such confiscatory rates, it's no wonder there exists a tremendous demand for special deductions and loopholes to lower the tax burden. But under a low flat tax rate, if people can keep 83, 84, or 85 cents of every dollar they earn, instead of only 50 cents, they won't need special deductions.

Deductions and loopholes make the tax system complex and tremendously unfair, allowing only a select few to take full advantage. Is it fair for a multimillionaire to donate a million-dollar piece of art and virtually wipe out his tax liability? Is it wise to have people invest in unproductive tax shelters in hopes of lowering their taxes?

Deductions and loopholes make the tax system complex and tremendously unfair, allowing only a select few to take full advantage.

How a Flat Tax Would Benefit Individuals

Frees savings and investments from double taxation. After income has been taxed once at a low, flat rate, if it is saved or invested, the returns (interest and dividends) are not taxed again, as under the current system.

Ends taxation of capital gains. An individual's income investment in a home or small business would be free from the punitive double taxation of capital gains when sold.

Ends estate and gift taxes that represent double taxation and unfairly transfer income from families to the government.

Slashes the time, effort, and cost of complying with the tax code. Taxes could be filed on a form the size of a post-card.

Reduces interest rates on home mortgages, credit cards, and auto loans. Since interest income is no longer taxable under the flat tax, interest rates would drop to reflect the tax-free status of interest.

Stops punishment of individuals and families who work longer or harder to improve their standard of living. With only one low tax rate, government would no longer take an increasingly larger bite of someone's income. One tax rate means a spouse's income could no longer push a family into a higher tax bracket.

Increases individual freedom of choice and civil liberties. One low tax rate would allow people to keep more of their money as they earn it and would end government's current micro-management of people's behavior through the tax code. A simple flat tax would dramatically reduce the IRS's infringements on privacy.

Q. What about the mortgage interest deduction; don't we want to encourage home ownership?

A. The removal of the mortgage interest deduction would be offset by a lower tax rate and lower interest rates. First, the demand for housing is driven largely by the amount of after-tax income and the growth of the economy. A low-rate flat tax that boosts incomes and lowers taxes would offset the need for the mortgage interest deduction. Second, interest rates would fall under a flat tax system, lowering the cost of home ownership. Since individual interest income is not taxed under the flat tax, interest rates would drop to reflect the tax-free status of interest (similar to current municipal bonds that pay a much lower interest rate because they are tax-free.) A flat tax system that improves economic growth and job opportunities, raises incomes, and lowers interest rates could only boost the demand for housing.

Q. If the flat tax doesn't tax interest, dividends and capital gains income, won't this be a "giveaway" to the "rich?"

A. Not at all. The flat tax would finally end the current class warfare mind set that has hurt everyone. "Soak-the-rich" talk may score political points, but it's bad economics.

The flat tax will not be a "giveaway" to the rich. Someone earning one hundred times another's taxable income would pay one hundred times more in taxes. Ending the tax on capital gains, dividends, and interest income would simply remove the punitive and destructive double taxation that everyone now faces when he or she decides to save and invest. Interest, dividends, and capital gains simply represent returns on income that has already been taxed. All income from businesses and individuals would be taxed under the same flat tax rate, but it would be taxed only once. Income earned by shareholders cannot escape taxation or be sheltered because it would be taxed at the business level. Interest and dividends paid out would not be deductible under the flat tax's business tax. In other words, no deductions would be allowed for these payments by those making them. This puts the equivalent of a withholding tax on interest, dividends and capital gains at the business level. Therefore, the interest, dividends and capital gains received by the "rich" and everyone else will have already been taxed at the business level and cannot be sheltered.

Q. Would a flat tax be "fair" given that today's system makes upper income individuals pay a higher or "progressive" tax rate?

A. What could be more fair than having two people with the same income pay the same tax? Can we say the tax system was fairer when the top rate was 28, 50, 70, or even 94 percent? Even with this wide range of tax rates, the federal government collected approximately 19 percent of GDP in income tax revenues. Everyone knows that some people manipulate the system to lower their taxes at the expense of others. Higher tax rates have not necessarily resulted in higher tax payments. In fact, higher tax rates more often have resulted in lower federal revenues because people work less and invest in unproductive tax shelters to avoid higher tax rates.

A flat tax system with a personal exemption, and a deduction for dependents, would protect low-income individuals and families.

Q. How would the flat tax affect Social Security?

A. *The flat tax would not change the current Social Security benefit system. The Social Security system deserves separate attention. However, Social Security benefits would not be included in income and taxes as under the current system.*

How a Flat Tax Would Benefit Business

Ends punitive double taxation of business income and fosters increased savings and investment needed for development and expansion.

Ends individual capital gains and dividends taxation, and would spur increased corporate investment.

Allows 100 percent first-year expensing of new business investment (plant, equipment, and land), eliminating one of the biggest accounting nightmares—numerous depreciation schedules that can stretch up to 40 years for investments or purchases.

Spurs new investment and increased productivity by quickly freeing up capital needed in fast growing businesses through immediate expensing.

Eliminates the cost of keeping track of all interest and dividends paid out (1099 forms); because this income would only be taxed at the business level. Corporate income would not be taxed again when interest and dividends are paid to individuals.

Eliminates the growth disincentives caused by high marginal tax rates now faced by expanding businesses.

Eliminates the corporate Alternative Minimum Tax (AMT), which forces many businesses to calculate their taxes twice under two different methods.

Reduces complexity in the taxation of multinational corporations. The flat tax only applies to domestic operations of all businesses, whether they are domestic, foreign, or mixed ownership. Only the revenue from sales of a product within the United States, plus the value of products at export would be reported.

Q. What about the popular deduction for state and local taxes? If this deduction is eliminated, would people in high tax states be forced to pay more? Is this "fair?"

A. Only deductions for individuals, families and dependents would be allowed. Beyond that, the tremendous benefit of a single low-rate tax would offset the need for deductions. People would be better off under a single low-rate tax that lets them keep their own money as they earn it.

The cost of a state's or local government's spending and high taxes should not be shifted to others through the federal tax code. The issue of high state and local taxes should be taken up with state and local officials who levy them. The burden should not be paid by others outside the state.

Q. How would state tax systems that largely piggyback on the federal income tax system be affected?

A. States can easily adapt their systems to the flat tax reform (as they did after the 1986 Tax Reform Act that lowered tax rates and broadened the tax base).

Q. Why would people's health benefits and other presently tax-free fringe benefits be taxed under the flat tax? Would employers drop their health insurance plans and other tax free benefits?

A. Employers could choose to pay their workers increased cash wages (which are deductible) rather than compensation in the form of fringe benefits. This would give employees more choice and control over benefits. Employers would not be prevented from providing benefits like health insurance.

Q. If we give up the bulk of our deductions in exchange for the low single flat tax rate, what's to prevent Congress from jacking up the rate later?

A. As we know all too well, Congress always has the ability to raise taxes. But under a flat tax, a tax rate increase would have an impact on all taxpayers. This would foster greater accountability and members of Congress would know that each and every constituent would be hit with a higher tax burden if they voted to raise the rate. Today, lawmakers can play the game of taxing one income group at a time. The flat tax would end the "soak-the-rich" bait-and-switch tax hikes that end up soaking everyone.

The flat tax would set one tax rate for businesses and individuals. This would also put an end to false claims that taxes were raised only on corporations when we know that all taxes are paid by individuals anyway.

Flat tax reform could also include a "super-majority" provision for tax increases. It would require a three-fifths vote of Congress to raise the tax rate. Some have suggested a Constitutional "super-majority" amendment to curb lawmakers' perpetual urge to raise taxes.

CONCLUSION

Since the passage of the Sixteenth Amendment in 1913, the income tax system has been incrementally reformed and tinkered with for eight decades. Tinkering has only compounded the complexity and distortion of the tax system. The time has come for a flat tax system that is simple and equitable.

Levying a flat tax is not a radical idea. In fact, except for the income tax, flat taxes abound. The Social Security tax, Medicare tax, sales taxes, property taxes, government licenses and user fees all use a single-fixed rate regardless of income.

The flat tax would end the inherent unfairness, complexity, government micro-management, and economic damage caused by the current income tax system. Replacing the current income tax system with a flat tax would foster increased economic growth and opportunity while providing all Americans a higher standard of living.

Prepared by Paul G. Merski, Economist, and Jeffery W. Styles, General Counsel.

Joint Economic Committee

U.S. SENATOR Connie Mack
CHAIRMAN

ISSUED BY:
CONNIE MACK (FL), CHAIRMAN
November 1995

ECONOMIC POLICY UPDATE

Give the Middle Class a Break: Cut the Capital Gains Tax Rate

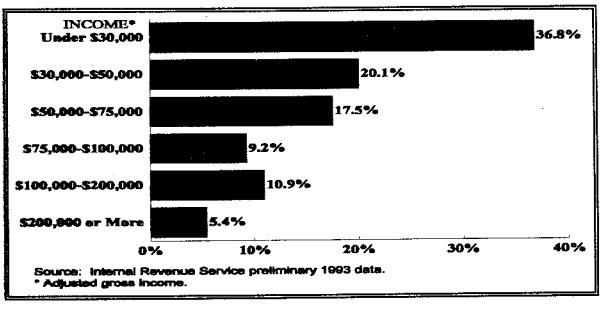
The Clinton Administration and other Democrat defenders of the status quo just don't want Americans to keep any more of their own hard-earned income. This is the clear message of the grotesque scare tactics they are using to try to derail Republican tax relief. Rants against "tax cuts for the rich" and "tax increases on the middle class" have become the Democrat mantra.

" not only "wealthy" Americans realize capital gains."

Democrats have labeled the Republican proposal to scale back capital gains taxes a "giveaway to the rich." Despite their class-warfare rhetoric, cutting the capital gains tax would help all taxpayers across the income spectrum. How? Because not only "wealthy" Americans realize capital gains.

Figure 1
TAXPAYERS REPORTING CAPITAL GAINS IN 1993
BY INCOME CLASS
(PERCENTAGE)

"more than eight million households earning less than $50,000 would likely benefit from capital gains tax relief."



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"more than one-third, or 36.8 percent of taxpayers with capital gains, had incomes of $30,000 or less"

The latest Internal Revenue Service (IRS) tax return data for 1993 show that all income groups reported capital gains.[1] In fact, 19.1 percent of all taxpayers reporting capital gains in 1993 had incomes less than $15,000. Another 17.7 percent of taxpayers reporting capital gains in 1993 were from the $15,000 to $30,000 income group. Combined, more than one-third, or 36.8 percent of taxpayers with capital gains, had incomes of $30,000 or less, as shown in Figure 1. Many elderly Americans fall into these lower-income categories, and depend on cashing in their capital gains as a source of retirement income.

IRS tax return data shows that more middle-income taxpayers stand to benefit from a capital gains tax cut than those at the upper-end of the income scale. Figure 2 shows that 56.9 percent of all tax returns reporting capital gains came from taxpayers with incomes below $50,000 per year, meaning that more than eight million households earning less than $50,000 would likely benefit from capital gains tax relief.

TAXPAYERS REPORTING CAPITAL GAINS IN 1993
BY INCOME CLASS*
(Percentage)

"the overwhelming majority of taxpayers who would benefit from lower capital gains taxes are not "rich.""

Figure 2

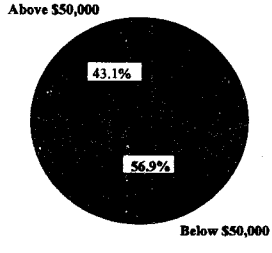
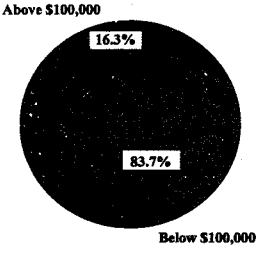


Figure 3



Source: Internal Revenue Service preliminary 1993 data.
* Adjusted gross income.

Contrary to the Democrat class-warfare party line, the overwhelming majority of taxpayers who would benefit from lower capital gains taxes are not "rich." Figure 3 shows that 83.7 percent of returns reporting capital gains - that's 12 million Americans - came from families with incomes under $100,000. By comparison, only 16.3 percent of taxpayers reporting capital gains in 1993 had incomes above $100,000.

Even these examples tend to overstate the capital gains taken by the so-called rich. Those who are labeled "rich" are often done so in error because one-time capital gains realizations are counted as income. Therefore, taxpayers who sell long-held assets often appear to have high incomes in the year in which they sell those assets. While this one-time gain is not representative of typical annual income, such income is counted to make a taxpayer appear "rich."

"This graphically illustrates the need to index capital gains for inflation."

For example, a family who bought a house in 1965 for $75,000 and sold it in 1995 for $225,000 would report a long-term capital gain of $150,000. If that family's regular annual income is $50,000, then their reported income in 1995 would be $200,000 ($50,000 + $150,000). To the Democrats, they're "rich!" The gain, which occurred over thirty years, is lumped into one year's income. However, simply adjusting this gain for inflation reveals that their real gain is only $27,000.[2] This graphically illustrates the need to index capital gains for inflation. After adjusting their 30-year gain for inflation, the family's one-time 1995 income would be $77,000. ($50,000 + $27,000). Such a one-time jump in annual income would hardly qualify them for "Lifestyles of the Rich and Famous."

In the final analysis, an examination of actual tax return data reveals why capital gains are not just for the "wealthy." All Americans would benefit from a reduction in the capital gains tax, both directly on their tax returns, and indirectly from increased investment and economic growth.

Prepared by Paul G. Merski, Economist, Joint Economic Committee. (202) 224-5171

Endnotes:

1. Internal Revenue Service, Statistics of Income Bulletin: Volume 15, Summer, 1995.
2. Inflation adjusted using CPI-U, U.S. Department of Labor, Bureau of Labor Statistics.

Joint Economic Committee

May, 1995

ECONOMIC POLICY UPDATE

U.S. SENATOR
Connie Mack
CHAIRMAN

ISSUED BY:
Connie Mack (FL), Chairman
Jim Saxton (NJ), Vice Chairman

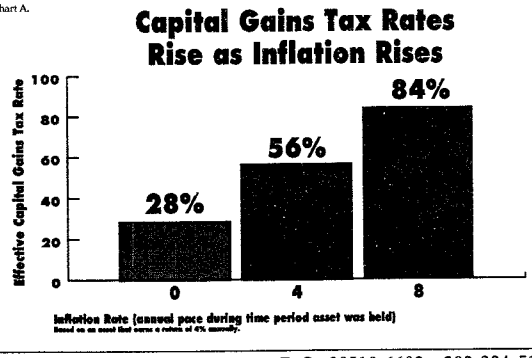
Capital Gains Tax: Fairness?

"[A]nyone earning a capital gain ends up paying taxes on gains that are not real — in some cases, paying effective rates of over 100 percent on inflation-adjusted gains."

Much of the recent tax debate has been focused on making taxes fair, and while there are many unjust consequences inherent in the current U.S. tax system, one example stands out — the treatment of capital gains. Capital gains are calculated by subtracting the purchase price of an asset from its sale price, and are taxed at 28%. No allowance is made for the effects of inflation upon the price of the asset. As a result, anyone earning a capital gain ends up paying taxes on gains that are not real — in some cases, paying effective rates of over 100 percent on inflation-adjusted gains.[1] As long as we are dealing with our current tax system, capital gains should be indexed for inflation, and the sooner, the better.

Just how unfair is the current capital gains tax structure? Consider the investor who put $100,000 into some type of investment (a small business, shares of stock, etc.) in 1980. That investor then sold that asset in 1992 for $200,000, making a nominal gain of $100,000. The investor owes $28,000 in capital gains taxes (based on the 28 percent tax rate on long-term capital gains). According to the consumer price index, inflation rose 70.4 percent between

Chart A.



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"When other income is indexed to inflation, but capital gains are not, taxpayers face a large disincentive to take part in the economically crucial act of investing."

1980 and 1992, a 4.5 percent annual rate.[2] This means that, even though the nominal gain was $100,000, the real gain was only $29,600 ($70,400 came from inflation). The effective real tax rate is much higher than the 28 percent that has been advertised, and is in fact *94.6 percent* ($28,000/$29,600). If the investor had sold the asset for less than $197,778, the tax burden would be greater than the total real return. The effective tax rate would be over 100 percent — in effect, a confiscation of property. When other income is indexed to inflation, but capital gains are not, taxpayers face a large disincentive to take part in the economically crucial act of investing. Those who still make the choice to invest face an undue, and unfair, tax burden.

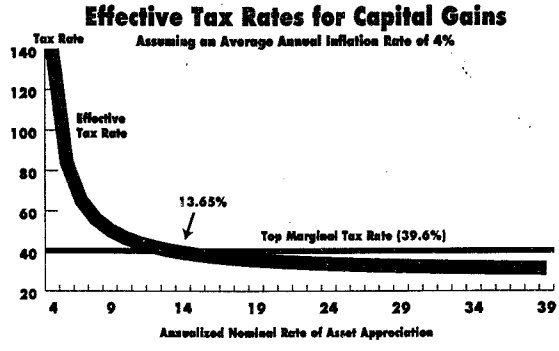
Effective Capital Gains Tax Rates

Real Rates of Return (Annual)

Inflation Rate (Annual)	2%	3%	4%	5%	6%
0%	28%	28%	28%	28%	28%
4%	84%	65.3%	56%	50.4%	46.7%
8%	140%	102.7%	84%	72.8%	65.3%

Charts A and B show just how damaging and unfair the current capital gains tax can be. If inflation rises at a 4 percent per year pace while an investor holds an asset, the returns must be staggering for that investor to see any benefit. If the asset returns a modest 8 percent per year (4 percent inflation + 4 percent real return), the middle-class investor ends up facing an effective tax rate of 56.0 percent on their capital gain. The asset has to earn a well-above-average 13.65 percent nominal return (with inflation at a 4 percent annual pace) just so the effective tax rate matches the <u>top</u> marginal income tax rate of 39.6 percent. In fact, as long as inflation exists, the effective capital gains tax rate will never fall to 28 percent.

Chart B.



"[I]n 1985, the U.S. dollar was worth as much as 260 yen. In 1986, the U.S passed an increase in capital gains tax rates in an effort to 'treat capital gains like regular income.' Since 1986, the dollar has steadily fallen, and is now worth less than 84 yen."

Indexation of capital gains for inflation would make the U.S. more attractive to foreign investment, which would no doubt help the value of the beleaguered U.S. dollar. In the U.S., foreign investors face a 30 percent capital gains tax rate, higher than even that faced by U.S. citizens.[3] At present, many countries have no capital gains tax, Germany does not tax assets held longer than six months, and Japan taxes capital gains at rates much lower than those in the U.S.[4] Japan and Germany are two of our largest competitors for foreign investment capital, and they provide investment with a far friendlier climate than does the U.S. While the elimination of capital gains taxes would provide the most encouraging environment for investment (and put the U.S. on equal footing internationally), indexation would remove some of the disincentives to investing in the U.S. Remember, in 1985, the U.S. dollar was worth as much as 260 yen.[5] In 1986, the U.S. passed an increase in capital gains tax rates in an effort to "treat capital gains like regular income." Since 1986, the dollar has steadily fallen, and is now worth less than 84 yen.[6]

"Small business owners, families who choose not to invest the proceeds of the sale of their homes in real estate, and anyone who has ever earned a capital gain have been, and will continue to be, victimized by the capital gains tax."

There is precedent in the tax law to account for the effects of inflation. Back in the late 1970s, when inflation was running rampant, federal income tax brackets were not indexed for inflation. Taxpayers whose purchasing power did not increase nevertheless found themselves in higher tax brackets (because their nominal salaries rose to adjust for the higher costs of living). Effective marginal tax rates rose rapidly and destructively during this time, a phenomenon known as "bracket creep." This bracket creep is associated with falling real median family incomes and a stagnating economy, the signs of the "malaise" that so perplexed President Carter. Politicians from both sides of the aisle recognized how unfair and damaging this situation was, and now federal income tax brackets have been indexed for inflation.

"Indexation of capital gains for inflation should be the law now. Since that is not the case, both houses of Congress must move swiftly to make indexation a reality. Why? Because, as you read this, prices continue to rise."

There is no logical defense for the current structure of the capital gains tax. The "rich vs. poor" argument serves no purpose. Small business owners, families who choose not to invest the proceeds of the sale of their homes in real estate, and anyone who has ever earned a capital gain have been, and will continue to be, victimized by the capital gains tax. Their choices, and their property, have both been eroded by the capital gains tax.

Indexation of capital gains for inflation should be the law now. Since that is not the case, both houses of Congress must move swiftly to make indexation a reality. Why? Because, as you read this, prices continue to rise. As long as we have inflation, investors will be taxed on gains they have not made on a real basis. What could be more unfair?

Prepared by the Joint Economic Committee: Chief Economist Brian Wesbury and Economist Jeffrey Given (authors) and Professional Staff Ross Lindholm (editor).

Endnotes:
1. Joint Economic Committee calculations.
2. U.S. Department of Labor, Bureau of Labor Statistics
3. Price Waterhouse, *Individual Taxes: A Worldwide Summary*, 1994 edition.
4. Ibid.
5. Haver Analytics
6. Ibid.

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Joint Economic Committee

U.S. SENATOR Connie Mack CHAIRMAN

September 1995

ECONOMIC POLICY UPDATE

THE $1.5 TRILLION HANDCUFF

"The slowdown in capital gains realizations is directly related to the misguided 1986 increase in the capital gains tax rate."

"The capital gains tax is forcing resources to remain in old technology industries by locking investors up in old investments."

"companies in old industries are often forced to rely on cuts in payrolls and expenses to maintain an acceptable level of profitability."

The Dow Jones Industrial average has soared 185 percent over the past nine years as new markets, products, and technologies have boosted the earnings potential for the U.S. economy.[1] With this tremendous boom in asset values, one would expect that capital gains tax revenues to the Federal government had soared. However, they have not. Capital gains realizations have stagnated as investors refuse to sell in the face of high capital gains tax rates.

The slowdown in capital gains realizations is directly related to the misguided 1986 increase in the capital gains tax rate. Economists at the Joint Economic Committee (JEC) estimate that $1.5 trillion in capital gains are locked-up in the economy, awaiting a reduction in the capital gains tax rate. The capital gains tax is forcing resources to remain in old technology industries by locking investors up in old investments. In addition, high capital gains tax rates force investors to forego flexibility in investment strategies by pushing them into tax-free investments such as pension funds, 401(k)s, IRAs or trusts.

The effective real capital gains tax rate, even at very low levels of inflation, can be higher than 100 percent because taxes are levied on both real gains and the illusory gains due to inflation.[2] Since many foreign countries tax capital gains very slightly (if at all),[3] U.S. companies must take drastic steps to ensure a great enough return on equity investment in order to attract capital. To achieve such returns, companies in old industries are often forced to rely on cuts in payrolls and expenses to maintain an acceptable level of profitability. At the same time, new industry, which tends to add most new jobs in the economy, must fight for capital and pay more for it.

Cutting the capital gains tax rate and then indexing it for inflation are clear ways to boost economic growth, job creation, and government revenues. Lowering the capital gains tax rate will raise government revenues and shift locked-up capital from old to new investments. The higher revenues and investment shifting may take place immediately or may be stretched over a number of years. Nonetheless, government revenues, even with the lower tax rates, should be significantly higher than in recent years and could easily rise above currently forecasted budget numbers much like they did following the 1982 tax cut.

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THROWING AWAY THE KEY

"realizations have fallen back to levels 35 percent below those ... before the capital gains tax increase."

Because capital gains result only from the sale of an asset and investors decide when to sell, the capital gains tax is a voluntary tax. While investors make decisions based on many different inputs, historical data on capital gains realizations show that tax rates are a significant factor. After the capital gains tax rate was cut to 20 percent in 1982, capital gains realizations during the four years from 1983 to 1986 totaled $763 billion, more than double the $369.2 billion in realizations during the previous five years.[4]

Part of this dramatic gain was due to a surge in 1986 when capital gains realizations shot up 90.6 percent as investors took gains before tax rates went up in 1987. Since 1987, capital gains realizations have fallen back to levels 35 percent below those of the three years before the capital gains tax increase. Even if the 1986 jump in realizations is excluded, capital gains realizations are still 11.5 percent below the pre-tax-hike levels of 1984 and 1985.[5] This decline in realizations has occurred despite record-setting gains in the stock market.

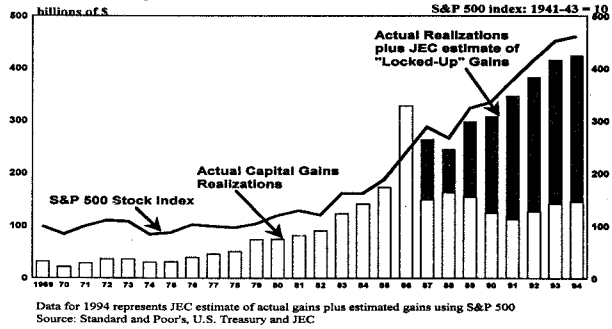
"This decline in realizations has occurred despite record-setting gains in the stock market."

In effect, we threw away the key to investment and economic growth in 1987 when the capital gains tax rate was increased. Between 1985 and 1994, the Standard and Poor's (S&P 500) increased by 146 percent.[6] If capital gains realizations had kept pace with the S&P 500, there would have been $2.7 trillion in realizations between 1987 and 1994. Instead, using any reasonable estimate of actual realizations for 1994, there were less than $1.2 trillion.[7] This suggests that at least $1.5 trillion in capital gains realizations are locked-up or forced into inflexible tax-free investment strategies. Obviously, investors are refusing to sell in the face of punitive tax treatment.

"investors are refusing to sell in the face of punitive tax treatment."

JEC analysis, as can be seen in the chart below, shows the shortfall in capital gains realizations suggested by the stock market gains. These estimates used 1985 realizations as a base, so that the artificial boost in realizations during 1986 did not lead to an overstatement of potential gains.

Capital Gains Realizations and The Stock Market



Data for 1994 represents JEC estimate of actual gains plus estimated gains using S&P 500
Source: Standard and Poor's, U.S. Treasury and JEC

FREEDOM IS THE KEY

"$ 1.5 trillion in locked-up gains can be released to ... create jobs and growth."

Entrepreneurial talent requires resources, and the opportunities today are the greatest they have been in decades. New technology is opening the door to productivity gains and a potential for new products not seen since the Industrial Revolution. By reducing the capital gains tax rate and indexing it for inflation, the $1.5 trillion in locked-up gains can be released to pursue investment opportunities which create jobs and growth as new investors both overseas and at home are enticed into investing in America.

New companies are attracting capital regardless of the current tax system. Nonetheless, given all of the new market potential and the tremendous rise in the stock market during recent years, total investment of venture capital in companies remains below 1986 levels. Venture-backed company investment in 1994 was $2.7 billion, only $60 million higher than in 1985 and $501 million below 1986.[8] And, while initial public offerings (IPO) have increased as the stock market reaches new highs, the 1994 IPO total of 646 is still below the 728 total of 1986.[9]

"cutting the capital gains tax rate has the potential to boost Federal revenues by more than $225 billion."

The benefits to American citizens from a cut in the capital gains tax rate are immense. Increased investment in new technologies will boost productivity, jobs and living standards. At a time when Congress is getting serious about balancing the budget, cutting the capital gains tax rate has the potential to boost Federal revenues by more than $225 billion above current estimates, which is seven years of capital gains tax revenue at the current pace.[10] These estimates of revenue depend only on capital gains and do not attempt to measure any boost to economic growth from a cut in capital gains tax rates.

CONCLUSION

High capital gains tax rates have led to a dramatic decline in realizations and new investment despite gains in the stock market and the potential of new technologies. Locked-up capital gains point to higher revenues and more investment in new technology if capital gains tax rates are cut. In order to free the American economy and unlock investment, the capital gains tax rate must be reduced. Only by doing so can the United States ensure that new technology can flourish and increase opportunities for all Americans.

This report, by Senator Connie Mack, appeared in the *Wall Street Journal* on August 29, 1995.

Staff Contacts: Brian Wesbury, Chief Economist, and Jeffrey Given, Economist (202) 224-5171.

Endnotes:

[1]Haver Analytics.
[2]JEC Economic Policy Update, "Capital Gains Tax: Fairness?" by Brian Wesbury and Jeffrey Given.
[3]Price Waterhouse, "Individual Taxes: A Worldwide Summary," 1994 edition.
[4]U.S. Department of the Treasury, Office of Tax Analysis.
[5]U.S. Department of the Treasury, Office of Tax Analysis; Joint Economic Committee.
[6]Standard & Poor's.
[7]The $2.7 trillion figure is based on 1985 realizations growing by the same percentage as the S&P 500 on a year-to-year basis. The $1.2 trillion comes from the U.S. Department of the Treasury, Office of Tax Analysis (along with a JEC estimate for 1994).
[8]Securities Data Company.
[9]*Ibid.*
[10]$1.5 trillion in locked up gains x 20 percent tax rate adjusted for offsetting losses.

Chapter Three

Budget Policy & Economic Growth

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

Robert N. Mottice
Executive Director

ECONOMIC POLICY UPDATE

Issued By:
JEC Majority Staff
November 1995

BALANCED BUDGET... BIG SAVINGS FOR AMERICAN FAMILIES

The benefits to American families from the Republican budget plan will be substantial and far-reaching. With a locked-in balanced budget and the government taking a smaller bite out of the economy, interest rates should come down dramatically. A typical American family could save nearly $1,800 *a year* in loan payments as a result of the Republican plan.

The day Republicans won control of Congress, 30-year Treasury bonds were trading at 8.16 percent, their highest level in more than two years. It marked the end of one of the worst years in the bond market's history. Since then, interest rates have fallen consistently as markets have anticipated the effects of the Republican economic plan. Recently, the 30-year bond was yielding 6.25 percent, a decline of almost 2 full percentage points.

This drop in interest rates has lowered the cost of home mortgages and car loans, and has also led to a dramatic increase in the price of stocks and bonds. With interest payments down and the value of pension funds, savings, and IRAs up, American families' financial future has begun to brighten.

Passing the Republican economic plan will lock in these financial gains, and should lead to another one percentage point drop in interest rates. What does this mean for the average family in America? Below, we have attempted to conservatively estimate what the Republican economic plan would mean for American families in terms of interest rates alone.

THE $1,800 ANNUAL BONUS

The attached charts show the lower monthly payments for home, automobile and student loans and the annual savings for American families. The comparisons show the benefit from the drop in interest rates since November 8, 1994, and the benefits that would result from:

i) a further one percent drop, and
ii) a return to the interest rate levels that prevailed in the 1950s, when the budget was in balance and the Federal Reserve focused on price stability.

A family with a $75,000 mortgage, a $15,000 auto loan and an $11,000 student loan could save $1,771 a year if interest rates drop another percentage point under the Republican plan, and $2,828 a year if interest rates return to the levels of the 1950s.

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2

In the aggregate, total consumer borrowing for home mortgages and auto debt is $4.775 trillion, and growing, so savings for families from a one percentage point drop in interest rates would be $48 billion per year. Over seven years, that would mean more than $336 billion back in the pockets of American families -- a benefit of comparable size to the tax cuts. And if rates fall back to the level of the 1950s, savings could be double that.

Putting government back on a path toward fiscal responsibility will also benefit American families in large and dramatic ways. With an outstanding federal debt of $4.9 trillion, if the government can refinance that debt at these lower interest rates, taxpayers will save $49 billion per year in future tax payments.

Monthly Payments for Consumer Loans[1]				
	November 8, 1994	Current Rates expecting GOP Plan	Balanced Budget Rates w\ GOP Plan	1950s Era Rates
Mortgage[2] ($75,000 30yr)	$613	$535	$484	$414
Auto Loan[3] ($15,000 4yr)	$384	$377	$370	$363
Student Loan[4] ($11,000 10yr)	$136	$139	$131	$120
Totals	$1,132	$1,051	$985	$897
Annual Savings		**$979**	**$1,771**	**$2,828**

1. Numbers for monthly payments and annual savings differ slightly due to rounding.

2. Mortgage rates used are from left to right in table 9.17%, 7.7%, 6.7%, and 5.25%.

3. Auto loan rates are from left to right in table 10.5%, 9.5%, 8.5%, and 7.5%.

4. Used a typical loan outstanding for undergraduate loans in the PLUS loan program and calculated loan payments as 1-year T-bill plus 3.1% (As reflected in the Senate passed Reconciliation bill). (Rates from left to right are 8.38%, 8.98%, 7.6%, and 5.6%)

APPENDIX:

IS A FURTHER DROP IN INTEREST RATES REALISTIC?

The growing consensus among credible economists is that instituting fiscal and monetary restraint and shrinking the government will lower interest rates dramatically. The simple prospects of balancing the budget at a smaller share of GDP and a Federal Reserve focused on price stability have already brought interest rates down and could lower them much further in the future.

Robert Lucas, the 1995 Nobel Laureate in Economics, has stated that rational expectations can cause individuals to react in advance of a policy change if they believe such a policy will actually occur. This is why interest rates have continued to fall during recent weeks despite President Clinton's dire predictions as the federal debt approaches the debt ceiling.

Since election day last year when it became clear that Republicans would have the chance to keep their promises about cutting taxes and balancing the budget, interest rates have dropped a remarkable two percentage points. Keeping those promises would lock those gains in place and help Americans realize even lower interest rates in the future.

Federal Reserve Board member Lawrence Lindsey has said that recent drops in interest rates reflect "maybe half" of the decline that could be expected if a credible package to balance the budget is implemented. In addition, he stated that by the year 2002, if "The Fed has engineered price stability...and we have balanced the budget as far as the eye can see. That's the 1950's...You'll have the 5 1/4 percent mortgages that our parents got and you'll have long bonds in the 4 to 4½ (percent) range and the short end in the 2½ percent range".

WHY ARE INTEREST RATES FALLING?

Interest rates are very sensitive to inflationary expectations. As a result, the financial markets watch the Federal Reserve closely to determine if its policies are likely to increase or decrease inflation in the future. Under current legislation (i.e. The Humphrey-Hawkins Act), the Federal Reserve is required to manage monetary policy to maximize employment. Therefore, when fiscal policy increases the burdens on the economy and threatens to slow growth, the Fed must attempt to offset those negative effects by artificially lowering interest rates.

Inflation is best defined as too much money chasing too few goods. Increased taxes and government interference in the economy lower the amount of goods and services produced. Attempting to boost the economy by using monetary policy increases the supply of money. The policy mix of easy money and government growth is a recipe for inflation, and causes the bond market to react negatively. Deficits increase the threat that taxes will rise in the future. Higher future taxes represent a burden on long-term growth which threatens to increase inflation. In addition, deficits increase the odds that the Federal Reserve will monetize the debt sometime in the future. As a result, investors protect themselves from potential future inflation by boosting real interest rates.

During the past 16 years, government bond yields have averaged 4.5 percent above the actual annual inflation rate. This is almost four times the 1.2 percent cushion that bond investors demanded between 1960 and 1979. Intractable deficits and the potential for activist monetary policy have caused investors to factor an inflation premium into interest rates, driving up the costs of borrowing for families, businesses and government.

The Federal Reserve is winning back the confidence of investors, Republicans are cutting spending and reducing the deficit, and interest rates are beginning to come down. But the economy will not receive the full benefits of falling interest rates unless serious fiscal reform is combined with a primary focus by the Fed on price stability.

ISN'T THE DEFICIT ALREADY COMING DOWN?

President Clinton points to the decline in the deficit in recent years as evidence that his plan of higher taxes and slower spending has already reduced the deficit, and claims credit for falling interest rates and continued economic growth. However, even though the deficit has improved in recent years, the Congressional Budget Office estimates that under current law the deficit will rise to over $400 billion per year soon after the turn of the century.

The bond market understood this in 1994. After falling dramatically in 1993 on the hope that the deficit would come down, interest rates shot up in 1994 as investors realized that any deficit reduction the Clinton Administration might offer would be short-lived. Interest rates rose more dramatically in 1994 than in almost any other year in American history.

The dramatic turnaround in interest rates that began November 8, 1994 is a clear signal that investors have changed their beliefs about the future direction of policy. However, in order to guarantee an additional reduction in rates in the future, a credible balanced budget plan must be adopted and signed into law.

Monthly Payments for Consumer Loans (with $120,000 mortgage)

	November 8, 1994	Current Rates expecting GOP Plan	Balanced Budget Rates w\ GOP Plan	1950s Era Rates
Mortgage ($120,000 30yr)	$980	$856	$774	$663
Auto Loan ($15,000 4yr)	$384	$377	$370	$363
Student Loan ($11,000 10yr)	$136	$139	$131	$120
Totals	$1,132	$1,371	$1275	$1,145
Annual Savings		**$1,540**	**$2,697**	**$4,257**

Monthly Payments for Consumer Loans (with $55,000 mortgage)				
	November 8, 1994	Current Rates expecting GOP Plan	Balanced Budget Rates w\ GOP Plan	1950s Era Rates
Mortgage ($55,000 30yr)	$408	$356	$323	$276
Auto Loan ($15,000 4yr)	$384	$377	$370	$363
Student Loan ($11,000 10yr)	$136	$139	$131	$120
Totals	$928	$872	$824	$759
Annual Savings		**$667**	**$1,256**	**$2,034**

Prepared by Chief Economist Brian S. Wesbury and Economist Jeffrey S. Given

Joint Economic Committee

U.S. SENATOR Connie Mack
CHAIRMAN

ISSUED BY:
JEC MAJORITY STAFF
March 1996

Robert N. Mottice
Executive Director

ECONOMIC
POLICY
UPDATE

FOCUS ON RUNAWAY SPENDING NOT CLASS WARFARE

The Clinton Administration and Democratic congressional leaders continue to hide behind the smokescreen of class warfare to criticize both Republican tax relief and spending reduction efforts. Stale as this "rich vs. poor" theme may seem, it has taken on a life of its own, as if the "rich" are culpable for our nation's fiscal woes. The genuine problem is the sheer level of federal spending growth, not the tax burden levied on the rich verses the poor or middle-class. Because runaway spending has reached such mammoth levels, even if the tax burden on the "rich" was doubled, Uncle Sam would spend every penny of the additional money in less than a month. This year, federal spending will consume more than $4.3 billion per day--$446 million per day of that in deficit spending.[1]

"The genuine problem is the sheer level of federal spending growth, not the tax burden levied on the rich verses the poor or middle-class."

FORGET THE WEALTHY

No matter what you've heard, there are simply not enough wealthy taxpayers to generate enough revenues to continue feeding the government's mushrooming spending and to close our deficit gap. Based on the latest available tax return data, in 1993, 65,646 taxpayers had adjusted gross incomes of $1 million or more.[2] That may seem like a lot, but it's less than 0.06 percent of all taxpayers. Even if the government doubled their tax bills, the extra $51.5 billion extracted from them would be enough to run the federal government for only 12 days. This of course assumes that these folks will continue to work as hard and pay up even if their taxes were doubled.

Well, you could expand the "rich" category to include all those with incomes of $500,000 or more. Now, you might think you're really rolling in the tax dough. Not exactly. If they doubled taxes on everyone earning $500,000 or more that would be enough to feed Uncle Sam's spending appetite for only 19 days.

Obviously, there aren't enough half-millionaires either. So let's look at the popular Democratic target so often scrutinized in the tax relief debate -- those earning $200,000 or more. Will that do the trick? No way. The increased revenues commandeered from doubling the tax burden on every person and family making $200,000 or more would be completely gobbled up by federal spending in little more than a month, or 32 days to be exact. In fact, even socking it to every $100,000 and

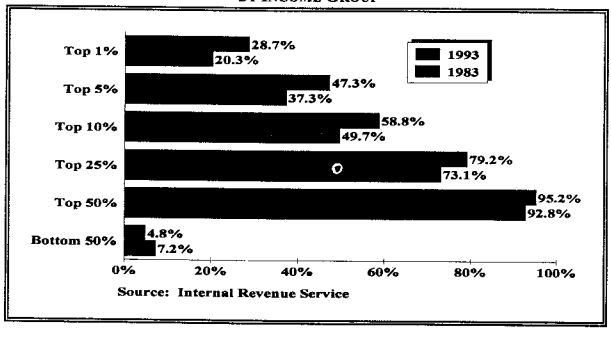
above tax filer by doubling their tax burden would last the spendthrift federal government just seven weeks.

"...the real fiscal problem facing our nation is the federal government's ferocious spending appetite that now exceeds $4.3 billion per day and growing."

This exercise shows why the real fiscal problem facing our nation is the federal government's ferocious spending appetite that now exceeds $4.3 billion per day and growing. Yet, Democratic defenders of the status quo continue to fuel class warfare to block spending reduction and tax relief solutions. This only confirms that they still believe government doesn't spend too much but that people are taxed too little. The reason most cited for this philosophy is that the "rich aren't paying their fair share."

Not true. High-income earners continue to pay a large and growing share of the rising tax burden. Figure 1 shows that in 1993, the top 5 percent of earners paid 47.3 percent of the federal income tax burden. That's up a sharp 10 percentage points from the 37.3 percent they paid in 1983. The top 10 percent of earners saw their share of the tax burden rise from 49.7 percent in 1983 to 58.8 percent by 1993. By contrast, the bottom 50 percent of income earners saw their percent of the federal tax burden fall from 7.2 percent to 4.8 percent between 1983 and 1993. And, effective tax rates remain steeply progressive, despite what the critics say. They range from less than 5 percent for the lowest 50 percent of income earners up to 27.7 percent for those in the top 1 percent.

FIGURE 1
PERCENT OF FEDERAL INDIVIDUAL INCOME TAXES PAID BY INCOME GROUP



"High-income earners continue to pay a large and growing share of the rising tax burden."

Due to President Clinton's 1993 tax hikes, the share of the tax burden at the high-end will likely increase as new data becomes available. Marginal tax rates that were set at 15 percent and 28 percent just a few years back now reach as high as 45 percent. Yet, deficit spending still outpaces higher levels of tax revenues. What that tells us is that we should be focusing on reducing the tax burden and runaway spending, not class warfare.

FRESH APPROACH

"Tax relief is not an optional idea in balancing the federal budget—it is essential."

In 1982, 1984, 1987, 1989, 1990 and 1993 deficit reduction budget deals paired promised spending cuts with tax increases. The persistent deficits that have resulted speak for themselves. Fortunately, a fresh Republican budget approach would finally reduce the size and scope of the federal government by reducing both spending and the tax burden. Tax relief is not an optional idea in balancing the federal budget--it is essential. When Presidents Kennedy and Reagan cut taxes, it resulted in two periods of our nation's most robust economic growth and windfall revenues for the Treasury.

The Democrats' promotion of class warfare designed to pit the rich against the middle-class and poor has not and will not reduce the federal tax burden, spending and deficits. Efforts to thwart federal tax relief and spending reduction plans can only hurt the middle-class. Ninety-three percent of taxpayers have annual incomes of less than $75,000. Because the greatest number of taxpayers fall into the broad middle-class, they will continue to pay for the bulk of runaway government spending. This is because, as the famous bank robber Willie Sutton said about banks, "that's where the money is." Therefore, only through the reductions in both government spending and the associated tax burden would the middle-class realize genuine relief.

"When Presidents Kennedy and Reagan cut taxes, it resulted in two periods of our nation's most robust economic growth and windfall revenues for the Treasury."

LOWER TAXES AND SPENDING = SURPLUS

Those who claim we cannot successfully reduce the tax burden while curtailing spending simply choose to ignore history. Today, the federal government spends 22 percent of GDP, runs a $160 billion deficit, and takes 28 percent in federal taxes from the family budget. In 1960, the federal government spent 18 percent of GDP, had a $300 million surplus, and total federal taxes on the typical family were 21 percent. Simply stated, Uncle Sam had no deficit problems with lower taxes on families and less spending. Class warfare rhetoric is no reason to prevent the Republican balanced-budget agenda from accomplishing this same fiscal balance today.

Prepared by Paul G. Merski, Economist, Joint Economic Committee. (202) 224-5171

Endnotes

1. Office of Management and Budget, Mid-Session Review of the FY 1996 Budget.
2. Internal Revenue Service, Statistics of Income Bulletin; preliminary 1993 data.

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

Robert N. Mottice
Executive Director

ECONOMIC POLICY UPDATE

ISSUED BY
JEC Majority Staff
March 1996

THOUGHTS ON CLINTON'S BUDGET

You've probably been inundated recently with information about president Clinton's latest budget. Here are a few things to keep in mind:

BORROW, BORROW...SPEND, SPEND

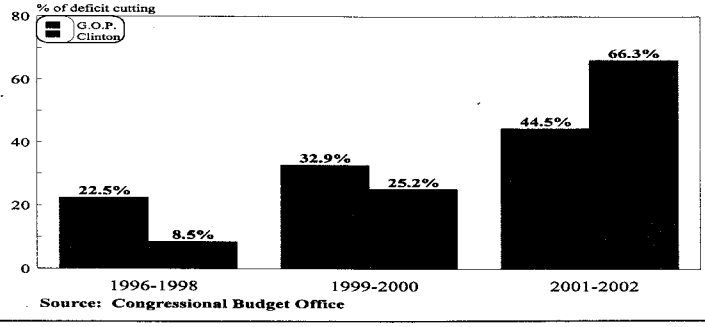
- Under Clinton's budget, federal spending will rise 24 percent by 2002, to almost $1.9 trillion.

- By 2002, total federal debt will soar by one-third, to at least $6.5 trillion. And that's only if his rosy economic assumptions come true, and not the more realistic assumptions Congress is using.

DEFICIT SHENANIGANS

- Clinton's deficit cuts are heavily backloaded, with two-thirds of his "deficit reduction" coming in the last two years and almost 40 percent coming in the last year. In other words, Clinton would leave the "dirty work" to future lawmakers and presidents.

CLINTON'S BACK-LOADED BUDGET PLAN



Source: Congressional Budget Office

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TAXES

- According to CBO, Clinton's budget would cut taxes by less than $40 billion over seven years, compared to Republican tax cuts of over $200 billion.

- Clinton's stingy tax cuts would hardly touch the amount Americans send to Washington each year. In 1995, federal revenue amounted to 19.1 percent of GDP. In 2002, under Clinton's tax cut, how much revenue would the federal government take? You guessed it -- 19.1 percent!

DISCRETIONARY SPENDING

- Clinton's defense budget would hurt readiness both today and in the future. Last year, the U.S. spent 3.6 percent of GDP on national defense. By comparison, defense made up 4.7 percent of GDP in President Bush's last budget. By 2002, Clinton would slash this to 2.6 percent, which would be the least we've spent on the military in more than 60 years, going back to the isolationist era before World War II.

- If the Congressional Budget Office finds that Clinton's plan won't reach balance by 2002, any additional deficit cutting would come out of discretionary spending, meaning even deeper defense cuts.

ENTITLEMENTS

- Clinton would increase Medicaid and Medicare spending by a yearly average of 7.7 percent, while the economy as a whole would grow at only little more than 5 percent per year. This 7.7 percent path would head the country toward national bankruptcy. Combined, spending on these programs would more than double with each passing decade, consuming an ever-larger share of both the budget and the economy.

- The Republican budget offered seniors more choices through innovative plans like Medical Savings Accounts. Clinton vetoed that plan, and his budget failed to offer any meaningful efforts to reform these programs.

UNREALISTIC ASSUMPTIONS

- Clinton's plan makes unrealistic economic assumptions in order to get to balance. For example, Clinton's budget team assumes interest rates for 10-year Treasury Notes will average 5.6 percent this year. Today, this interest rate is almost 6.3 percent.

Contact: Bob Stein, Economist, (202) 224-5171

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

ECONOMIC POLICY UPDATE

ISSUED BY
JEC Majority Staff
March 1996

Robert N. Mottice
Executive Director

CLINTON'S DEFICIT DECEPTION

"... the deficit is lower than when he took office. But this drop has had little, if anything, to do with Clinton. If his policies alone were at work, the deficit would have grown since he took office, not shrunk."

President Clinton claims he's cut the deficit three years in a row -- the first time that's happened since Harry Truman was in office. Clinton may soon claim a fourth, based on his latest budget plan. True, the deficit *is* lower than when he took office. But this drop has had little, if anything, to do with Clinton. If his policies alone were at work, the deficit would have *grown* since he took office, not shrunk.

WHY SHOULDN'T CLINTON GET CREDIT?

"President Clinton has taken credit for this three-year drop. But the facts contradict his claim."

- The first year of deficit reduction happened under President Bush's last budget, passed before Clinton took office. In fact, this last Bush deficit would have been even lower were it not for policy changes made by Clinton.
- Rather than changes in policy, technical factors make up the lion's share of Clinton's supposed deficit cutting. These technical factors include lower than expected spending on Medicaid and Medicare and revenue from the sale of property gathered during the S&L bailout.
- Changes in the economy also have eased the deficit a bit. But the meager deficit cutting that has come from the economy doesn't owe anything to Clinton's policies.
- Moreover, by continuing the tactic of using increases in the Social Security Trust Fund surplus, the true size of the underlying deficit remains masked.
- Deficit cuts for this year are due to Republican efforts to balance the budget by 2002. The deficit would be even lower were it not for Clinton's roadblocks.

WHAT'S DRIVING THE DEFICIT DOWN?

In fiscal year 1992 the federal government ran a $290 billion deficit. Since then, it's reported lower deficits: $255 billion in fiscal 1993, $203 billion in 1994 and

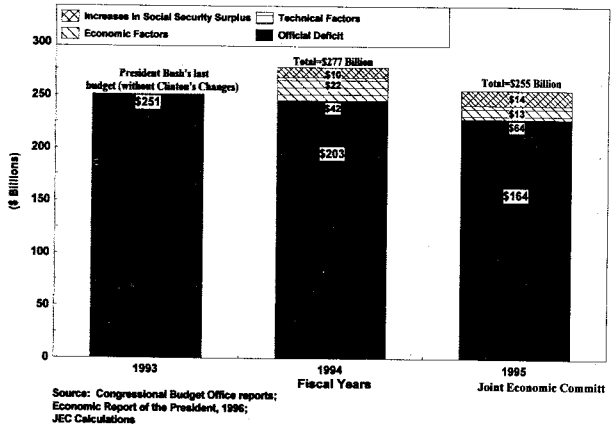
$164 billion in 1995. President Clinton has taken credit for this three-year drop. But the facts contradict his claim.

"... policy changes enacted under Clinton and a majority Democrat Congress actually raised the 1993 deficit by $4 billion."

The first year of deficit reduction -- from $290 billion to $255 billion -- came under President Bush's last budget. Although President Clinton was in office for most of fiscal year 1993, that budget was passed before he was even elected. Worse, policy changes enacted under Clinton and a majority Democrat Congress actually raised the 1993 deficit by $4 billion.[1] In other words, Bush bequeathed Clinton a budget with a deficit of $251 billion. That's the starting point from which Clinton's deficit cutting skills should be judged.

Based on this $251 billion standard, Clinton could try to claim two straight years of deficit reduction, but only if we look at the *official* deficit. A totally different picture, much less flattering to Clinton, is revealed if we look at what the deficit would have been if only Clinton's policy changes were at work and if the Social Security Trust Fund were not used to make the deficit look smaller. Adjusting for the drop in the deficit due to technical factors, economic factors and the use of Social Security shows that the underlying deficit has grown under Clinton, not shrunk.

THREE YEARS OF DEFICIT CUTTING?



DEFICIT SLIGHT OF HAND

What are the "technical" factors that have cut the deficit? These have nothing to do with actual changes in policy or the economy, and include things like the cleanup of savings and loans and lower than expected spending on Medicare and Medicaid. For example, when states change their Medicaid policies in a way that cuts spending by the federal government this is included as a technical factor that cuts the deficit.

"A totally different picture, much less flattering to Clinton, is revealed if we look at what the deficit would have been if only Clinton's policy changes were at work and if the Social Security Trust Fund were not used to make the deficit look smaller."

How important are these technical factors? Very. The official deficit for 1995 was $164 billion. But, from the time Clinton took office, technical factors lopped $64 billion off this figure, most of which was attributable to lower than expected spending on health care programs and the bailout of savings and loans. (The bailout cost the government a great deal in the early years. In recent years, however, it has generated revenue as property taken over by the government has been sold.)

Were it not for these factors, which were completely out of Clinton's control, the official 1995 deficit would have been $228 billion. And that's not even accounting for economic factors or the use of Social Security.

Economic factors, such as lower interest rates in 1993 and better economic growth in 1994, account for $13 billion in deficit reduction for 1995. Were it not for these, when piled atop the technical factors, the deficit for 1995 would have been $241 billion, a mere stone's throw from where Bush left off.

"Should Clinton get credit for lower interest rates and more economic growth? No."

Should Clinton get credit for lower interest rates and more economic growth? No. His administration argues that his budget lowered interest rates, which stimulated growth. But the fall in rates in 1993 was nothing more than the extension of the fall that started in 1990, under Bush. Soon after Congress passed Clinton's tax hike, rates on 30-year Treasury bonds started moving back up, from less than 6 percent in October 1993 to more than 8 percent by November 1994. Since Republicans won control of Congress rates have moved back down, to about 6.7 percent.

"Without this tactic, as well as technical and economic factors, the deficit would have been $255 billion – $4 billion more than the deficit he inherited from President Bush."

That's where Social Security comes in. In the early 1980s, social security taxes were raised so its revenues would exceed its costs, yielding a surplus. One problem: official reports of the deficit include these surpluses. That means if Social Security were treated like the separate system it's supposed to be, by not counting these surpluses in the overall budget, then the official deficit would be even higher. Clinton is using this to his advantage. The social security surplus in 1995 was $14 billion higher than its 1993 level, giving Clinton another way to mask the true size of the underlying deficit. Without this tactic, as well as technical and economic factors, the deficit would have been $255 billion -- $4 billion more than the deficit he inherited

CONCLUSION

"In order to tout deficit reduction, Clinton has to use surpluses in social security, take credit for a budget passed under another president and ignore the technical and economic factors that affect the budget deficit."

In order to tout deficit reduction, Clinton has to use surpluses in social security, take credit for a budget passed under another president and ignore the technical and economic factors that affect the budget deficit. If not for these, both of his budget deficits would have surpassed the one he inherited from President Bush.

Prepared by Robert S. Stein, Economist, Joint Economic Committee. (202) 224-5171

Endnotes:

Congressional Budget Office, The Economic and Budget Outlook, September 1993. Added spending included extended unemployment spending enacted in March 1993 and a supplemental appropriations bill enacted in August 1993.

THE GROWTH DEBATE:

How Fast Can We Grow?

Prepared by
The Joint Economic Committee
August 1996

http://www.senate.gov/~jec/grwthdeb.html

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Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)
Washington, DC 20510–6602

MEMORANDUM

TO: SENATE REPUBLICAN COLLEAGUES
FROM: Senator Connie Mack
RE: The Growth Debate
DATE: August 8, 1996

Today's national debate about economic growth is fundamental to America's future. It is significant that America now debates the pace, rather than the possibility of economic growth. The Republican-led Congress has been the key to moving the growth debate in the right direction.

President Clinton and his Administration argue for status quo growth -- they claim that this economy is growing as fast as it possibly can. But despite their rhetoric to the contrary, this is the slowest economic expansion in more than a century! Bill Clinton's economic policies are robbing America of its full growth potential.

Republicans know we can do better. History shows us that with reduced taxes, less government spending, fewer burdensome regulations and more freedom for people to make their own decisions about saving and investing, Americans enjoy a more robust economy. Only vigorous growth will produce hope, opportunity and higher living standards for everyone.

The growth debate will likely be the subject of considerable attention in your state. To help clarify some of these arguments, I am sending you this packet which contains several pieces of information I hope you will find useful. It includes:

- An adaptable op-ed that illustrates our pro-growth vision and the sound economics behind it;
- An analysis of tax cuts and tax revenues;
- A comprehensive analysis of Clintonomics;
- What Democrats are saying about today's anemic growth;

If you have any questions about this information, please contact the JEC at 224-5171. In the months ahead, the JEC will make every effort to provide you with updated economic information on these and other subjects.

A Pro-Growth Vision for America

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

A PRO-GROWTH VISION FOR AMERICA

The current economic debate revolves around two schools of thought. The "status quo" school dictates that this economy is as good as it gets. The "we can do better" school embraces the ideas that America can and must do better, that middle class families are bearing the burden of an anemic economy, and that it *is* possible to improve our economy through more robust economic growth. Bill Clinton represents the status quo thinkers; Republicans stand for change and a better tomorrow.

Republicans believe that a brighter economic future requires a pro-growth economic plan that provides greater independence for the American family. Pro-growth policies such as a meaningful income tax cut, significant capital gains tax relief, a pro-family tax credit, and an honest balanced budget plan will free the American people and America's economy from the burdens of a bloated government and an oppressive tax system. A vital economy will provide Americans with the opportunity to save, succeed and make their own decisions about their own hard-earned tax dollars.

Despite Clinton Administration rhetoric that we are experiencing the best economy in three decades, the facts tell a very different story. The truth is, this is the slowest economic expansion in more than a century! Bill Clinton's record tax hike, his increased government spending and regulating, and his veto of the Republican's balanced budget have robbed America of its full economic potential. As a result, incomes have stagnated or declined. The tax burden is at a record high, interest rates have risen, and real median family incomes have fallen. Many families are paying more in taxes than they spend on food, clothing and housing combined. The number of people working two or more jobs has increased dramatically in recent years. Today's families are working as hard as they can just to keep up. No wonder Americans are anxious about this economy.

America needs a pro-growth plan that addresses our nation's core economic problem -- anemic growth. However analyzed, economic growth under President Clinton pales in comparison to historic growth rates. Whether compared with the year before he entered office, the decade before, the last five economic expansions or the 1947-1992 postwar period, Clinton's economy has been lackluster at best. Simply stated, weak growth under Clinton has stymied wage increases and the creation of high paying jobs. Slow economic growth costs real people real money. According to the latest research by Congress's Joint Economic Committee, Clinton's economic growth gap will cost each household $3,116 in 1996 alone -- that's $260 a month.

The basic difference between a Republican approach to economic growth and that of the Clinton Administration is that Republicans understand that government does not create economic

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growth -- it can only affect the climate in which prosperity is either fostered or frustrated. Free individuals, through their creative ideas, risk taking and hard work, create growth and boost living standards for all Americans. For too long, big government has stifled the dreams of hard-working Americans. The arrogance of a Washington bureaucracy believing it can solve people's problems by taking more of their hard earned money must come to an end. A free-market, pro-growth package will help return more money and power back to its rightful owners -- the American people.

To meet the challenge of boosting economic growth and living standards, it is imperative that we reduce the massive government drag placed on hard working individuals, families, and businesses. Reducing marginal tax rates is a necessary first step toward the goal of stronger growth. Lowering marginal tax rates will provide immediate relief for every American. Capital gains tax relief will free up more job producing investment and make America more competitive internationally. A pro-family tax credit will provide working families with incentives to save for their children's educations.

Finally, any comprehensive pro-growth plan must include an honest approach to balancing the federal budget. A strong economy and a pro-growth economic agenda will make balancing the budget that much easier. Once enacted, a Balanced Budget Amendment to the Constitution will be a guarantee to the American people that government spending will get under control and stay that way.

In the meantime, what is President Clinton doing for anxious workers? He's working hard to preserve the destructive status quo, and "feeling America's pain" while simultaneously claiming that this is "the best economy in three decades." The American people know we can do better. America needs a pro-growth agenda that will make this economy as strong as it should be, bring the budget into balance, and create unprecedented opportunities for every American.

The status quo just doesn't work, and Americans won't tolerate it. History has proven that hard working Americans, not big government, hold the key to stronger economic growth and a better future. Independence for every American from the tyrannies of heavy taxation and burdensome regulation will result in unbridled opportunity, prosperity and hope for future generations.

The Anemic Economy

TODAY'S ANEMIC ECONOMY

The current expansion, which began in the second quarter of 1991, is the SLOWEST of any in more than a century.

Clinton's Growth Gap. Economic growth of only 2.4% per year under President Clinton has lagged well behind the normal growth rates of the past. For example, the economy grew an average of 3.2% per year in the decade before Clinton took office, 4.4% in the last five expansions and 3.7% in the year before Clinton took office. This lost GDP translates into $3,116 for each American household this year alone!

Just what has this meant for America's economy, families, and workers? Here's the picture:

Stagnant Income. The typical household has suffered during the Clinton years. Real median household income averaged $33,119 in the decade before President Clinton took office. By contrast, it has averaged $966 *less* ($32,153) under President Clinton (through 1994, the latest data available.) Workers' wages and benefits have *declined* during the Clinton years after growing steadily during the previous decade.

High Taxes. Taxes are taking a bigger bite of family incomes than ever before. While after-inflation, after-tax incomes grew at a yearly rate of 3.2% in the decade before President Clinton took office, disposable income growth has *slowed* to only 1.8% per year during the Clinton era. It's not surprising that the share of our nation's income going to federal taxes is now at the second highest level since WWII -- exceeded only in the year before the Reagan tax cuts began.

Higher Interest Costs. Since President Clinton's veto of the Republican balanced budget plan, interest rates have spiked nearly one full percentage point. This can cost families *more* than $50 per month for extra payments on mortgages and auto loans.

Future Looks Bleaker. Standards of living ultimately depends on how productive people are. In turn, this depends on how much investment capital they have to work with. Under President Clinton, net private domestic investment as a share of GDP has been about 30% *lower* than the average over the past five economic expansions. Naturally, productivity has suffered, growing at only one-fifth of the pace set in the decade before President Clinton took office.

Prepared by Joint Economic Committee staff: Paul G. Merski, Chief Economist; and Robert S. Stein, Economist. (202) 224-5171

FACTS ABOUT THE ECONOMY

ECONOMIC GROWTH

- Compared to the year before President Clinton entered office, the decade before, the last five expansions, or the entire post-war period (1947-1992), economic growth under President Clinton has been abnormally low.

- 1996 GDP has fallen behind by some $308 billion, costing each American household $3,116 this year alone. That is Bill Clinton's growth gap.

ECONOMIC EXPANSION

- The current expansion, which began in the second quarter of 1991, is the slowest of any in more than 100 years, remaining nearly two full percentage points lower than the average real GDP growth attained during the last six economic expansions.

REAL MEDIAN HOUSEHOLD INCOME

- In the decade before President Clinton took office, America's real median household income averaged $33,119. During the Clinton Administration, however, real median household income has averaged only $32,153 (through 1994, the latest data available).

REAL HOURLY COMPENSATION

- Under President Clinton, real hourly compensation (wages and benefits) has declined. Weak economic growth is especially hurting middle-class working Americans who depend on wage and benefit increases to maintain their standards of living.

JOB LOCK

- Slow economic growth under President Clinton has fostered "job lock." Workers fear voluntarily leaving their current jobs because they don't believed there will be better jobs around the corner.

- The share of voluntary job leavers as a percentage of all unemployed is 16 percent lower than at the end of the last recession. During normal economic expansions, as more jobs are created, people are more confident in leaving their current job to look for new jobs that offer greater opportunities for advancement and pay.

REAL DISPOSABLE INCOME

- Under President Clinton, real after-tax incomes have risen at almost half the pre-Clinton rate: 1.8 percent versus 3.2 percent.

PRODUCTIVITY

- Better productivity is the key to attaining higher wages and benefits. Unfortunately, productivity growth has virtually stopped under President Clinton. At an average annual growth rate of .27 percent, productivity is growing slower during this expansion than during any other in recent history.

INVESTMENT

- Net investment is essential for economic growth because it allows American firms to boost production, create jobs, raise wages, and expand their business.

- Under President Clinton net investment has been almost 2 percent of GDP lower than during the last five expansions, and 1.5 percent lower than the previous thirty years.

LABOR FORCE

- As more potential workers become discouraged, the labor force declines and the growth of goods and services that can be produced diminishes.

- During President Clinton's expansion, the employment to population ratio has increased at half the rate of the previous expansion, and at present there are more than 1.5 million Americans who no longer consider themselves part of the labor force.

TAXES AS SHARE OF 1995 FAMILY BUDGET

- The typical American family - two incomes and two or more children - pays more in total taxes than it spends on food, clothing and housing combined. That's over 38 percent for total taxes versus 28 percent for food, clothing, and housing.

TAX DEDUCTIONS AND EXEMPTIONS

- Inflation has eroded the value of the standard deduction and personal exemptions for each member of the family, causing an effective increase in the tax burden.

- If the standard deduction and personal exemptions had merely kept pace with inflation since 1950, a typical family with two children would pay $1,012 less in federal income taxes today.

GOVERNMENT RECEIPTS AS A SHARE OF GDP

- In 1995, total government receipts represented a record share of America's total income: 31.4 percent.

- The federal income tax burden alone jumped from 19 percent of GDP in 1993 to an estimated 20.5 percent today.

TOP MARGINAL TAX RATE

- In 1993, President Clinton levied the largest tax increase in history, including higher taxes on Social Security recipients, steep income tax hikes on individuals and small business owners, and higher taxes on gasoline.

- This total tax increase was $241 billion, and the top marginal tax rate was increased as much as 14.5 percent percentage points (from 31 percent to 45.5 percent) for many individuals and small businesses.

TAX FREEDOM DAY

- Tax Freedom Day for the typical American worker didn't arrive until May 7 this year -- the latest day ever. This means that Americans worked from January 1 thru May 7 just to earn enough to pay all federal, state and local taxes.

- Since 1950, the typical American has forfeited more than an extra month's work to cover the growing cost of taxes.

REGULATORY COSTS

- Total federal regulatory costs are estimated at nearly $7,000 per household in 1996.

- While federal regulatory costs per household dropped from $7,495 in 1980 to $6,020 in 1988, they have since climbed back up to $6,831 today.

INTEREST RATES

- Higher interest rates can force families to pay more for home mortgages, car loans, and student loans. On November 8, 1994 interest rates turned downward as investors anticipated lower taxes, less federal spending, and a faster growing economy.

- Since President Clinton's veto of the Republican balanced budget plan and his refusal to adopt pro-growth policies, interest rates have spiked nearly one full percentage point; adding more than $50 per month on a typical mortgage or auto loan.

PERSONAL BANKRUPTCY FILINGS

- As many as 1.1 million people are expected to declare personal bankruptcy in 1996, the highest level in more than 16 years.

CONSUMER DEBT

- Under President Clinton total consumer debt has increased from $730.8 million in 1992 to $1.024 billion in 1995.

Joint Economic Committee.

HOW HEALTHY IS THIS ECONOMY? WHY NOT ASK THE DEMOCRATS?

While President Clinton and his advisers try to crow about the economy, outside the White House there is bi-partisan disappointment:

"...when I go home, I hear a lot of anxiety from farmers, small business people, and families just trying to make a living wage. In fact wages have stagnated for many middle-class working families. Every year it seems harder and harder to make ends meet."

- Senator Tom Daschle, D-SD, 6/20/96

"We have had growth. It has been comparatively about a C average. If we are happy with a C average in America, fine. I am not. I believe we can do a B, or an A in America. I believe our workers can be more productive...We have heard it time and time again -- that somehow we have reached our limits of growth in America. I do not buy that for a minute. And I do not buy it --that we can only grow 2 or 2.5 percent when there are so many indicators out there that we can grow at 3 or 3.5 maybe as much as 4 percent for a sustained period of time."

- Senator Tom Harkin, D-IA, 6/20/96

"Even though some Clinton administration economic advisers have begun to highlight certain positive economic news...it is still true that for many, especially low and moderate income working people, the economic recovery is spotty, partial, and has failed to increase their real take-home pay."

- Senator Paul Wellstone, D-MN, 6/20/96

"(W)e have an anemic rate of economic growth. Mr. President, 2 or 2.3 percent economic growth is not the kind of economic growth that is going to provide the opportunity and the jobs that the American people need and deserve."

- Senator Byron Dorgan, D-ND, 6/20/96

Tax Rates and Revenues

What Has Happened to Tax Rates Under President Clinton

"We will lower the tax burden on middle class Americans." [1]

Presidential candidate Bill Clinton, 1992

"Probably there are people in this room still mad at me because you think I raised your taxes too much. It might surprise you to know that I think I raised them too much, too." [2]

President Bill Clinton, October 17, 1995

Despite inheriting an improving economy when he entered the Oval Office, President Clinton abandoned his campaign promise of middle-class tax relief, and instead levied a $241 billion tax hike. The Omnibus Budget Reconciliation Act, signed into law on August 10, 1993, contained the largest tax increase in history. This $241 billion net tax hike included retroactive income tax increases effective January 1, 1993, before Clinton assumed office.[3]

CLINTON'S IMPACT ON THE TOP MARGINAL TAX RATE

Previous top marginal income tax rate	**31.0%**
Top rate increases from 31% to 36% ($115,000 single return, $140,000 joint return)	+5.0%
10% surcharge on more successful individuals and small businesses (incomes over $250,000)	+3.6%
Elimination of $130,000 wage cap on health insurance payroll tax	+2.9%
Permanent extension of both personal exemptions and itemized deductions phase-outs	+2.0 - 3.0%
New top marginal tax rate	**44.5 - 45.5%**

Source: U.S. Department of Treasury; Joint Economic Committee.

1. The Clinton for President Committee, "Putting People First, A National Economic Strategy for America," by Governor Bill Clinton, 1992.

2. President Bill Clinton at Democratic fundraiser in Houston, Texas October 17, 1995.

3. Revenue-raising provisions in OBRA'93 totaled $268 billion (1994-1998). Including the revenue-losing provisions e.g., extending existing tax credits and the repeal of certain luxury taxes, results in a net tax increase of $241 billion (1994-1998) for the total tax package.

TAX CUTS AND TAX REVENUE

History shows we can cut tax rates and still balance the budget. As the following charts clearly show, tax rates have had little influence over how much revenue the government reaps. In fact, tax cuts in the 1960s and the 1980s both led to higher revenue.

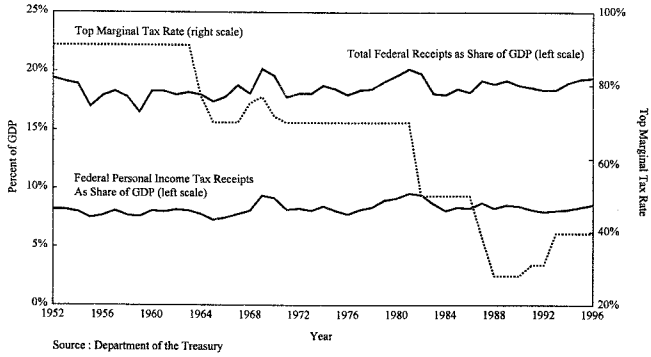
There is widespread, bi-partisan agreement that stronger economic growth can pay for **27%** of a tax cut. Among those who agree about this is Alice Rivlin, President Clinton's former head of the Office of Management and Budget, who directed the Congressional Budget Office (CBO) from 1975 to 1983.

- A June 1982 CBO report says that **33% to 50%** of a tax cut could pay for itself through higher economic growth.
- An October 1978 CBO analysis of the tax cut later passed under President Reagan assumed a 24% feedback in the first year alone -- rising to **52%** in the fifth year.
- An April 1978 CBO study on the Kennedy tax cut found an economic feedback of **25% to 75%.**

Even people still in the Clinton administration support the idea that lower tax rates can boost the economy, leading to revenue growth.

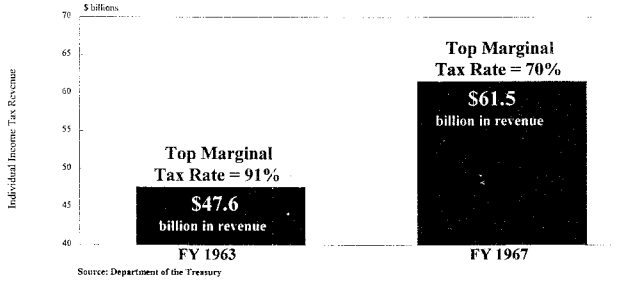
- Testifying in 1994 about the GATT Agreement, then-U.S. Trade Representative Mickey Kantor told the House Ways and Means Committee: "I think everyone would agree, certainly economists agree, that because of the tariff cuts and because of the increase in exports, because of the growing jobs here, the Federal Treasury would gain many, many more dollars than it will lose in terms of the tariff cuts."

Despite huge changes in tax rates, both overall federal revenue and revenue from the individual income tax have stayed fairly constant as shares of GDP:



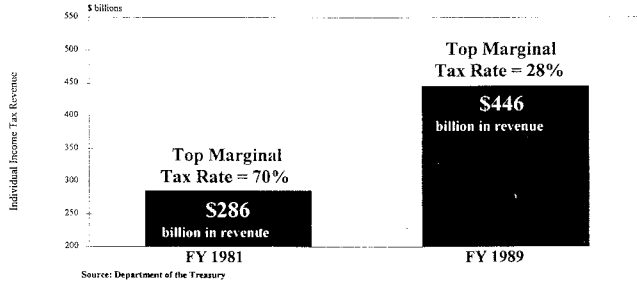
Source : Department of the Treasury

INCOME TAX REVENUE AFTER KENNEDY TAX CUT



- In 1964, Congress passed a tax cut planned originally put forth by President Kennedy. This plan cut the top tax rate on incomes from 91% to 70%. Despite this rate reduction, income tax revenue rose -- from $47.6 billion in 1963 to $61.5 billion in 1967. Factoring out inflation still resulted in a revenue hike of 18% or 4.3% per year.

INCOME TAX REVENUE AFTER REAGAN TAX CUTS



- In 1981, the last budget year before President Reagan took office, federal revenue from personal income tax totaled $286 billion. During his two terms, Ronald Reagan cut taxes across the board, including chopping the top tax rate from 70% to 28%. In 1989, President Reagan's last budget year, the individual income tax took in $446 billion. Even factoring out inflation leaves a total increase in real revenue of 14%.

Chart Package: Anemic Growth

Why Isn't The American Economy Growing Faster?

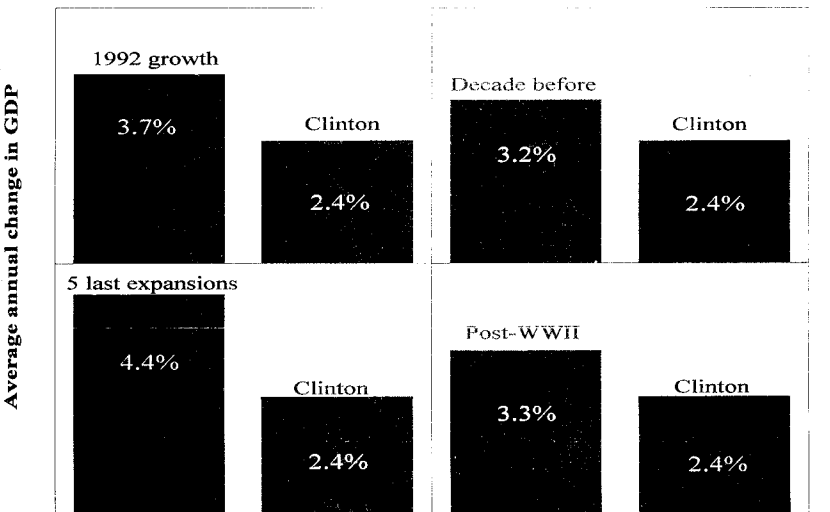
What's Behind America's Anemic Growth

Prepared by
The Joint Economic Committee
August 1996

THE ANEMIC ECONOMY

1. THE CLINTON GROWTH GAP
2. SLOWEST EXPANSION IN MORE THAN A CENTURY
3. REAL MEDIAN HOUSEHOLD INCOME STAGNATES
4. WORKERS' REAL HOURLY COMPENSATION STAGNATES
5. DISPOSABLE INCOME GROWTH STAGNATES
6. JOB LOCK
7. PRODUCTIVITY PROBLEMS UNDER CLINTON
8. NET PRIVATE INVESTMENT STAGNATES
9. DECLINING LABOR FORCE GROWTH UNDER CLINTON
10. 1995 BUDGET FOR A TWO-INCOME FAMILY
11. PERSONAL DEDUCTIONS AND DEPENDENT EXEMPTIONS ERODED
12. TOTAL GOVERNMENT RECEIPTS HIT RECORD HIGH AS SHARE OF GDP
13. CLINTON'S IMPACT ON THE TOP MARGINAL TAX RATE
14. TAX FREEDOM DAY IS LATEST EVER
15. REGULATORY COSTS PER HOUSEHOLD
16. INTEREST RATES ON THE RISE
17. RECORD PERSONAL BANKRUPTCY FILINGS
18. CONSUMER DEBT HAS SKYROCKETED UNDER CLINTON

THE CLINTON GROWTH GAP

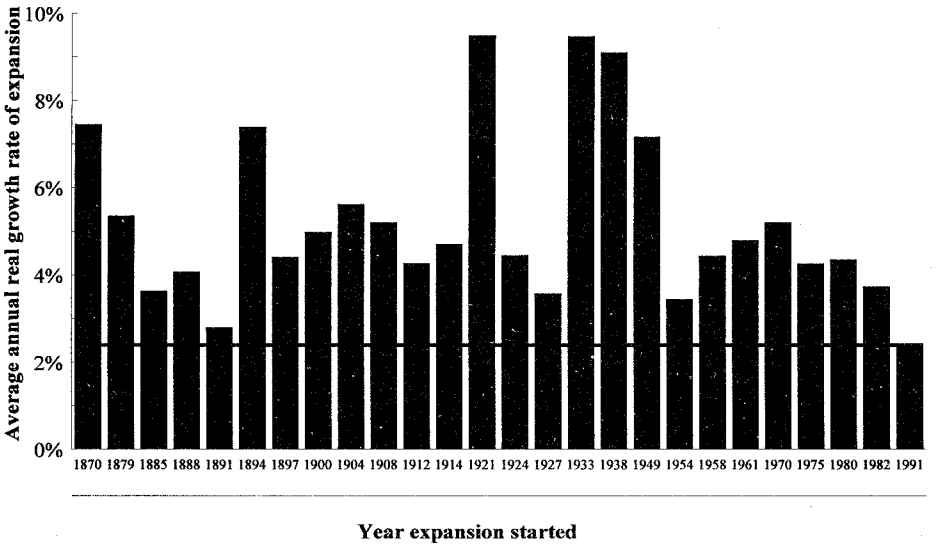


Sources: Department of Commerce, NBER, and JEC calculations

- Compared to the year before President Clinton entered office, the decade before, the last five economic expansions, or the entire post-war period (1947-1992), economic growth under President Clinton has been abnormally slow.

- 1996 GDP has fallen behind by some $308 billion, costing each American household $3,116 this year alone. That's Bill Clinton's growth gap.

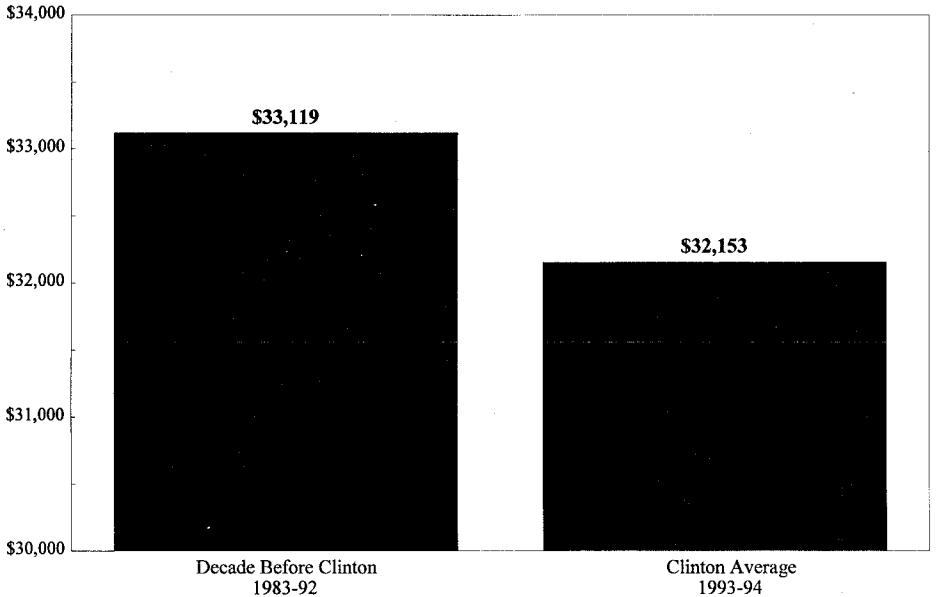
SLOWEST EXPANSION IN MORE THAN A CENTURY



Sources: Department of Commerce; Dr. Christina Romer, Stanford University, NBER

- The current expansion, which began in the second quarter of 1991, is the slowest of any in more than 100 years, remaining nearly two full percentage points lower than the average real GDP growth attained during the last six economic expansions.

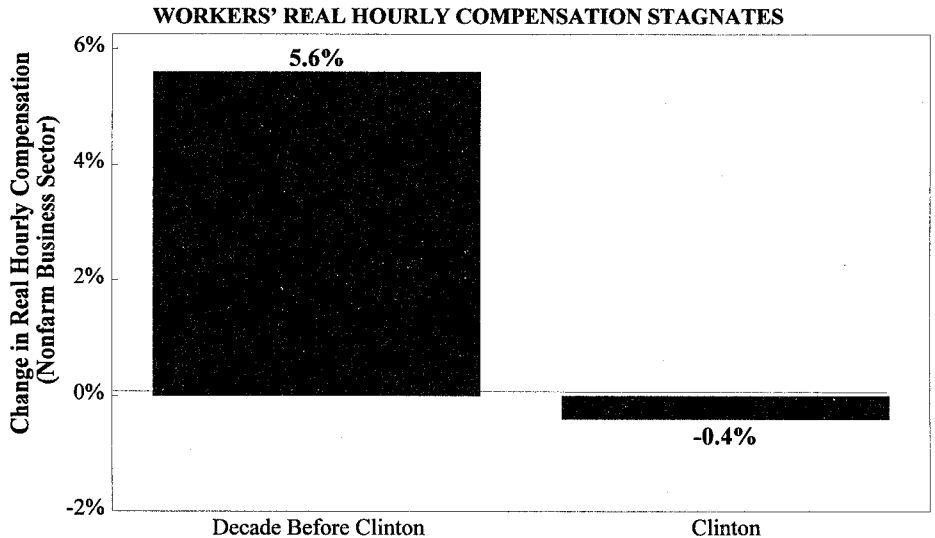
REAL MEDIAN HOUSEHOLD INCOME STAGNATES



Source: United States Census Bureau

- In the decade before President Clinton took office, America's real median household income averaged $33,119. During the Clinton Administration, however, real median household income has averaged only $32,153 (through 1994, the latest data available).

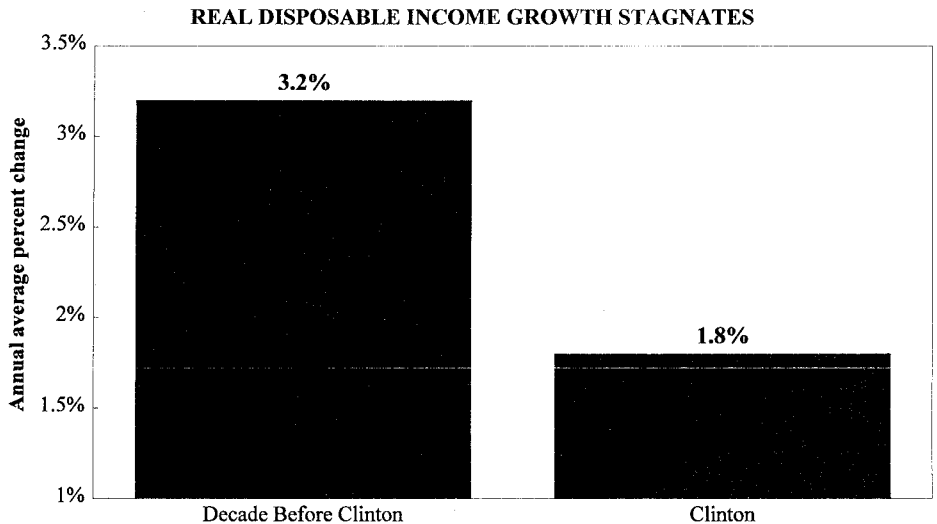
WORKERS' REAL HOURLY COMPENSATION STAGNATES



Source: Bureau of Labor Statistics

- Under President Clinton, real hourly compensation has declined. Weak economic growth is especially hurting middle-class working Americans who depend on wage and benefit increases to maintain their standards of living.

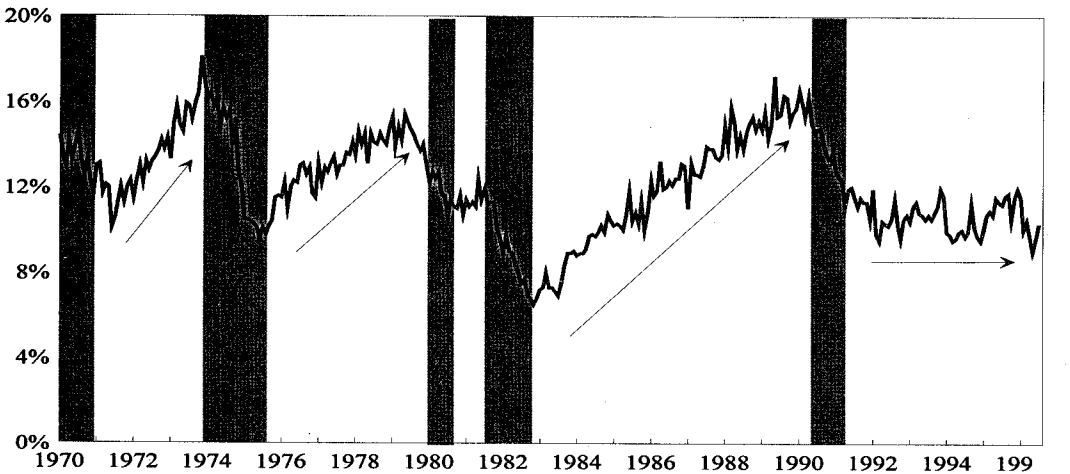
REAL DISPOSABLE INCOME GROWTH STAGNATES



Source: Bureau of Economic Analysis

- Under President Clinton, real after-tax incomes have risen at almost half the pre-Clinton rate: 1.8% versus 3.2%.

JOB LOCK:
VOLUNTARY JOB LEAVERS AS A SHARE OF UNEMPLOYED

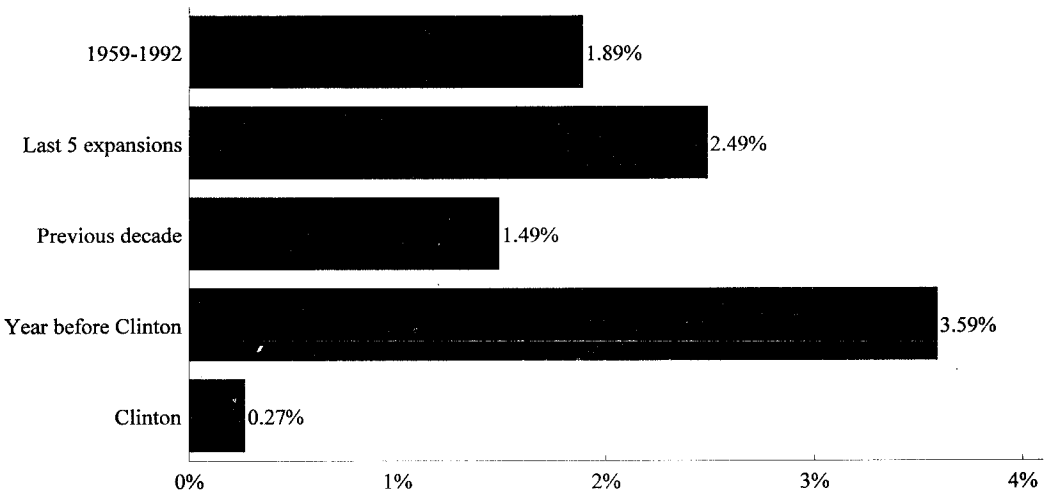


Source: Bureau of Labor Statistics

- Slow economic growth under President Clinton has fostered "job lock." Workers fear voluntarily leaving their current jobs because they don't believe there will be better jobs around the corner.

- The share of voluntary job leavers as a percentage of all unemployed is 16% lower than at the end of the last recession. During normal economic expansions, as more jobs are created, people are more confident in leaving their current job to look for new jobs that offer greater opportunities for advancement and pay.

PRODUCTIVITY PROBLEMS UNDER CLINTON

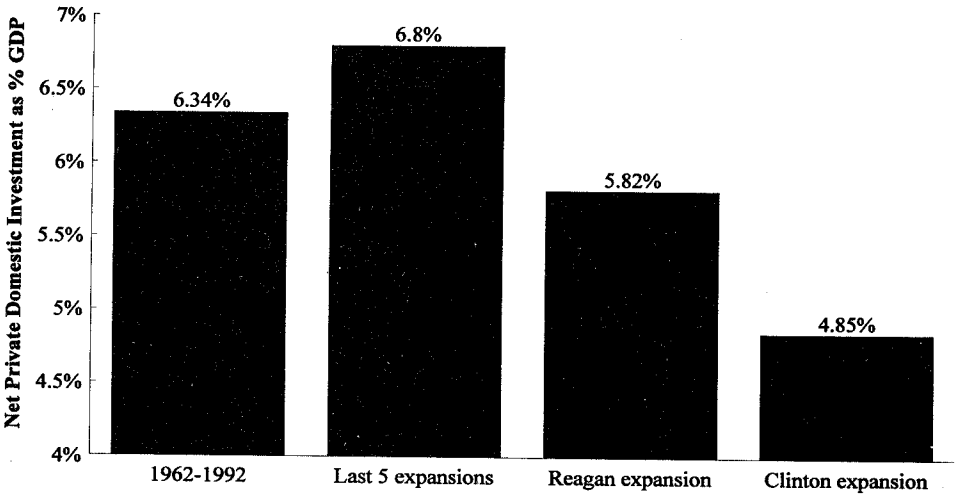


Average annual percent change in nonfarm business sector productivity

Source: Bureau of Labor Statistics

- Better productivity is the key to attaining higher wages and benefits. Unfortunately, productivity growth has virtually stopped under President Clinton. At an average annual growth rate of 0.27%, productivity is growing slower during this expansion than during any other in recent history.

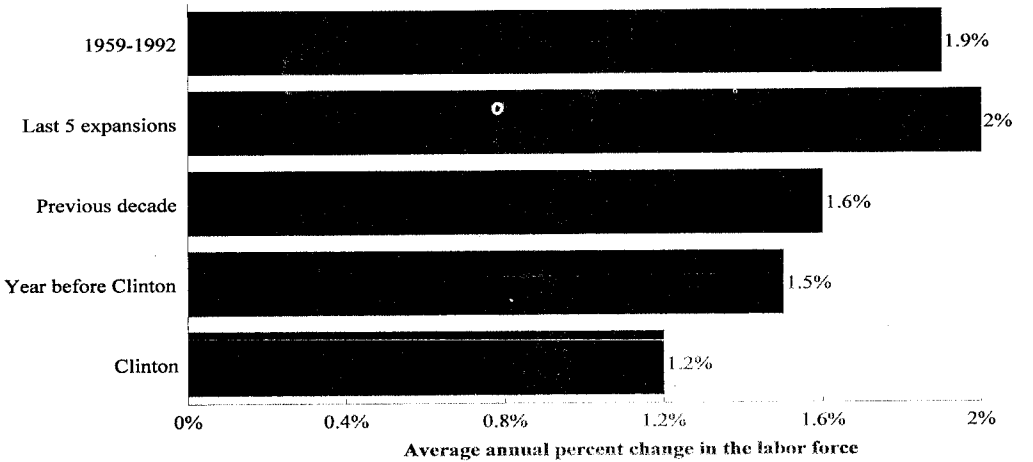
NET PRIVATE INVESTMENT STAGNATES



Source: Bureau of Economic Analysis

- Net investment is essential for economic growth because it allows American firms to boost production, create jobs, raise wages, and expand their business.
- Under President Clinton net investment has been almost 2% of GDP lower than during the last five expansions, and 1.5% lower than the previous thirty years.

DECLINING LABOR FORCE GROWTH UNDER CLINTON

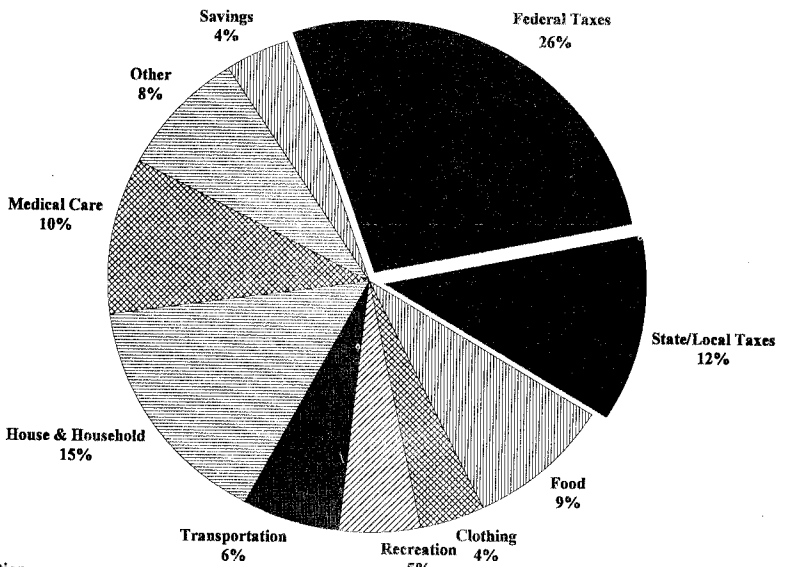


Source: Bureau of Labor Statistics

- As more potential workers become discouraged, the labor force declines and the growth of goods and services that can be produced is diminished.

- During President Clinton's expansion, the employment to population ratio has increased at half the rate of the previous expansion, and at present there are more than 1.5 million Americans who no longer consider themselves part of the labor force.

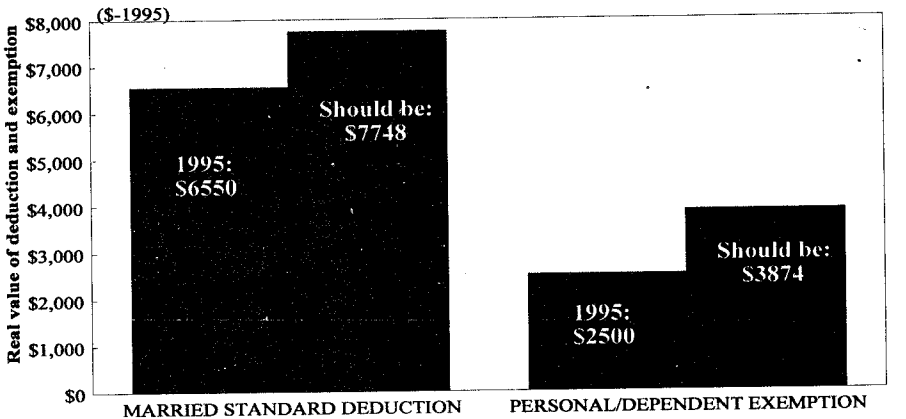
1995 BUDGET FOR A TWO INCOME FAMILY



Source: Tax Foundation
Segments may not total 100% due to rounding.

- The typical American family - two incomes and two or more children - pays more in total taxes than it spends on food, clothing, and housing combined. That's over 38% for total taxes versus 28% for food, clothing, and housing.

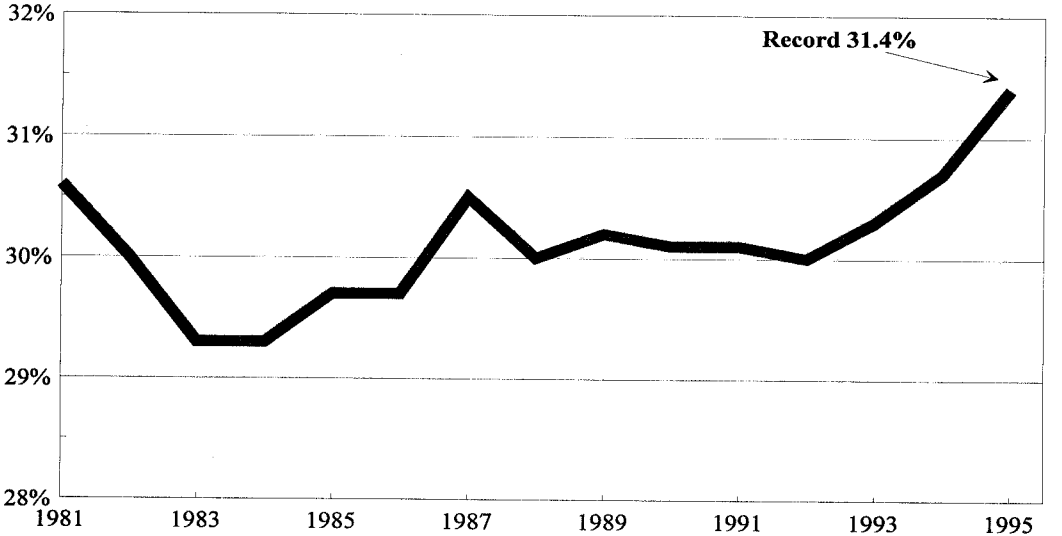
PERSONAL DEDUCTIONS AND DEPENDENT EXEMPTIONS ERODED



Sources: Internal Revenue Service; Bureau of Labor Statistics

- Inflation has eroded the value of the standard deduction and personal exemptions for each member of the family, causing an effective increase in the tax burden.
- If the standard deduction and personal exemptions had merely kept pace with inflation since 1950, a typical family with two children would pay $1,012 less in federal income taxes today.

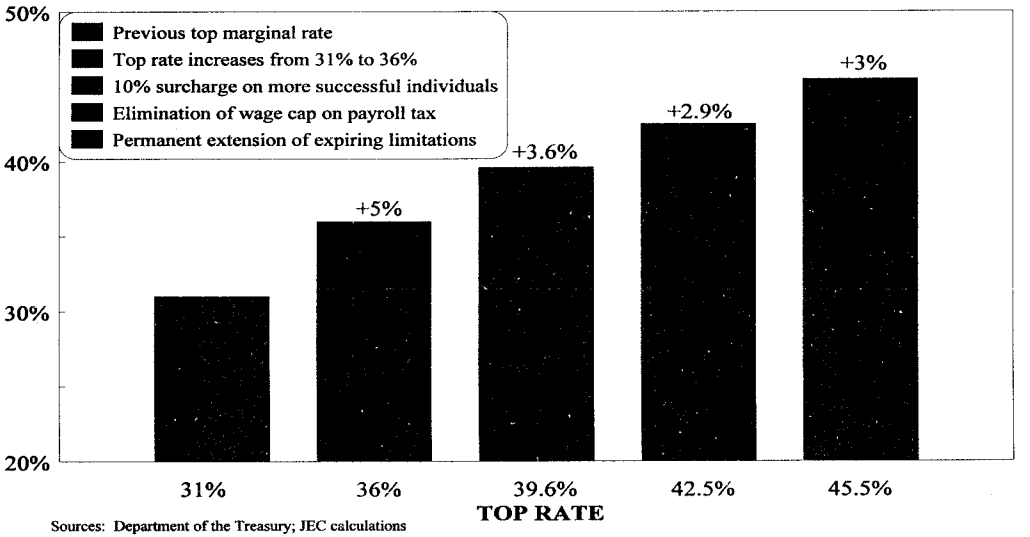
TOTAL GOVERNMENT RECEIPTS HIT RECORD HIGH AS A SHARE OF GDP



Source: Department of Commerce

- In 1995, total government receipts represented a record share of America's total income: 31.4%.
- The federal tax burden alone jumped from 19% of GDP in 1993 to an estimated 20.5% today.

CLINTON'S IMPACT ON THE TOP MARGINAL TAX RATE

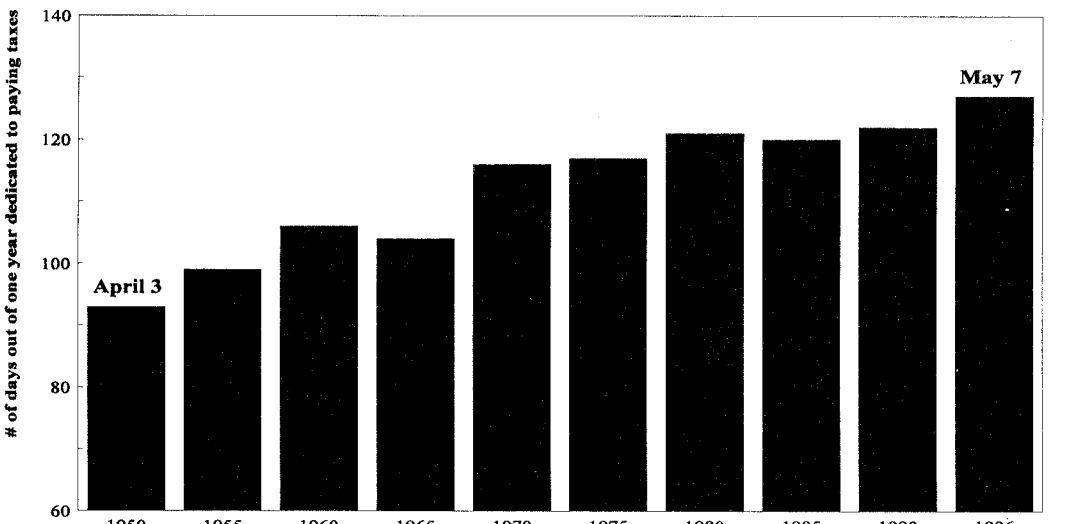


Sources: Department of the Treasury; JEC calculations

- In 1993, President Clinton levied the largest tax increase in history, including higher taxes on Social Security recipients, steep income tax hikes on individuals and small business owners, and higher taxes on gasoline.

- This total tax increase was $241 billion, and the top marginal tax rate was increased as much as 14.5 percentage points (from 31% to 45.5%) for many individuals and small businesses.

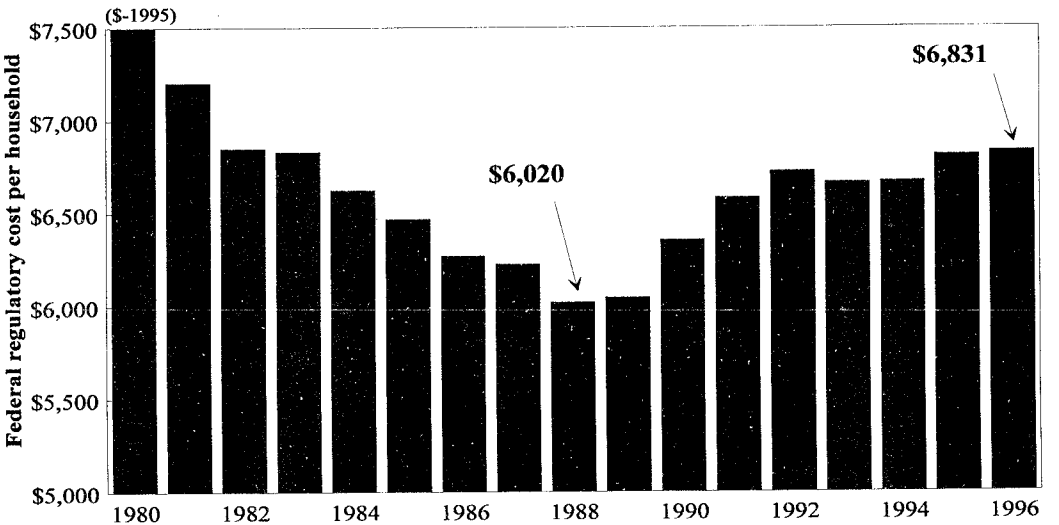
TAX FREEDOM DAY IS LATEST DAY EVER



Source: Tax Foundation

- Tax Freedom Day for the typical American worker didn't arrive until **May 7** this year - the latest day ever. This means Americans worked from January 1 thru May 7 just to earn enough to pay all federal, state and local taxes.
- Since 1950, the typical American has forfeited more than an extra month's work to cover the growing cost of taxes.

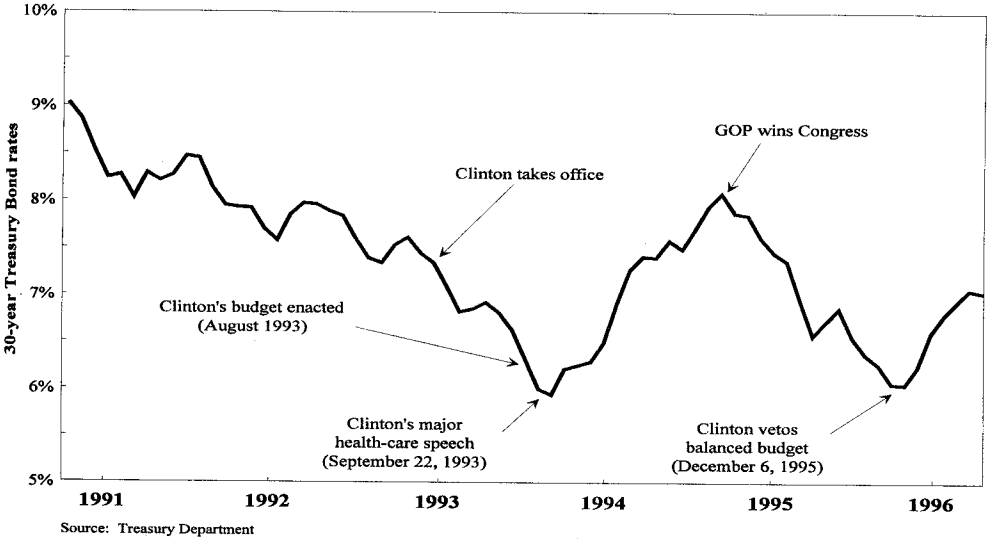
GROWING REGULATORY COSTS PER HOUSEHOLD



Source: Thomas B. Hopkins, "Profiles of Regulatory Costs," Report to the SBA, November 1995

- Total federal regulatory costs are estimated at nearly $7,000 per household in 1996.
- While federal regulatory costs per household dropped from $7,495 in 1980 to $6,020 in 1988, they have since climbed back up to $6,831 today.

INTEREST RATES ON THE RISE

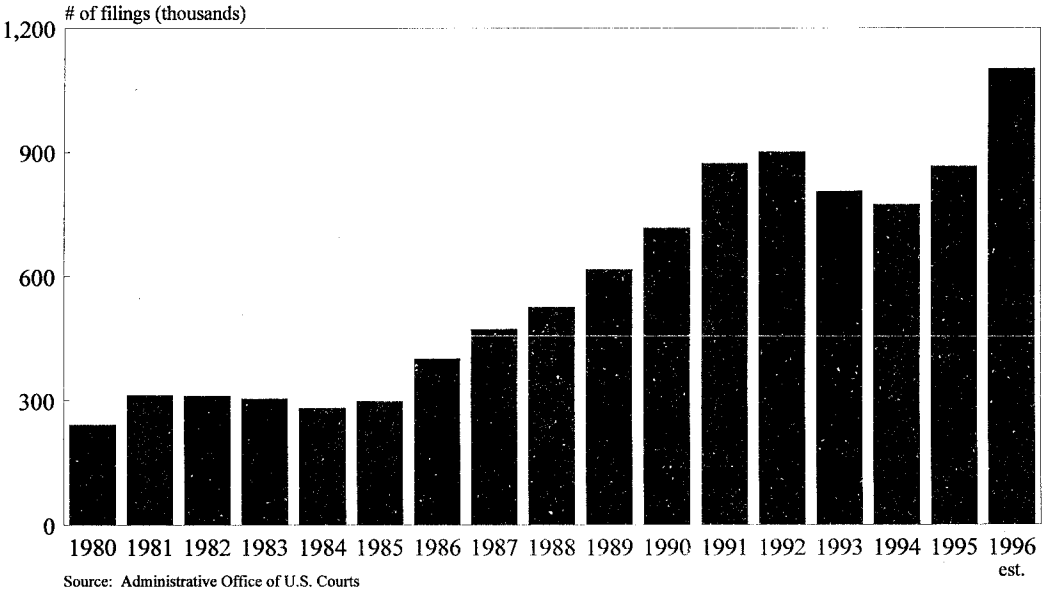


Source: Treasury Department

- Higher interest rates can force families to pay more for home mortgages, car loans, and student loans. On November 8, 1994 rates turned downward as investors anticipated lower taxes, less federal spending, and a faster growing economy.

- Since President Clinton's veto of the Republican balanced budget plan and his refusal to adopt pro-growth policies, interest rates have spiked nearly one full percentage point; adding more than $50 per month on a typical mortgage and auto loan.

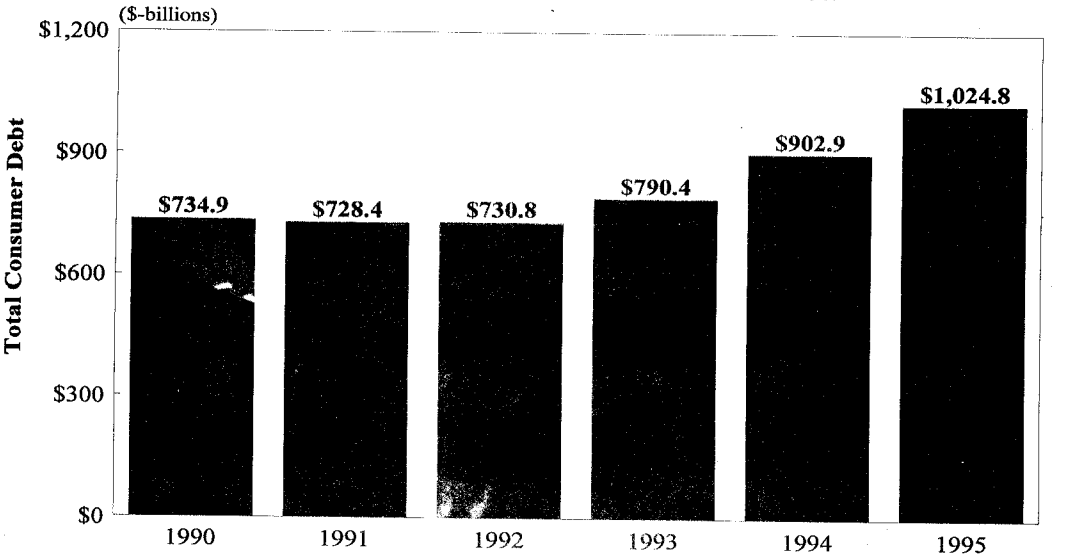
RECORD PERSONAL BANKRUPTCY FILINGS



Source: Administrative Office of U.S. Courts

- As many as 1.1 million people are expected to declare personal bankruptcy in 1996, the highest level in more than 16 years.

CONSUMER DEBT HAS SKYROCKETED UNDER CLINTON



Source: Federal Reserve Board

- Under President Clinton total consumer debt has increased from $730.8 million in 1992 to $1.024 billion in 1995.

THE GROWTH DEBATE:

How Fast Can We Grow?

Prepared by
The Joint Economic Committee
August 1996

http://www.senate.gov/~jec/grwthdeb.html

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Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)
Washington, DC 20510–6602

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MEMORANDUM

TO: SENATE REPUBLICAN COLLEAGUES
FROM: Senator Connie Mack
RE: The Growth Debate
DATE: August 8, 1996

Today's national debate about economic growth is fundamental to America's future. It is significant that America now debates the pace, rather than the possibility of economic growth. The Republican-led Congress has been the key to moving the growth debate in the right direction.

President Clinton and his Administration argue for status quo growth -- they claim that this economy is growing as fast as it possibly can. But despite their rhetoric to the contrary, this is the slowest economic expansion in more than a century! Bill Clinton's economic policies are robbing America of its full growth potential.

Republicans know we can do better. History shows us that with reduced taxes, less government spending, fewer burdensome regulations and more freedom for people to make their own decisions about saving and investing, Americans enjoy a more robust economy. Only vigorous growth will produce hope, opportunity and higher living standards for everyone.

The growth debate will likely be the subject of considerable attention in your state. To help clarify some of these arguments, I am sending you this packet which contains several pieces of information I hope you will find useful. It includes:

- An adaptable op-ed that illustrates our pro-growth vision and the sound economics behind it;
- An analysis of tax cuts and tax revenues;
- A comprehensive analysis of Clintonomics;
- What Democrats are saying about today's anemic growth;

If you have any questions about this information, please contact the JEC at 224-5171. In the months ahead, the JEC will make every effort to provide you with updated economic information on these and other subjects.

A Pro-Growth Vision for America

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

A PRO-GROWTH VISION FOR AMERICA

The current economic debate revolves around two schools of thought. The "status quo" school dictates that this economy is as good as it gets. The "we can do better" school embraces the ideas that America can and must do better, that middle class families are bearing the burden of an anemic economy, and that it *is* possible to improve our economy through more robust economic growth. Bill Clinton represents the status quo thinkers; Republicans stand for change and a better tomorrow.

Republicans believe that a brighter economic future requires a pro-growth economic plan that provides greater independence for the American family. Pro-growth policies such as a meaningful income tax cut, significant capital gains tax relief, a pro-family tax credit, and an honest balanced budget plan will free the American people and America's economy from the burdens of a bloated government and an oppressive tax system. A vital economy will provide Americans with the opportunity to save, succeed and make their own decisions about their own hard-earned tax dollars.

Despite Clinton Administration rhetoric that we are experiencing the best economy in three decades, the facts tell a very different story. The truth is, this is the slowest economic expansion in more than a century! Bill Clinton's record tax hike, his increased government spending and regulating, and his veto of the Republican's balanced budget have robbed America of its full economic potential. As a result, incomes have stagnated or declined. The tax burden is at a record high, interest rates have risen, and real median family incomes have fallen. Many families are paying more in taxes than they spend on food, clothing and housing combined. The number of people working two or more jobs has increased dramatically in recent years. Today's families are working as hard as they can just to keep up. No wonder Americans are anxious about this economy.

America needs a pro-growth plan that addresses our nation's core economic problem -- anemic growth. However analyzed, economic growth under President Clinton pales in comparison to historic growth rates. Whether compared with the year before he entered office, the decade before, the last five economic expansions or the 1947-1992 postwar period, Clinton's economy has been lackluster at best. Simply stated, weak growth under Clinton has stymied wage increases and the creation of high paying jobs. Slow economic growth costs real people real money. According to the latest research by Congress's Joint Economic Committee, Clinton's economic growth gap will cost each household $3,116 in 1996 alone -- that's $260 a month.

The basic difference between a Republican approach to economic growth and that of the Clinton Administration is that Republicans understand that government does not create economic

G-01 Dirksen Senate Office Building, Washington, D.C. 20510-6602 202-224-5171

growth -- it can only affect the climate in which prosperity is either fostered or frustrated. Free individuals, through their creative ideas, risk taking and hard work, create growth and boost living standards for all Americans. For too long, big government has stifled the dreams of hard-working Americans. The arrogance of a Washington bureaucracy believing it can solve people's problems by taking more of their hard earned money must come to an end. A free-market, pro-growth package will help return more money and power back to its rightful owners -- the American people.

To meet the challenge of boosting economic growth and living standards, it is imperative that we reduce the massive government drag placed on hard working individuals, families, and businesses. Reducing marginal tax rates is a necessary first step toward the goal of stronger growth. Lowering marginal tax rates will provide immediate relief for every American. Capital gains tax relief will free up more job producing investment and make America more competitive internationally. A pro-family tax credit will provide working families with incentives to save for their children's educations.

Finally, any comprehensive pro-growth plan must include an honest approach to balancing the federal budget. A strong economy and a pro-growth economic agenda will make balancing the budget that much easier. Once enacted, a Balanced Budget Amendment to the Constitution will be a guarantee to the American people that government spending will get under control and stay that way.

In the meantime, what is President Clinton doing for anxious workers? He's working hard to preserve the destructive status quo, and "feeling America's pain" while simultaneously claiming that this is "the best economy in three decades." The American people know we can do better. America needs a pro-growth agenda that will make this economy as strong as it should be, bring the budget into balance, and create unprecedented opportunities for every American.

The status quo just doesn't work, and Americans won't tolerate it. History has proven that hard working Americans, not big government, hold the key to stronger economic growth and a better future. Independence for every American from the tyrannies of heavy taxation and burdensome regulation will result in unbridled opportunity, prosperity and hope for future generations.

The Anemic Economy

TODAY'S ANEMIC ECONOMY

The current expansion, which began in the second quarter of 1991, is the SLOWEST of any in more than a century.

Clinton's Growth Gap. Economic growth of only 2.4% per year under President Clinton has lagged well behind the normal growth rates of the past. For example, the economy grew an average of 3.2% per year in the decade before Clinton took office, 4.4% in the last five expansions and 3.7% in the year before Clinton took office. This lost GDP translates into $3,116 for each American household this year alone!

Just what has this meant for America's economy, families, and workers? Here's the picture:

Stagnant Income. The typical household has suffered during the Clinton years. Real median household income averaged $33,119 in the decade before President Clinton took office. By contrast, it has averaged $966 *less* ($32,153) under President Clinton (through 1994, the latest data available.) Workers' wages and benefits have *declined* during the Clinton years after growing steadily during the previous decade.

High Taxes. Taxes are taking a bigger bite of family incomes than ever before. While after-inflation, after-tax incomes grew at a yearly rate of 3.2% in the decade before President Clinton took office, disposable income growth has *slowed* to only 1.8% per year during the Clinton era. It's not surprising that the share of our nation's income going to federal taxes is now at the second highest level since WWII -- exceeded only in the year before the Reagan tax cuts began.

Higher Interest Costs. Since President Clinton's veto of the Republican balanced budget plan, interest rates have spiked nearly one full percentage point. This can cost families *more* than $50 per month for extra payments on mortgages and auto loans.

Future Looks Bleaker. Standards of living ultimately depends on how productive people are. In turn, this depends on how much investment capital they have to work with. Under President Clinton, net private domestic investment as a share of GDP has been about 30% *lower* than the average over the past five economic expansions. Naturally, productivity has suffered, growing at only one-fifth of the pace set in the decade before President Clinton took office.

Prepared by Joint Economic Committee staff: Paul G. Merski, Chief Economist; and Robert S. Stein, Economist. (202) 224-5171

FACTS ABOUT THE ECONOMY

ECONOMIC GROWTH

- Compared to the year before President Clinton entered office, the decade before, the last five expansions, or the entire post-war period (1947-1992), economic growth under President Clinton has been abnormally low.

- 1996 GDP has fallen behind by some $308 billion, costing each American household $3,116 this year alone. That is Bill Clinton's growth gap.

ECONOMIC EXPANSION

- The current expansion, which began in the second quarter of 1991, is the slowest of any in more than 100 years, remaining nearly two full percentage points lower than the average real GDP growth attained during the last six economic expansions.

REAL MEDIAN HOUSEHOLD INCOME

- In the decade before President Clinton took office, America's real median household income averaged $33,119. During the Clinton Administration, however, real median household income has averaged only $32,153 (through 1994, the latest data available).

REAL HOURLY COMPENSATION

- Under President Clinton, real hourly compensation (wages and benefits) has declined. Weak economic growth is especially hurting middle-class working Americans who depend on wage and benefit increases to maintain their standards of living.

JOB LOCK

- Slow economic growth under President Clinton has fostered "job lock." Workers fear voluntarily leaving their current jobs because they don't believed there will be better jobs around the corner.

- The share of voluntary job leavers as a percentage of all unemployed is 16 percent lower than at the end of the last recession. During normal economic expansions, as more jobs are created, people are more confident in leaving their current job to look for new jobs that offer greater opportunities for advancement and pay.

REAL DISPOSABLE INCOME

- Under President Clinton, real after-tax incomes have risen at almost half the pre-Clinton rate: 1.8 percent versus 3.2 percent.

PRODUCTIVITY

- Better productivity is the key to attaining higher wages and benefits. Unfortunately, productivity growth has virtually stopped under President Clinton. At an average annual growth rate of .27 percent, productivity is growing slower during this expansion than during any other in recent history.

INVESTMENT

- Net investment is essential for economic growth because it allows American firms to boost production, create jobs, raise wages, and expand their business.

- Under President Clinton net investment has been almost 2 percent of GDP lower than during the last five expansions, and 1.5 percent lower than the previous thirty years.

LABOR FORCE

- As more potential workers become discouraged, the labor force declines and the growth of goods and services that can be produced diminishes.

- During President Clinton's expansion, the employment to population ratio has increased at half the rate of the previous expansion, and at present there are more than 1.5 million Americans who no longer consider themselves part of the labor force.

TAXES AS SHARE OF 1995 FAMILY BUDGET

- The typical American family - two incomes and two or more children - pays more in total taxes than it spends on food, clothing and housing combined. That's over 38 percent for total taxes versus 28 percent for food, clothing, and housing.

TAX DEDUCTIONS AND EXEMPTIONS

- Inflation has eroded the value of the standard deduction and personal exemptions for each member of the family, causing an effective increase in the tax burden.

- If the standard deduction and personal exemptions had merely kept pace with inflation since 1950, a typical family with two children would pay $1,012 less in federal income taxes today.

GOVERNMENT RECEIPTS AS A SHARE OF GDP

- In 1995, total government receipts represented a record share of America's total income: 31.4 percent.

- The federal income tax burden alone jumped from 19 percent of GDP in 1993 to an estimated 20.5 percent today.

TOP MARGINAL TAX RATE

- In 1993, President Clinton levied the largest tax increase in history, including higher taxes on Social Security recipients, steep income tax hikes on individuals and small business owners, and higher taxes on gasoline.

- This total tax increase was $241 billion, and the top marginal tax rate was increased as much as 14.5 percent percentage points (from 31 percent to 45.5 percent) for many individuals and small businesses.

TAX FREEDOM DAY

- Tax Freedom Day for the typical American worker didn't arrive until May 7 this year -- the latest day ever. This means that Americans worked from January 1 thru May 7 just to earn enough to pay all federal, state and local taxes.

- Since 1950, the typical American has forfeited more than an extra month's work to cover the growing cost of taxes.

REGULATORY COSTS

- Total federal regulatory costs are estimated at nearly $7,000 per household in 1996.

- While federal regulatory costs per household dropped from $7,495 in 1980 to $6,020 in 1988, they have since climbed back up to $6,831 today.

INTEREST RATES

- Higher interest rates can force families to pay more for home mortgages, car loans, and student loans. On November 8, 1994 interest rates turned downward as investors anticipated lower taxes, less federal spending, and a faster growing economy.

- Since President Clinton's veto of the Republican balanced budget plan and his refusal to adopt pro-growth policies, interest rates have spiked nearly one full percentage point; adding more than $50 per month on a typical mortgage or auto loan.

PERSONAL BANKRUPTCY FILINGS

- As many as 1.1 million people are expected to declare personal bankruptcy in 1996, the highest level in more than 16 years.

CONSUMER DEBT

- Under President Clinton total consumer debt has increased from $730.8 million in 1992 to $1.024 billion in 1995.

Joint Economic Committee.

HOW HEALTHY IS THIS ECONOMY? WHY NOT ASK THE DEMOCRATS?

While President Clinton and his advisers try to crow about the economy, outside the White House there is bi-partisan disappointment:

"...when I go home, I hear a lot of anxiety from farmers, small business people, and families just trying to make a living wage. In fact wages have stagnated for many middle-class working families. Every year it seems harder and harder to make ends meet."

- Senator Tom Daschle, D-SD, 6/20/96

"We have had growth. It has been comparatively about a C average. If we are happy with a C average in America, fine. I am not. I believe we can do a B, or an A in America. I believe our workers can be more productive...We have heard it time and time again -- that somehow we have reached our limits of growth in America. I do not buy that for a minute. And I do not buy it --that we can only grow 2 or 2.5 percent when there are so many indicators out there that we can grow at 3 or 3.5 maybe as much as 4 percent for a sustained period of time."

- Senator Tom Harkin, D-IA, 6/20/96

"Even though some Clinton administration economic advisers have begun to highlight certain positive economic news...it is still true that for many, especially low and moderate income working people, the economic recovery is spotty, partial, and has failed to increase their real take-home pay."

- Senator Paul Wellstone, D-MN, 6/20/96

"(W)e have an anemic rate of economic growth. Mr. President, 2 or 2.3 percent economic growth is not the kind of economic growth that is going to provide the opportunity and the jobs that the American people need and deserve."

- Senator Byron Dorgan, D-ND, 6/20/96

Tax Rates and Revenues

What Has Happened to Tax Rates Under President Clinton

"We will lower the tax burden on middle class Americans." [1]

Presidential candidate Bill Clinton, 1992

"Probably there are people in this room still mad at me because you think I raised your taxes too much. It might surprise you to know that I think I raised them too much, too." [2]

President Bill Clinton, October 17, 1995

Despite inheriting an improving economy when he entered the Oval Office, President Clinton abandoned his campaign promise of middle-class tax relief, and instead levied a $241 billion tax hike. The Omnibus Budget Reconciliation Act, signed into law on August 10, 1993, contained the largest tax increase in history. This $241 billion net tax hike included retroactive income tax increases effective January 1, 1993, before Clinton assumed office.[3]

CLINTON'S IMPACT ON THE TOP MARGINAL TAX RATE

Previous top marginal income tax rate	**31.0%**
Top rate increases from 31% to 36% ($115,000 single return, $140,000 joint return)	+5.0%
10% surcharge on more successful individuals and small businesses (incomes over $250,000)	+3.6%
Elimination of $130,000 wage cap on health insurance payroll tax	+2.9%
Permanent extension of both personal exemptions and itemized deductions phase-outs	+2.0 - 3.0%
New top marginal tax rate	**44.5 - 45.5%**

Source: U.S. Department of Treasury; Joint Economic Committee.

1. The Clinton for President Committee, "Putting People First, A National Economic Strategy for America," by Governor Bill Clinton, 1992.

2. President Bill Clinton at Democratic fundraiser in Houston, Texas October 17, 1995.

3. Revenue-raising provisions in OBRA'93 totaled $268 billion (1994-1998). Including the revenue-losing provisions e.g., extending existing tax credits and the repeal of certain luxury taxes, results in a net tax increase of $241 billion (1994-1998) for the total tax package.

TAX CUTS AND TAX REVENUE

History shows we can cut tax rates and still balance the budget. As the following charts clearly show, tax rates have had little influence over how much revenue the government reaps. In fact, tax cuts in the 1960s and the 1980s both led to higher revenue.

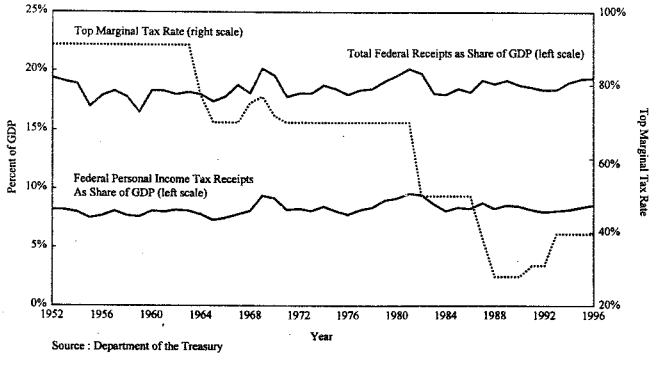
There is widespread, bi-partisan agreement that stronger economic growth can pay for **27%** of a tax cut. Among those who agree about this is Alice Rivlin, President Clinton's former head of the Office of Management and Budget, who directed the Congressional Budget Office (CBO) from 1975 to 1983.

- A June 1982 CBO report says that **33% to 50%** of a tax cut could pay for itself through higher economic growth.
- An October 1978 CBO analysis of the tax cut later passed under President Reagan assumed a 24% feedback in the first year alone -- rising to **52%** in the fifth year.
- An April 1978 CBO study on the Kennedy tax cut found an economic feedback of **25% to 75%.**

Even people still in the Clinton administration support the idea that lower tax rates can boost the economy, leading to revenue growth.

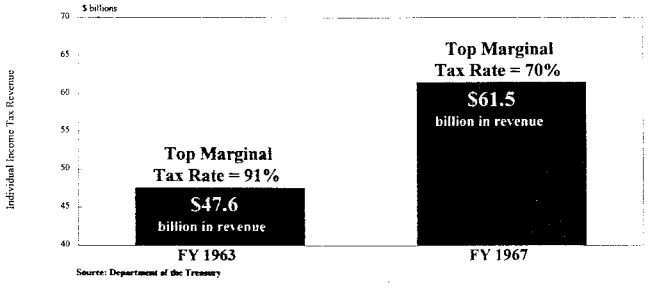
- Testifying in 1994 about the GATT Agreement, then-U.S. Trade Representative Mickey Kantor told the House Ways and Means Committee: "I think everyone would agree, certainly economists agree, that because of the tariff cuts and because of the increase in exports, because of the growing jobs here, the Federal Treasury would gain many, many more dollars than it will lose in terms of the tariff cuts."

Despite huge changes in tax rates, both overall federal revenue and revenue from the individual income tax have stayed fairly constant as shares of GDP:



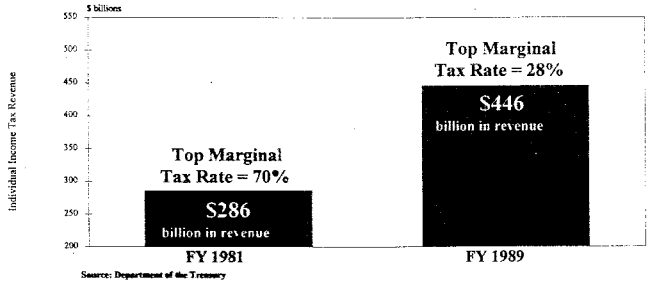
Source : Department of the Treasury

INCOME TAX REVENUE AFTER KENNEDY TAX CUT



- In 1964, Congress passed a tax cut planned originally put forth by President Kennedy. This plan cut the top tax rate on incomes from 91% to 70%. Despite this rate reduction, income tax revenue rose -- from $47.6 billion in 1963 to $61.5 billion in 1967. Factoring out inflation still resulted in a revenue hike of 18% or 4.3% per year.

INCOME TAX REVENUE AFTER REAGAN TAX CUTS



- In 1981, the last budget year before President Reagan took office, federal revenue from personal income tax totaled $286 billion. During his two terms, Ronald Reagan cut taxes across the board, including chopping the top tax rate from 70% to 28%. In 1989, President Reagan's last budget year, the individual income tax took in $446 billion. Even factoring out inflation leaves a total increase in real revenue of 14%.

Chart Package: Anemic Growth

Why Isn't The American Economy Growing Faster?

What's Behind America's Anemic Growth

Prepared by
The Joint Economic Committee
August 1996

THE ANEMIC ECONOMY

1. THE CLINTON GROWTH GAP
2. SLOWEST EXPANSION IN MORE THAN A CENTURY
3. REAL MEDIAN HOUSEHOLD INCOME STAGNATES
4. WORKERS' REAL HOURLY COMPENSATION STAGNATES
5. DISPOSABLE INCOME GROWTH STAGNATES
6. JOB LOCK
7. PRODUCTIVITY PROBLEMS UNDER CLINTON
8. NET PRIVATE INVESTMENT STAGNATES
9. DECLINING LABOR FORCE GROWTH UNDER CLINTON
10. 1995 BUDGET FOR A TWO-INCOME FAMILY
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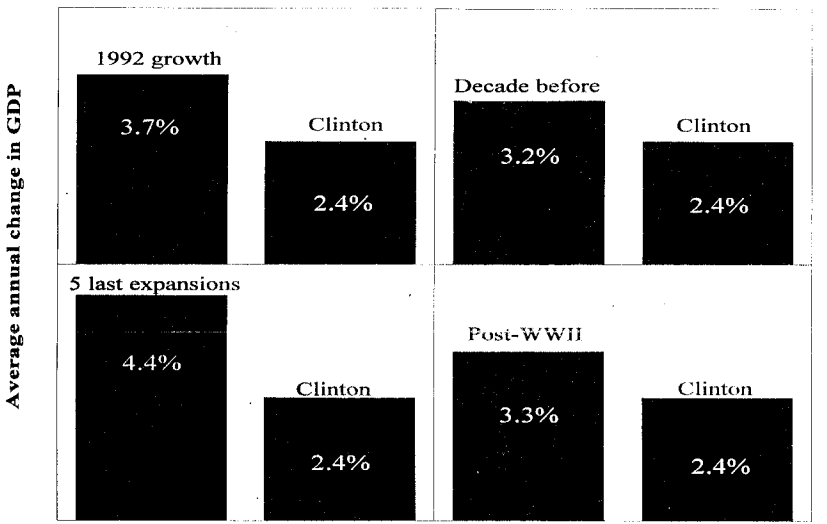
13. CLINTON'S IMPACT ON THE TOP MARGINAL TAX RATE
14. TAX FREEDOM DAY IS LATEST EVER
15. REGULATORY COSTS PER HOUSEHOLD
16. INTEREST RATES ON THE RISE
17. RECORD PERSONAL BANKRUPTCY FILINGS
18. CONSUMER DEBT HAS SKYROCKETED UNDER CLINTON

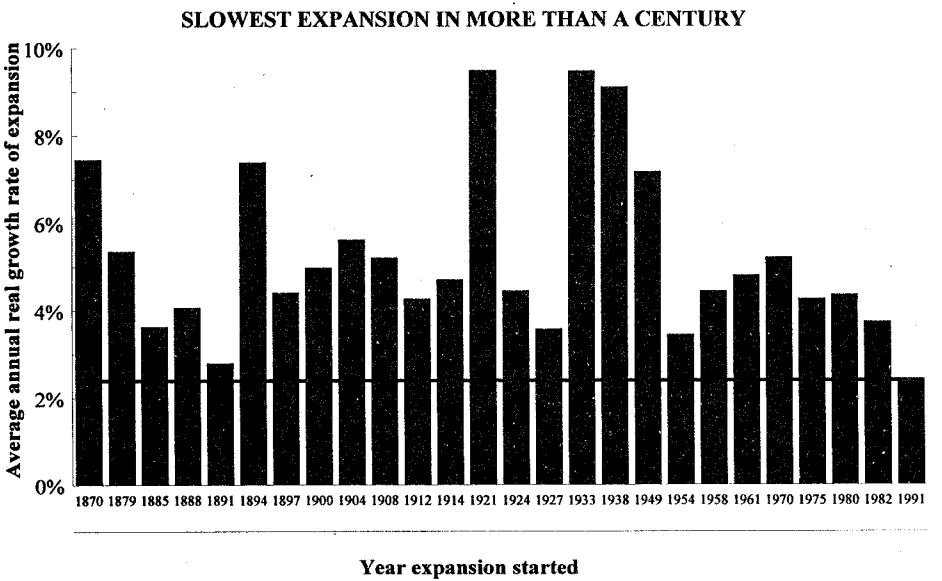
THE CLINTON GROWTH GAP



Sources: Department of Commerce, NBER, and JEC calculations

- Compared to the year before President Clinton entered office, the decade before, the last five economic expansions, or the entire post-war period (1947-1992), economic growth under President Clinton has been abnormally slow.

- 1996 GDP has fallen behind by some $308 billion, costing each American household $3,116 this year alone. That's Bill Clinton's growth gap.



Sources: Department of Commerce; Dr. Christina Romer, Stanford University, NBER

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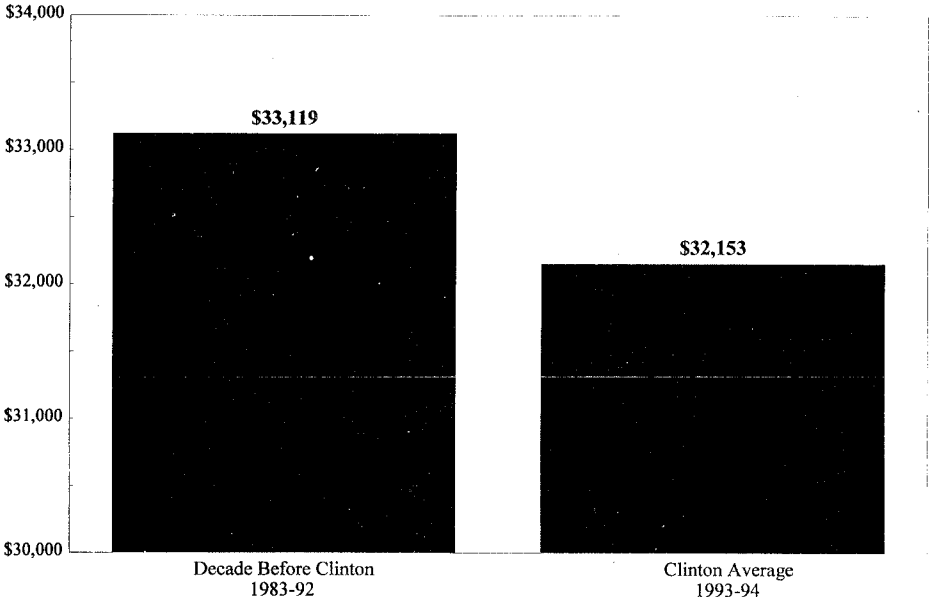

Source: United States Census Bureau

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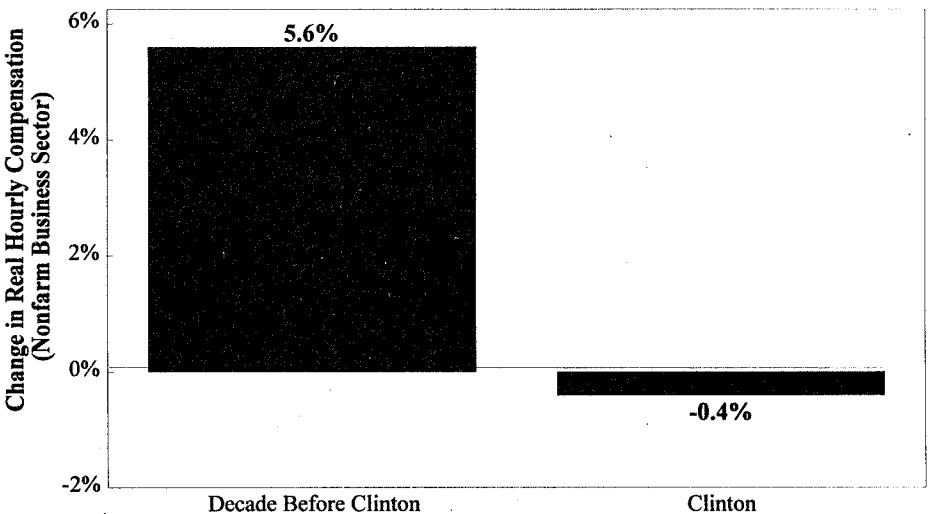
WORKERS' REAL HOURLY COMPENSATION STAGNATES



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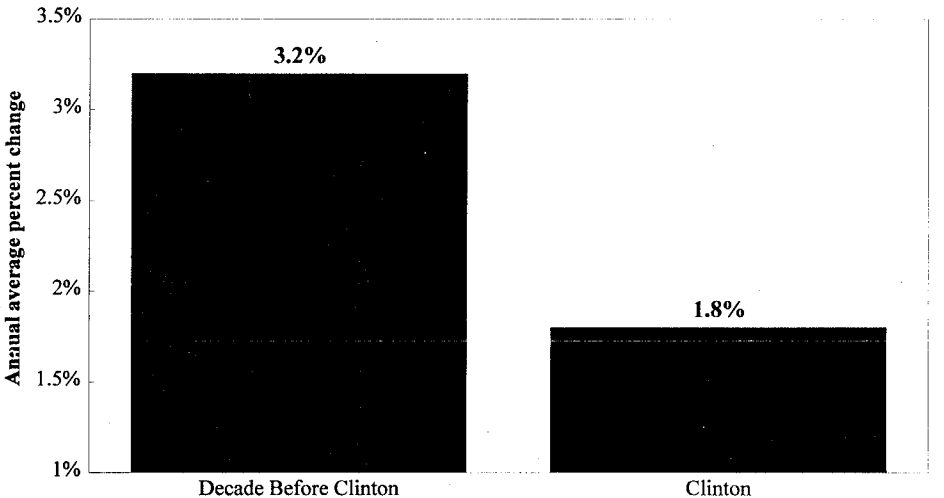

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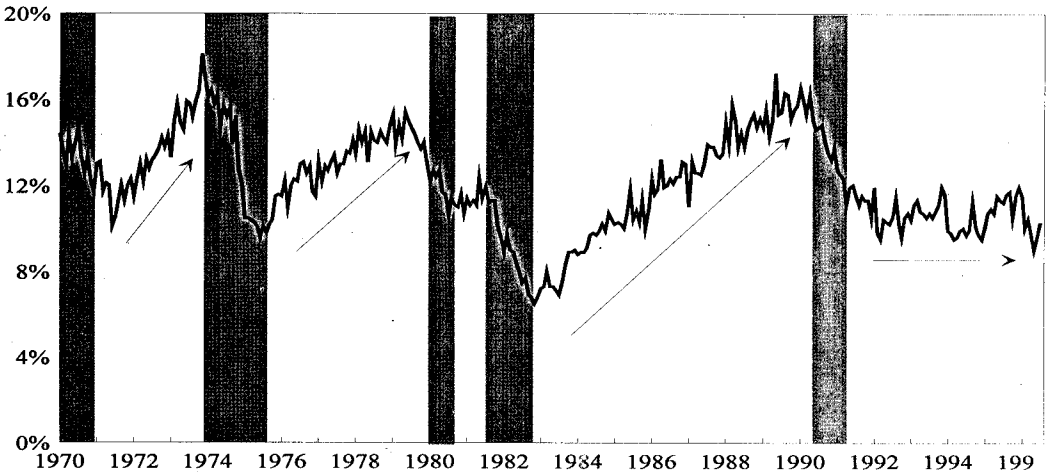
JOB LOCK:
VOLUNTARY JOB LEAVERS AS A SHARE OF UNEMPLOYED



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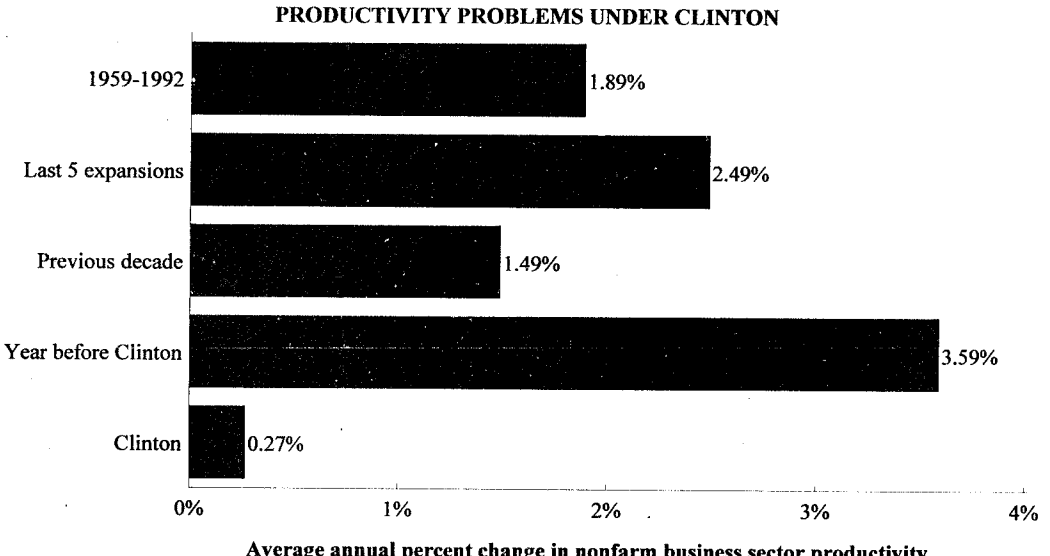

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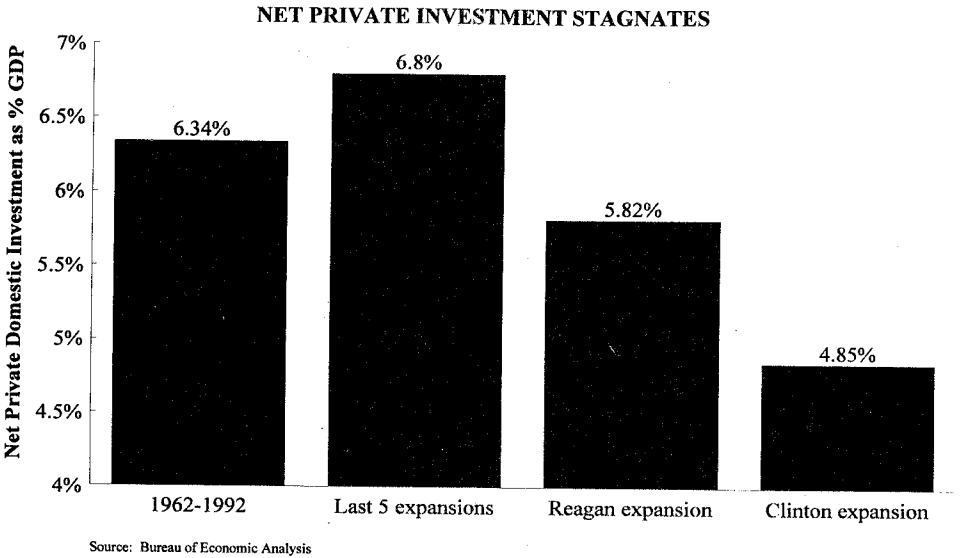

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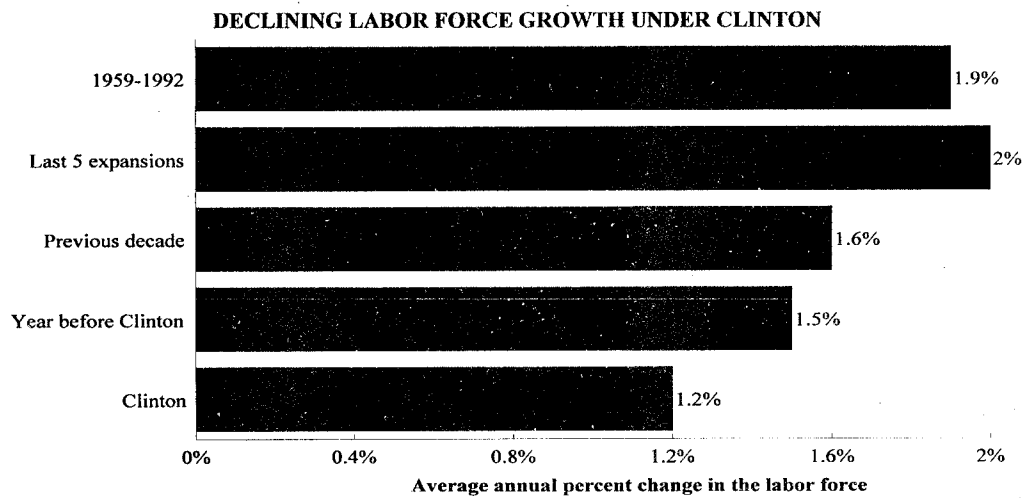

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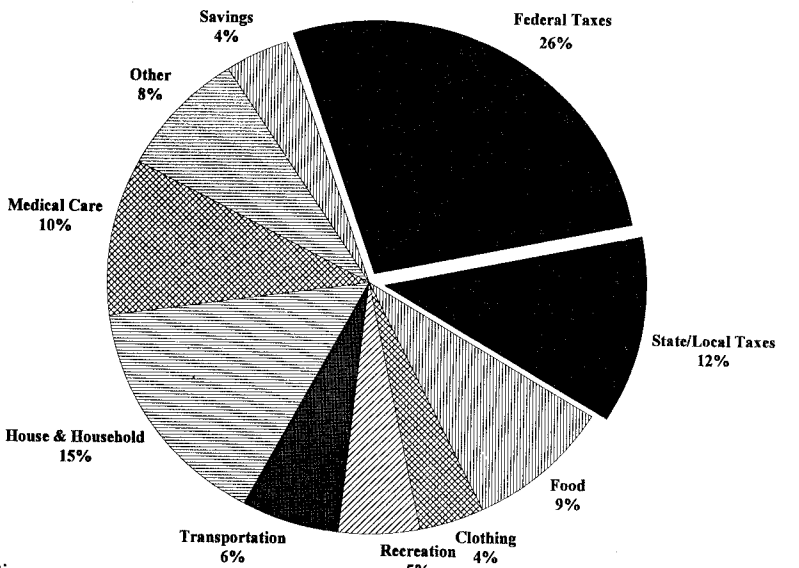
1995 BUDGET FOR A TWO INCOME FAMILY



Source: Tax Foundation
Segments may not total 100% due to rounding.

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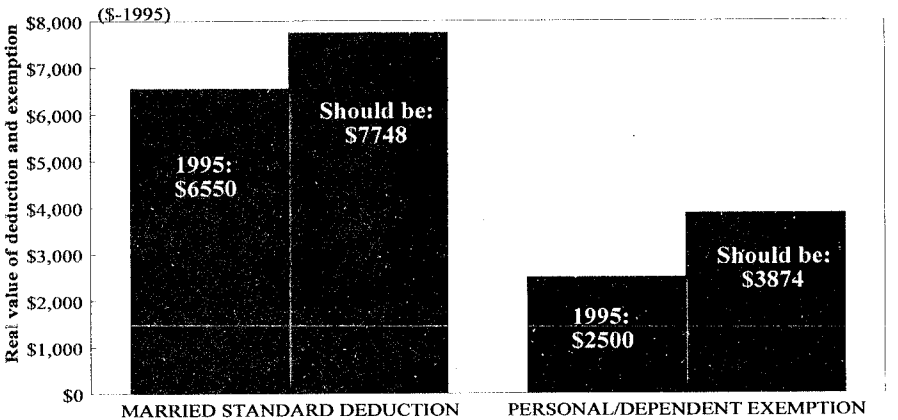

Sources: Internal Revenue Service; Bureau of Labor Statistics

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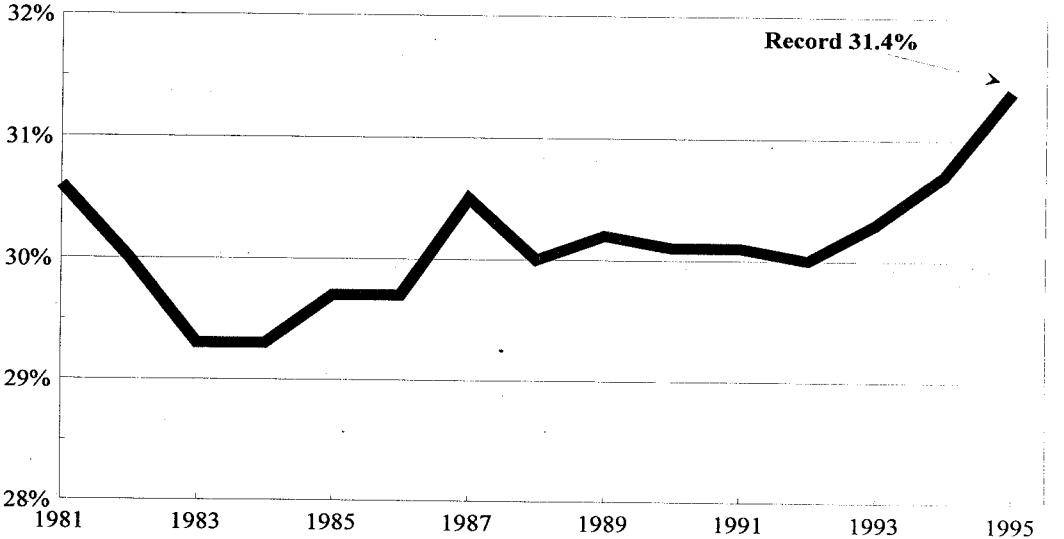

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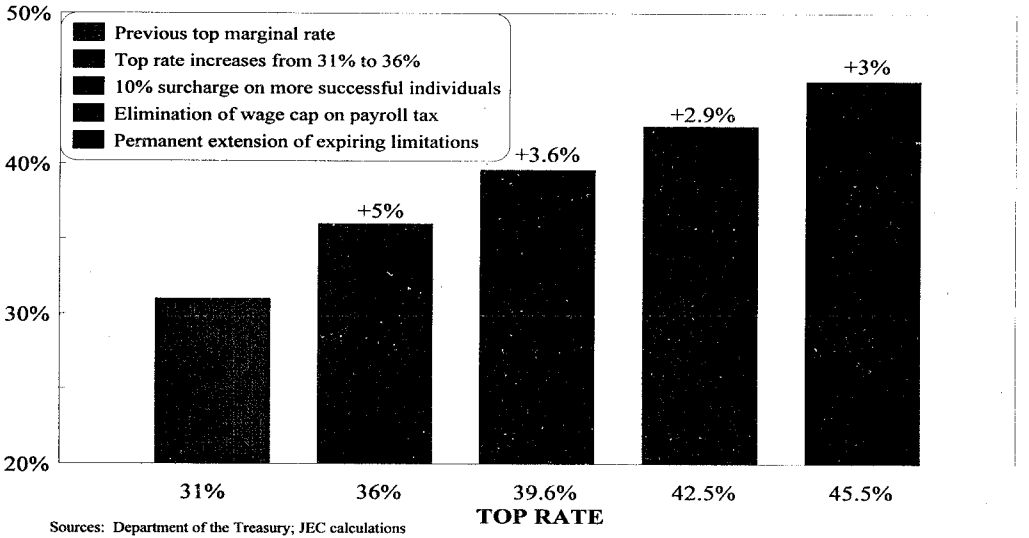
CLINTON'S IMPACT ON THE TOP MARGINAL TAX RATE



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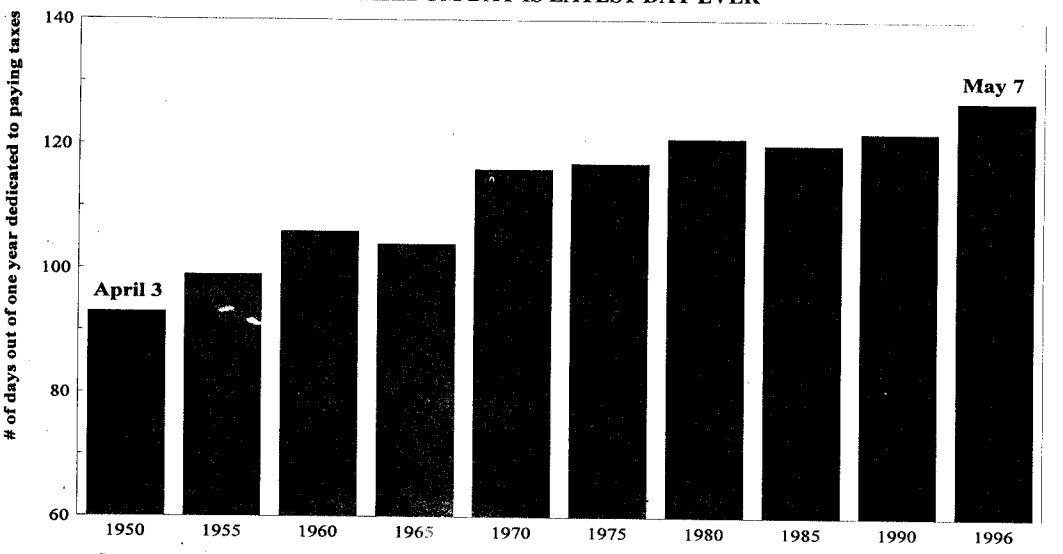
TAX FREEDOM DAY IS LATEST DAY EVER



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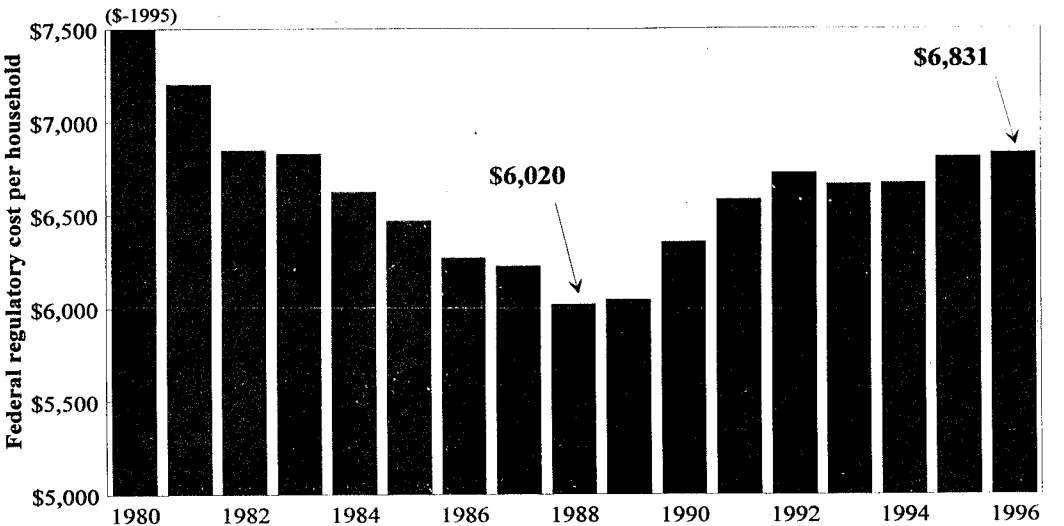
GROWING REGULATORY COSTS PER HOUSEHOLD



Source: Thomas B. Hopkins, "Profiles of Regulatory Costs," Report to the SBA, November 1995

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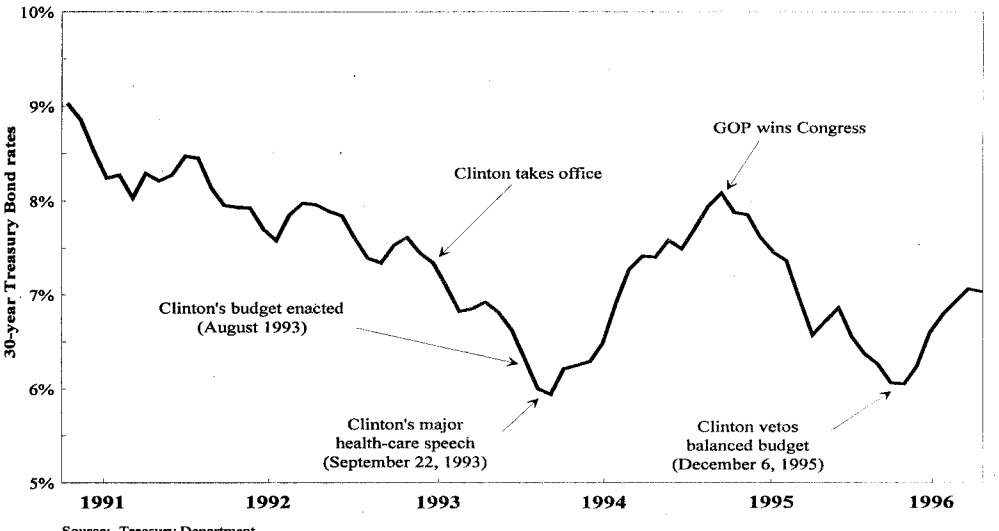
INTEREST RATES ON THE RISE



Source: Treasury Department

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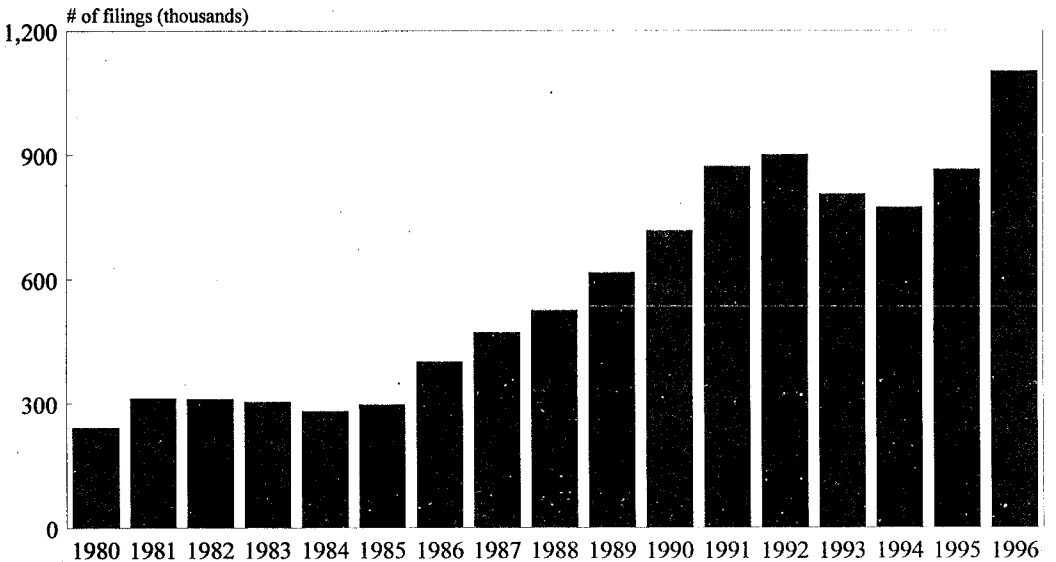
RECORD PERSONAL BANKRUPTCY FILINGS



Source: Administrative Office of U.S. Courts

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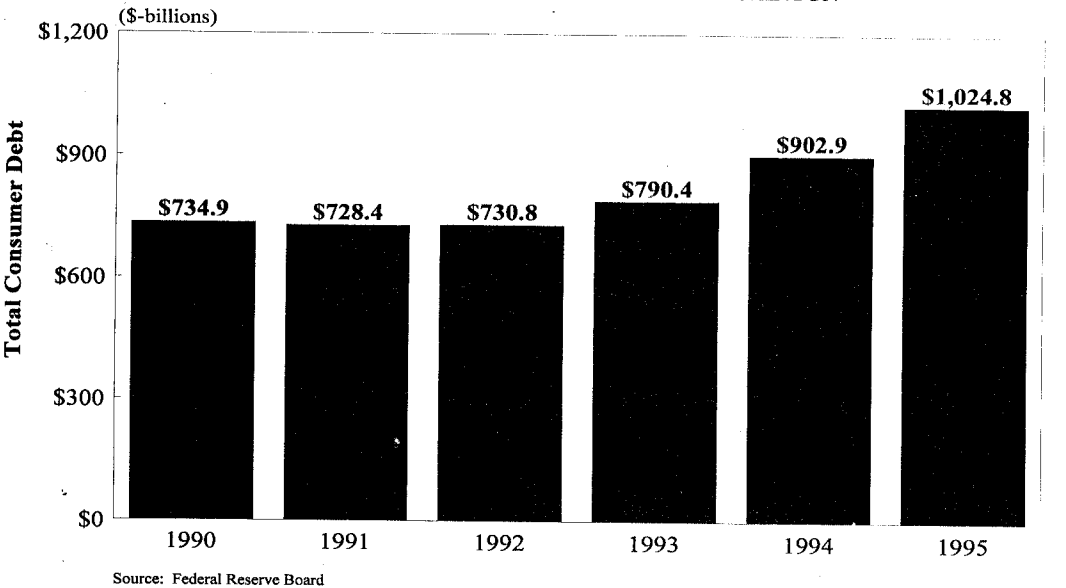
CONSUMER DEBT HAS SKYROCKETED UNDER CLINTON



Source: Federal Reserve Board

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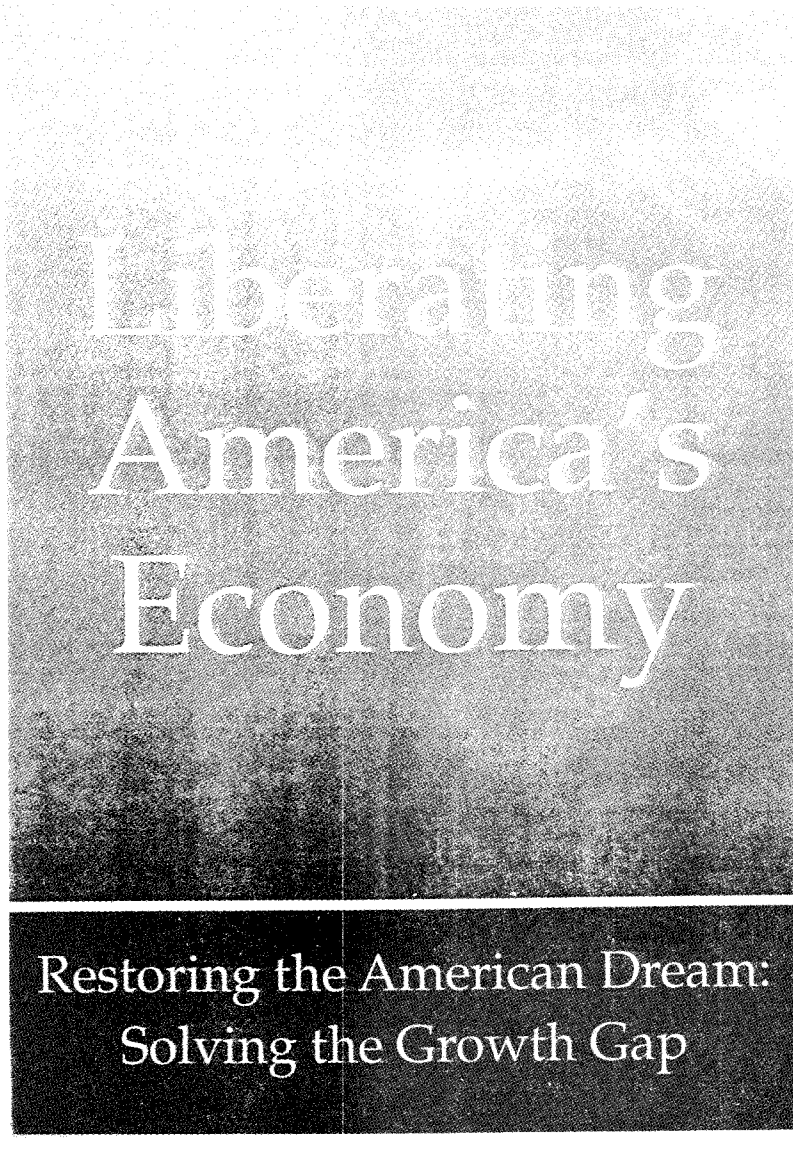
Liberating
America's
Economy
Restoring the American Dream:
Solving the Growth Gap

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

MEMORANDUM

TO: REPUBLICAN COLLEAGUES
FROM: Senator Connie Mack
RE: Stronger Economic Growth
Date: July 1996

Can America's economy grow faster? I believe it can, and many economists and historians agree. Faster economic growth will mean more jobs, better paychecks and a higher standard of living. It will boost revenues to help balance the budget. And it will bring new opportunities for all Americans and a brighter future for tomorrow's generations.

For practically this entire century, American families have enjoyed the benefits of stronger economic growth. But recently, we have seen our economic growth rate fall from a robust 4.4 percent annual average over the last five expansions to an anemic 2.3 percent annual average during Bill Clinton's tenure. Still, some people, including President Clinton, consider a growth rate of 2.3 percent acceptable - even laudable. Why accept such mediocrity? We can and must do better.

In recent years, too much government spending, regulation and taxes have taken their toll on the economy, as well as the American people. Conversely, the periods of better growth in days gone by were marked by lower taxes, lower government spending and fewer federal regulations. A return to policies of less taxing, less spending, less government and more freedom will allow Americans to enjoy stronger economic growth and higher standards of living, and more readily attain the American dream, regardless of where they may be on the economic ladder.

The following report considers three important questions:

- Why is today's economy growing so slowly?
- Can America's economy grow faster?
- What will faster growth mean for Americans?

I hope you find this packet useful and informative. If you have any questions or comments, please contact the Joint Economic Committee at 224-5171.

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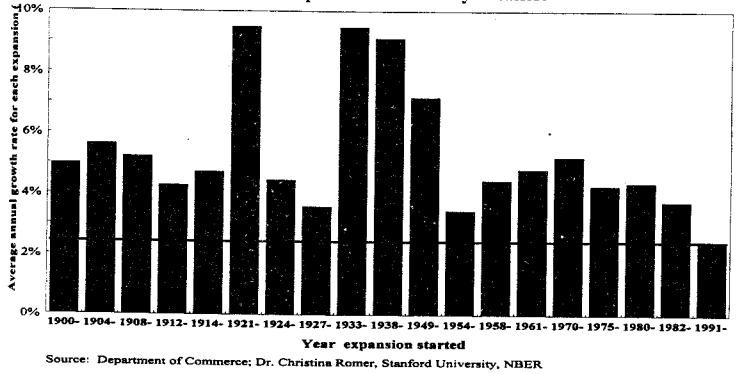
104th CONGRESS

WHY IS TODAY'S ECONOMY GROWING SO SLOWLY?

WHY IS TODAY'S ECONOMY GROWING SO SLOWLY?

Despite President Clinton's self-congratulatory portrayal of the economy's performance, economic growth during this Administration has been lackluster at best. In fact, this expansion, which began in the second quarter of 1991 while George Bush was president, has become the slowest of any in more than 100 years. Bill Clinton's 2.3 percent average GDP growth is unusually weak - at least two full percentage points lower than the average growth rate attained during the last five economic expansions. Such anemic growth has characterized the Clinton economy and has become the source of real anxiety for American workers, saddling them with stagnating incomes and fewer job opportunities. President Clinton's policies of higher taxes, increased government spending and more regulation, along with diminished savings, investment, and productivity, have dramatically impeded economic growth.

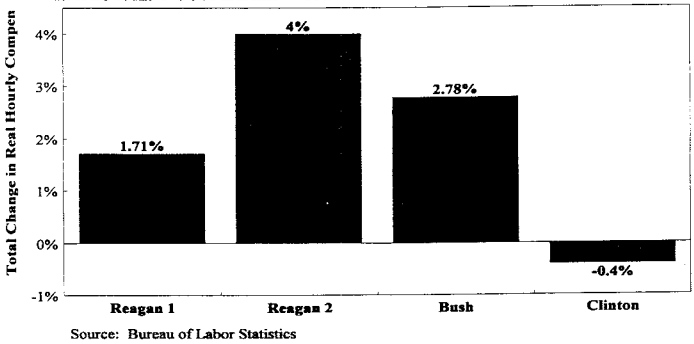
Economic Expansion Historically Weakest



Source: Department of Commerce; Dr. Christina Romer, Stanford University, NBER

On top of this, hourly compensation, which measures both workers' wages and benefits, has fallen 0.4 percent after inflation under President Clinton's tenure. Under President Bush, compensation grew by 2.78 percent, while President Reagan's two terms saw compensation rise by 1.71 percent and 4 percent, respectively. Bill Clinton's slow economic growth is not just some abstract phenomenon of concern to only politicians and academics. Weak economic growth is especially hurting middle-class working Americans who depend on wage and benefit increases for their economic well-being.

EMPLOYMENT COST INDEX: WORKER'S WAGES AND BENEFITS DECLINE



Source: Bureau of Labor Statistics

GOVERNMENT IS TOO BIG

The underlying problem is that the federal government has grown so large that it has become a real deterrent to economic growth, if only because the sheer volume of productive resources it consumes or directs through government spending.

Consider that:

- Outlays in recent years have remained at about 22 percent of GDP, rising higher during years of weak growth.
- Government outlays between the 1950s and 1970s, when economic growth was stronger, averaged about 18 percent of GDP.
- Tax rates have a clear impact on economic growth. A recent study for the JEC[1] demonstrated that relatively low-tax states in the United States grew nearly one-third faster than high-tax states.

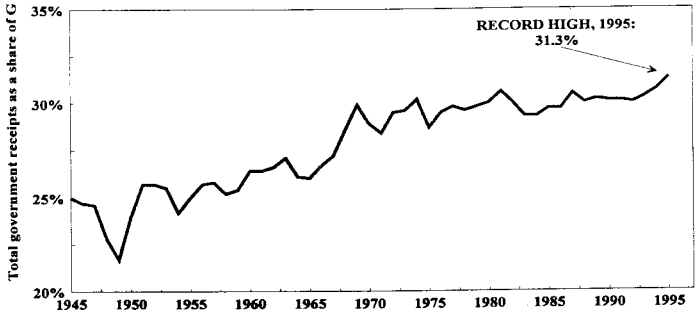
Research has continued to demonstrate the worldwide fact of life that economic growth slows when government grows. For example:

- National Bureau of Economic Research: an increase "in government spending and taxation of 10 percentage points was predicted to decrease long-term growth rates by 1.4 percentage points."[2]
- American Sociological Review: "Increases of one percent in the tax burden relative to household income are directly associated with a 2.8 percent decline in economic growth over three years, or just under one percent annually."[3]
- Journal of Political Economy: based on worldwide data, increasing the tax burden by ten percentage points will reduce annual growth by two percentage points.[4]

TAX INCREASES TAKE THEIR TOLL

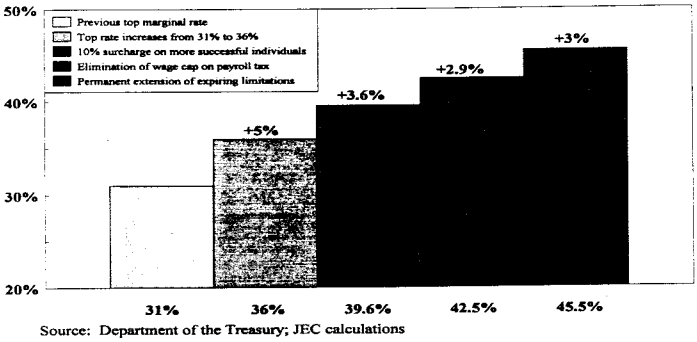
The level of taxation on private resources has an enormous impact on growth. Changes in the marginal tax rate and after-tax income impact work, savings and investment decisions. In 1993, President Clinton levied the largest tax hike in history, including steep income tax hikes on successful individuals and small businesses. The federal tax burden alone went from 19.2 percent of GDP in 1992 to an estimated 20.5 percent today. The total tax burden on the economy has reached a record high of 31.3 percent of GDP. President Clinton dramatically increased the marginal tax rate from 31 to 45.5 percent. Higher taxes translate into lower private savings and investment, and reduced capital accumulation and technological progress, which in turn reduce productivity growth, incomes, and the overall standard of living.

TOTAL TAX BURDEN HITS RECORD HIGH



Source: Department of Commerce

CLINTON BOOSTS MARGINAL TAX RATES

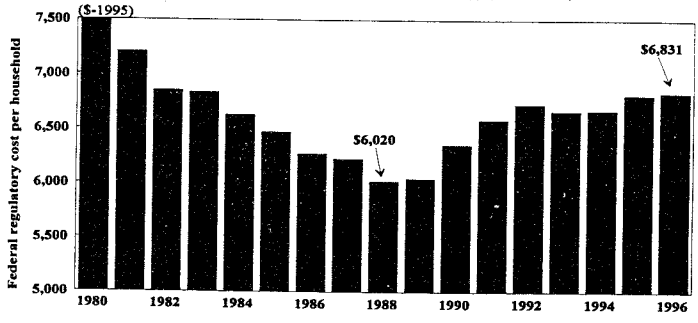


Source: Department of the Treasury; JEC calculations

THE REGULATORY BURDEN GROWS

Similar to taxes, government regulations reduce the income private individuals and businesses are able to spend, save or invest. During President Clinton's tenure, regulatory costs per household have risen steadily to their highest levels in more than a decade. Total federal regulations amount to an estimated $6,831 per household this year. Another measure of government regulation is the number of pages in the Federal Register. This publication records all regulatory agency activity, including meetings held, regulations proposed and policies changed. Although not precise, there is a significant link between the activity of regulatory agencies and the amount of new regulations passed each year. Despite this Administration's talk of "re-inventing" government, the regulatory burden imposed on the private sector has expanded.

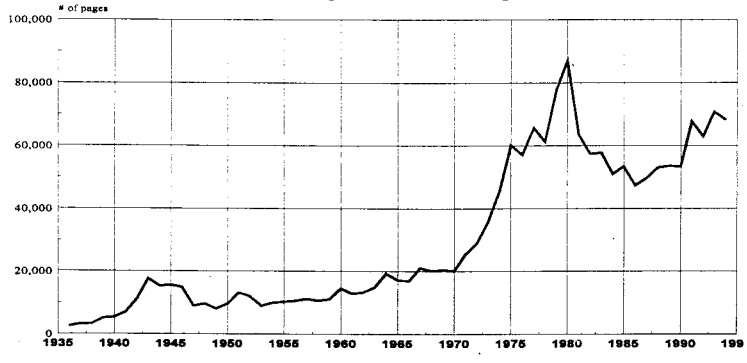
REGULATORY COSTS PER HOUSEHOLD



Source: Thomas B. Hopkins, "Profiles of Regulatory Costs," Report to the SBA, November 1995

In fact, a recent survey of more than 800 companies by the U.S. Chamber of Commerce[5] found that the burden of regulations imposed on employers is a major deterrent to productivity and growth. Half of the firms in the survey spend up to 5 percent of their annual budgets just to comply with federal regulations. More than half reported having to hire lawyers and other consultants to comply with government regulations. And about a fifth had hired permanent staff to deal with labor and benefits requirements. One in six firms reported having laid off employees due to the high cost of labor-benefits regulations.

Number of Pages in the Federal Register



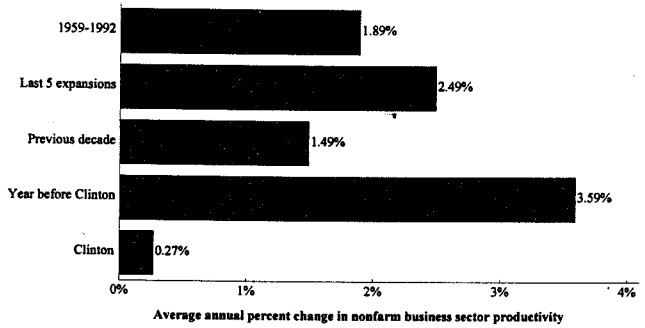
Source: Marvin Zonis & Associates, Inc.

PRODUCTIVITY PROBLEMS

Productivity is the key measure of the effectiveness of labor. A more productive workforce results in increased economic growth and raises the overall standard of living. Higher productivity growth is integral to attaining higher wages and benefits. Unfortunately, productivity growth continues to decline under Bill Clinton. Productivity is growing more slowly than in any expansion in recent history, at an average annual rate of 0.27 percent.

The combination of higher tax burdens and lower savings and investment over the past several years has diminished productivity growth. Less investment translates into less expansions, fewer jobs, and foregone technological advances, reducing the effectiveness of their labor and limiting their productivity and wage growth.

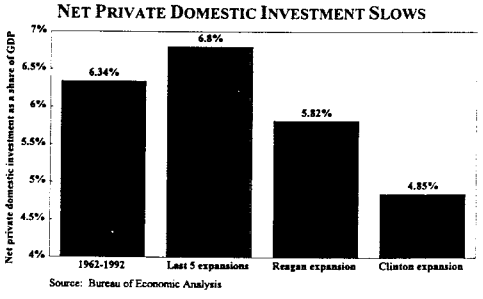
PRODUCTIVITY STAGNANT UNDER CLINTON



Source: Bureau of Labor Statistics

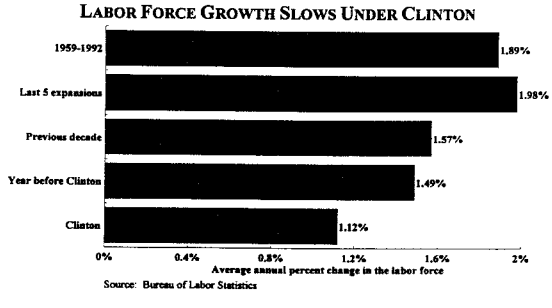
NET PRIVATE DOMESTIC INVESTMENT SLOWS

In order to provide consumers with the goods and services that they need, private industry needs capital: machinery, computers, tools, and all the other factors of production. Net private domestic investment is the amount that private American firms and individuals invest in capital less the amount of capital they consume, or take out of production. Net investment is essential for economic growth because it allows American firms to boost production, create jobs, raise wages, and expand their businesses. During the Clinton expansion, the annual average growth of net investment has been lower than in any other expansion in recent history. It has been almost 2 percent of GDP lower than the average of all expansions since 1962, and almost 1.5 percent of GDP lower than the previous 30 years, including recessions, periods of double-digit inflation, wars, and oil shocks.



DECLINING LABOR FORCE GROWTH

The labor force includes the total number of people currently working or looking for work. As working spouses in high-tax-rate households and more potential workers become discouraged, the labor force declines and the growth of goods and services that can be produced drops. Slower labor force growth prevents the economy from growing at its full potential. During the Clinton expansion, the employment to population ratio has increased at half the rate of the previous expansion. At present there are at least 1.5 million Americans who no longer consider themselves part of the labor force.



CAN AMERICA'S ECONOMY GROW FASTER?

CAN AMERICA'S ECONOMY GROW FASTER?

The Clinton Administration seems to think that 2.3 - 2.5 percent growth is the best America can hope for. Given the difficulties that slow economic growth has caused American families, they have a right to ask whether it is possible to sustain long-term economic growth above the current anemic rates. The evidence clearly shows that the answer to that question is a resounding "yes."

WE HAVE GROWN FASTER IN THE PAST: The economy's weak performance during this period of "expansion" - 2.3 percent average annual growth - stands in sharp contrast to the economic growth record during most decades this century.

- Economic growth averaged 3.7 percent following the 1982 recession, 4.4 percent following the 1980 recession, 4.4 percent following the 1974 recession, and 5.2 percent following the 1969 recession.
- The Kennedy-Johnson economic expansion saw an annual average 4.8 percent in real GDP growth.
- In fact, during the decade before President Clinton took office, the economy grew at 3.2 percent per year. In the five most recent economic expansions, the economy grew an average of 4.4 percent. And since the end of World War II, including both expansions and recessions, the economy has averaged 3.3 percent growth. The Clinton economy falls short by every measure.
- Earlier periods in American history have also enjoyed much higher economic growth: In the 1920s, average annual growth was above five percent and the 1950s enjoyed an average annual growth above six percent.

OTHER COUNTRIES ARE GROWING FASTER: Higher economic growth is not only possible, but widespread among countries with very different histories and cultures. In fact, 66 of America's trading partners grew faster in 1995 than the United States' 1.4 percent growth.[6] Some of these include:

COUNTRY	GDP	COUNTRY	GDP	COUNTRY	GDP
Canada	2.5 %	Denmark	3.5%	Turkey	5.9%
Germany	2.5 %	New Zealand	3.7%	Ireland	6.3%
France	2.7 %	Sweden	3.9%	Poland	6.5%
Italy	3.0 %	Norway	4.4%	Taiwan	6.6%
Netherlands	3.0 %	Brazil	4.9%	Chile	7.5%
Australia	3.1 %	Finland	5.0%	Korea	9.1%
U.K.	3.2 %	India	5.5%	China	9.5%

TECHNOLOGY IS EXPLODING: America leads the world in office computerization and the introduction of new computer-aided design and manufacturing processes in the workplace. Fiber optic telecommunications lines are linking homes and offices faster than ever before. Wireless communications systems, cellular telephones and pagers are allowing ever closer coordination among American workers and the customers they serve. The pace of economic *change* is so fast that some Americans feel they cannot keep up. Many parents find themselves relying on their children to teach them how to use new electronic equipment in their homes. But workers of all ages are continually upgrading their workplace skills and establishing the potential for increased productivity and economic growth.

- The number of people using computers is skyrocketing. In 1970, fewer than 100,000 Americans used computers, but by 1990 that number was 75.9 million. Plus, the U.S. has over 40 percent of all the computers in use worldwide. *(World Competitiveness Report, 1994)*

- American businesses invested over $13 billion in 1994 to install local area computer networks. Today, over 61 percent of all business computers in the United States are hooked up. *(World Competitiveness Report, 1994)*

- The U.S. has more than twice the number of research and development scientists and engineers working in its private industries than its nearest competitor (Japan), and spends nearly one-and-a-half times as much on R&D as Japan. *(World Competitiveness Report, 1994)*

- Technology growth is more than a promise for the future. During the expansion of the 1980s, when today's tech boom was in its infancy, economic growth soared at a 3.7 percent annual rate.

FOREIGN MARKETS CAN BE OPENED FURTHER: Since 1970, international trade has more than doubled as a percentage of the total U.S. economy, from 11 percent of GDP to 22 percent in 1995. American exports to the rapidly growing economies in Asia and Latin America support millions of high-paying jobs. The new international trade rules for intellectual property - a major category of United States exports - and services - the most rapidly growing sector of the American economy for two decades - offer the prospect of faster U.S. economic growth.

- World economic freedom is expanding[7], and freer economies have higher potential for economic growth. As the rest of the world grows faster, demand for U.S. exports increases, entrepreneurial ideas flourish, and the U.S. should gain through faster growth, too.

CONCLUSION

Clintonomics is responsible for the barriers to a more rapid economic growth rate: high taxes, heavy regulations, onerous mandates, and misdirection of productive resources. However, the economy is poised on the brink of a golden era of prosperity. With lower taxes, less government regulations, and greater freedom, America will be ready to reap the benefits and opportunities that the next century holds.

WHAT WILL FASTER GROWTH MEAN FOR AMERICANS?

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What would an America freed from Clintonomics look like? Much better than our present economy. So far, the Clinton economy has sputtered along at 2.3 percent annual real growth. The budget President Clinton released earlier this year foresees more of the same through the end of the decade. Based on past calculations by the Joint Economic Committee, Bill Clinton's slow-growth policies will cost America $308 billion in 1996 alone - that's $3,116 per household. That $308 billion is the difference between what will actually be produced in 1996 versus what would have been produced had growth merely kept up with the post-World War II average.

But people would lose even more income in a second Clinton term. President Clinton's latest budget forecasts more of the same anemic growth rates. This slow-growth trend would see GDP increase to $9,295 billion by 2000. By contrast, a growth rate of 3.5 percent would push GDP to $9,727 by 2000 - a difference of $432 billion.

Is a growth rate of 3.5 percent too much to ask for? Definitely not. The economy was growing at a yearly rate of 3.7 percent as recently as 1992, before Bill Clinton and the Democrats passed the largest tax hike in history. And during the last five economic expansions, growth averaged a robust 4.4 percent. So, 3.5 percent growth is clearly attainable.

A growth rate of 3.5 percent would have enormous effects:

- In 2000 alone, America would enjoy a "growth bonus" of $432 billion. Assuming 99 million households, that's $4,364 per household in 2000. Over a full four-year period (1997-2000) the growth bonus would total $1.03 trillion, or $10,385 per household.[8]

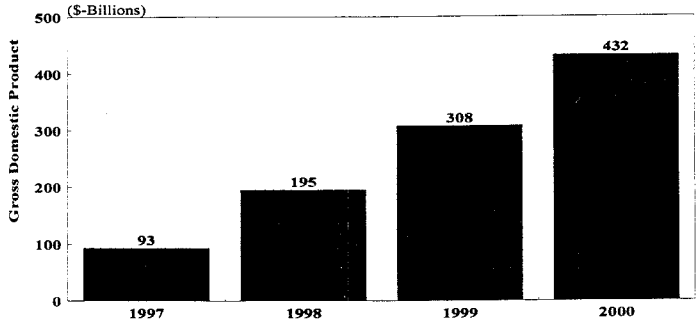
- Wages and salaries alone would increase by an extra $488 billion, or $3,898 per household.[9]

- By the year 2000, the economy would create an additional 860,000 jobs, pushing the unemployment rate down to an average of 5.1 percent, rather than the 5.7 percent that President Clinton predicts.[10]

- Without a tax hike, the federal government will collect at least $159 billion in extra revenue over four years (1997-2000). Reaching a balanced budget would become much easier. The Administration's plan claims to reach balance in 2002. By contrast, the Republican budget plan combined with a 3.5 percent growth rate would achieve balance in 2001 and leave a $143 billion surplus in 2002.[11]

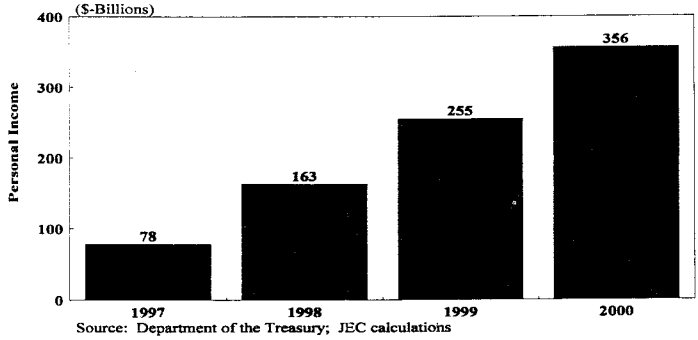
- With GDP boosted by $1.03 trillion over a four-year period, people would start 200,000 more new businesses. Using today's business formation rates, minority entrepreneurs would also benefit, with more than 11,000 extra black-owned businesses and 21,000 extra Hispanic-owned businesses.[12]

CHART 1
EXTRA GROWTH



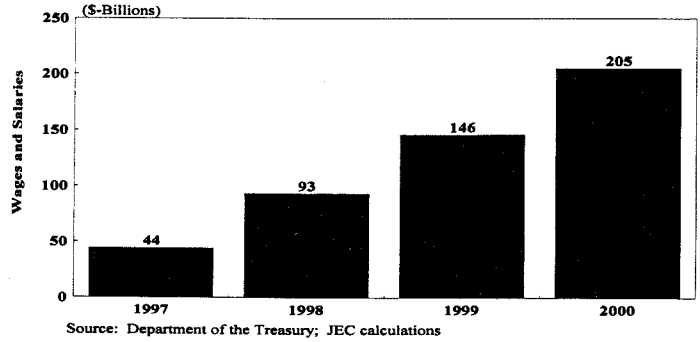
Source: Department of the Treasury; JEC calculations

CHART 2
EXTRA PERSONAL INCOME



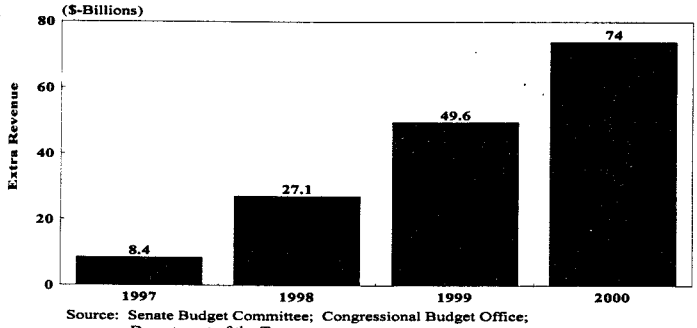
Source: Department of the Treasury; JEC calculations

CHART 3
EXTRA WAGES AND SALARIES



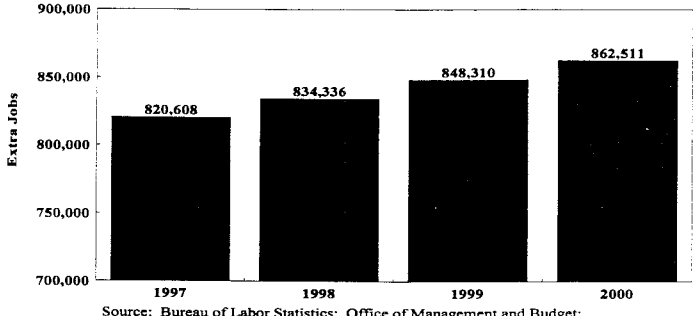
Source: Department of the Treasury; JEC calculations

CHART 4
EXTRA REVENUE



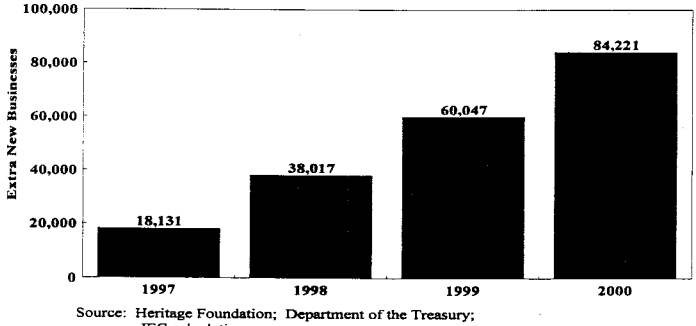
Source: Senate Budget Committee; Congressional Budget Office; Department of the Treasury

CHART 5
EXTRA PEOPLE WORKING



Source: Bureau of Labor Statistics; Office of Management and Budget; JEC calculations

CHART 6
EXTRA NEW BUSINESSES



Source: Heritage Foundation; Department of the Treasury; JEC calculations

ENDNOTES

1. Richard K. Vedder, "State and Local Taxation and Economic Growth," December 1995.

2. Eric M. Engen and Jonathan Skinner, "Fiscal Policy and Economic Growth," National Bureau of Economic Research, *Working Paper Series*, No. 4223, December 1992.

3. Roger Friedland and Jimy Sanders, "The Public Economy and Economic Growth in Western Market Economies," *American Sociological Review*, Vol. 50 (August 1985), pp. 421-437.

4. Robert G. King and Sergio Rebelo, "Public Policy and Economic Growth: Developing Neoclassical Implications," *Journal of Political Economy*, Vol. 98 (October 1990), pp. S126-S150.

5. U.S. Chamber of Commerce, June 25, 1996.

6. Department of State, "Country Reports on Economic Policy and Trade Practices," report to Committee on Foreign Relations and Committee on Finance of the U.S. Senate and Committee on International Relations and Committee on Ways and Means of the U.S. House of Representatives, March 1996.

7. Heritage Foundation, Index of Economic Freedom, 1996.

8. President Clinton's most recent budget projects 1996 GDP at $6,888 billion, in chain-weighted 1992 dollars. Applying a real yearly growth rate of 3.5 percent to this figure yields a result of $7,904 billion in 2000. To convert this into current dollars, multiply this $7,904 billion by Clinton's predicted current-dollar GDP for 2000 ($9,295 billion), then divide by his forecast for real chain-weighted GDP ($7,553 billion). That factors-in Clinton's predicted inflation levels and yields a current-dollar GDP of $9,727.

   Applying the same method for each of 1997, 1998 and 1999 gives results of $8,101 billion, $8,612 billion and $9,156 billion, respectively. The differences between these figures and Clinton's GDP estimates for these years totals $1,028 billion.

9. Wages and salaries figures were derived by multiplying the share of GDP that Clinton estimates will go to wages and salaries in each year by the higher GDP figures that come from a 3.5 percent growth rate, then adding the differences for each year.

10. Assume that the labor force continues to grow through 2000 at the same rate it has grown since 1948. Also assume that a sustained 1.2 percentage point increase in GDP leads to a drop of 0.6 percentage points in the unemployment rate. This assumption comes from Clinton's budget which assumes a negative link between an extra 1 percentage point in economic growth and 0.5 percentage points in the unemployment rate.

11. Page 13 of Analytical Perspectives in Clinton's budget forecasts the added revenue generated by a sustained 1 percentage point rise in the GDP growth rate. In the first four years this totals $129 billion. This converts to $154.8 billion as the actual increase in the growth rate would be 1.2 percentage points, not 1 percentage point. In turn, this rises to $159.1 billion as the extra growth would start one year later and Clinton expects a 2.8 percent rise in the chained price index during 1996. To get the surplus in 2002 under 3.5 percent growth and the Republican budget plan, simply continue the same method through 2002, factoring in changes in spending too. Then apply this deficit change to the GOP budget plan.

    Although added growth should generate less unemployment, this estimate assumes no change in the unemployment rate. A fall in the unemployment rate would yield even more revenue.

12. A recent study by the Heritage Foundation found that a change of $1 billion in GDP is positively linked to 194.957 new business incorporations. Multiplying this number by 1,028 ($1,028 billion in extra GDP) yields a result of 200,416 extra businesses incorporated. From 1987 to 1992, the number of businesses in the U.S. rose by more than 3.5 million, according to the Census Bureau. Of these, 5.537 percent were black-owned. Applying this same share to the projected increase in the number of new businesses yields a result of 11,098 new black-owned businesses. The same method yields a result of 21,019 for the potential increase in Hispanic-owned businesses.

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Joint Economic Committee Report

Limiting Government to Protect Freedom: Reclaiming an American Tradition

An examination of why Budget Balancing enforcement mechanisms are necessary to counteract the inherent lack of discipline in the political process.

February 1995

Joint Economic Committee
U.S. SENATOR
Connie Mack
CHAIRMAN

LIMITING GOVERNMENT TO PROTECT FREEDOM: RECLAIMING AN AMERICAN TRADITION

With high levels of deficit spending and national debt projected to grow ever higher in coming years, a variety of proposals have been advanced to stem the flow of red ink. Several of these proposals seek to address deficiencies in the way Congress considers tax and spending legislation. According to the perspective underlying these proposals, current Congressional procedures embody a bias towards higher Federal spending and against full and informed consideration of its cost.

The reforms advanced to correct this bias include the balanced budget constitutional amendment, line-item veto, super-majority vote requirements for tax increases and spending initiatives, and the spending reduction commission. All attempt to effect institutional reform in order to constrain the bias towards additional Federal spending expressed through Congressional action. None is likely to be sufficient alone, but in concert these proposals could have a powerful corrective impact.

This paper will examine the concept of constraining government fiscal action in the context of the American tradition, using some of the tools provided by modern public choice economics. Limits on government discretion will be considered in relation to the political philosophy expressed in the Constitution, as defined in The Federalist.

Such limits will also be viewed as preventing the abuse of our Republican system of government by special interest groups, and also serving to avert national bankruptcy. The discussion begins with a consideration of limited government by the Framers of the Constitution. As we shall see, many of the arguments involving constitutional constraints on government can be applied to non-constitutional reforms as well.

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Constitution of Freedom

As set forth by the Founders and in The Federalist, the Constitution placed limits on the national government in order to protect individual freedom. Though there were differences of opinion among the Framers as to which branches, departments, and levels of government posed the gravest potential danger to personal liberty, there was broad agreement that government power should be limited and that unbridled government was dangerous.

The Framers went about their work without utopian delusions about changing human nature, but with the practical objective of designing a system that did not completely depend upon the virtue of politicians and office holders, which Madison pointed out in The Federalist No. 51:

> "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself."

There was little expectation that human nature would be improved by virtue of public service. The same limitations of human nature so evident in private life would also appear in public service, though in the latter case the potential for harm is much greater due to the coercive nature of government.

To limit the concentration of government power exercised by public officials, the government was divided. The functions of government were divided between the national and state governments, and the national government was divided into branches so that "each may be a check on the other." The objective was to maintain "that separate and distinct exercise of the different powers of government, which to a certain extent is admitted on all hands to be essential to the preservation of liberty."

Furthermore, according to Madison, "It will not be denied that power is of an encroaching nature, and that it ought to be effectually restrained from passing the limits assigned to it." The structure of government was not designed to improve human nature, but so that "Ambition must be made to counteract

ambition." The institutions of government were intended to limit each other to keep them within bounds.

This view of human nature in politics also leads to the conclusion that temporary coalitions of special interest must be controlled to protect the general welfare. As James Madison argued in The Federalist No. 10, one of the virtues of a constitutional order would be

> "its tendency to break and control against the violence of faction...united and actuated by some common impulse of passion, or of interest, adverse to the rights of other citizens...To secure the public good and private rights against the danger of such a faction, and at the same time to preserve the spirit and the form of popular government, is then the great object to which our inquiries are directed."

Clearly, breaking the influence of faction, or in contemporary usage, special interest groups, is central to Madison's argument for the Constitution.

The Federalist political philosophy that men do not become wiser or more virtuous upon entering government, that institutional checks and limits are necessary to protect freedom, and that coalitions of special interest groups must be contained to protect the constitutional order, are as relevant today as they were over 200 years ago. These are timeless features of sound policy that are relevant to all fiscal reforms, whether constitutional or statutory in nature.

A Revolution In Constitutional Economics

In consideration of issues pertaining to the Constitution, it is appropriate to consider recent advances in economic theory that have improved our understanding of constitutional limits to government. Much of this progress is associated with two economists, both Nobel Laureates, James Buchanan, and the late F. A. Hayek.

Though using different approaches, both have reached conclusions in keeping with the spirit of the Federalist philosophy embraced by most of the Founding Fathers. That spirit acknowledges human fallibility in government and supports the principles of limited government, individual freedom and equal justice under law.

James Buchanan is considered the father of modern public choice economics, an approach that applies the principles of microeconomic analysis to political decision-making. F.A. Hayek has made a number of critical contributions to both economics and political science, including an analysis of why government attempts to manage the economy end in failure, as well as a comprehensive analysis of constitutional issues, in The Constitution of Liberty, and other works.

As a number of economists has noted, a balanced budget rule was implicitly part of the Constitution from the beginning. As public choice economists such as James Buchanan have emphasized, it was only after neo-Keynesian economics and its endorsement of deficit spending became accepted in the early 1960s, did deficit spending become the rule instead of the exception.

According to the neo-Keynesian view, the main object of government policy should be to balance the economy, not the budget. It was argued that government policy could "fine-tune" the economy to achieve targeted levels of economic growth, unemployment, and inflation. Although this view was later embodied in the Humphrey-Hawkins Act, the attempts to fine-tune the economy failed, and resulted in the simultaneous rise of inflation and unemployment in the late 1970s, breaking the back of the Phillips curve.

As Hayek pointed out, the rationale of such policies as "fine-tuning" was based on the assumption that government officials possess more information than they actually have; he calls this the "pretense of knowledge." Hayek's insight harkens back to The Federalist, in the recognition of limits in human nature shared by public officials.

Modern public choice economists have also noted the fact that the "fine-tuning" approach assumes a degree of omniscience and disinterest among public officials and their advisers that is totally unrealistic. This also legitimizes a concentration of power in government that although well-intentioned, is extremely dangerous and runs against the whole spirit of The Federalist.

The broadly perceived failure of fine-tuning has undermined the belief in government management of the economy. However, by breaking what Buchanan has called the traditional "taboo" against deficit spending, this neo-Keynesian thinking left a legacy of unconstrained spending. No longer did increases in spending remain within the level set by expected revenues, but could exceed them whenever policy-makers deemed it desirable.

Without this balanced budget constraint, it is very difficult for members of representative institutions to resist pressures for additional spending. The benefits of Federal spending programs are typically concentrated among program beneficiaries, while their costs are diffused among all taxpayers. This asymmetry means there is usually more intense and focused political pressure brought to bear in favor of specific programs than that reflecting the interest of all taxpayers in opposing program spending.

This modern perception of public choice economics is very similar in spirit to Madison's observations about the need for institutional safeguards to constrain the dangers of "faction." The point here is not to allege shortcomings amongst members of the legislature, but simply to identify the tremendous pressures for additional spending they so often face. If the current structure of our political institutions makes resistance to such pressure in the public interest more difficult, then this suggests the need for institutional reform.

Institutional Reforms Needed

We need to restore the lost balanced budget rule of our constitutional order by making it a written part of the U.S. Constitution. However, other reforms will also be needed to successfully implement any such constitutional restoration.

To achieve its constitutional purpose in limiting government, the balanced budget amendment will likely need some mechanism to at least assist the achievement of fiscal balance. The balanced budget rule as an abstract concept cannot, in and of itself, provide the appropriate budgetary decisions needed to bring Federal outlays and receipts into balance by the fiscal year 2002.

Congress, acting in the budget process, may make significant strides towards this objective, but may well fall short. An institutional safeguard is needed to backstop the political system and ensure that the job is finished. This would be the role of the proposed Spending Reduction Commission, modeled after the highly successful Base Closure and Realignment Commission.

In the absence of this kind of institutional reform, there would be valid reasons for concern about the ability of Congress to balance the budget. As Madison pointed out, the power of coalesced factions, or special interest groups, is immense, and they will resist any effort to reduce spending growth in their favored programs. Public choice economists have also identified a kind of legislative myopia, called fiscal illusion, which is facilitated by deficit spending.

The benefits of program spending are all too visible, while the costs they impose through debt financing are much harder to identify. The legislative consideration of new spending is distorted by fiscal illusion. Fiscal illusion, via deficit finance, can be addressed by the balanced budget amendment, but the problem that spending benefits are more concentrated than their costs to taxpayers remains.

What is needed to redress the balance is a single-minded focus on the spending side of the budget. The current fiscal problem originates from the failure of spending to remain within the bounds set by revenues. While revenues normally oscillate around 18-19 percent of the Gross Domestic Product (GDP), the spending share of GDP has climbed far above this level, and is currently estimated at about 22 percent of GDP.

The Spending Reduction Commission proposed by Senator Mack would help Congress maintain its attention on the spending side of the Federal budget. Congressional actions to reduce Federal spending growth would not be adversely affected in any way, but any shortfalls in achieving the glide path to a balanced budget would be covered by the commission.

Given the intense pressures brought to bear by special interest groups and the procedural obstacles that could be invoked, some back-stopping of the normal budget process is clearly needed. The commission is essentially an insurance policy in which the American taxpayer is the beneficiary.

It is essential that the path to a balanced budget be followed by reductions in spending growth, not tax increases. Tax increases would increase both the economic and political cost of excessive government. Moreover, research at the Joint Economic Committee suggests that such attempts would be futile and self defeating, since in the postwar period studied, each $1 of taxes raised by Congress resulted in $1.59 of new spending. The Spending Reduction Commission would avoid the counterproductive path tax increases.

Fiscal Disorder Erodes Democracy

Unchecked deficit spending has permitted the Federal government to expand far beyond any achievable political consensus. The German economist, Wilhelm Roepke, an architect of the German economic miracle, predicted the effects on unchecked government in eerily prophetic terms over 30 years ago:

> "The power of the state grows uncontrollably; yet, since powerful forces are at the same time eroding its structure and weakening the sense of community, there is less and less assurance that the administration and legislation unswervingly serve the whole nation and its long term interests. Demagogy and pressure groups turn politics into the art of finding the way of least resistance and immediate expediency or into a device for channeling other people's money to one's own group. Government, legislation, and politics of this kind are bound to forfeit public esteem and to lose their moral authority."

A balanced budget amendment that does not limit the size of government will do little to prevent this outcome, so evident in the previous Congress. The problem with the Federal government today is that its size and range of activities lack legitimacy because they exceed the wishes of the governed and of the taxpayers.

Moreover, big government exceeds its competence in the sense that in an attempt to do everything, it does nothing well, even those functions supported by a broad range of opinion. Thus a new fiscal regime that will constrain government will also limit the power of special interest pressures to distort the political process and undermine the legitimacy of democratic institutions. This constraint will also help the government adequately perform those functions broadly agreed upon.

Conclusion

In sum, a balanced budget amendment, supplemented with the Spending Reduction Commission, would constrain government growth and prevent excessive deficit spending and tax increases. An economic policy to constrain excessive government is very much in keeping with the views of the Framers in limiting government and the dangerous pressures of special interest groups corrosive to democratic institutions. While the political costs of unconstrained government are very serious, the purely economic costs are also unacceptable.

Christopher Frenze
Majority Senior Economist

Joint Economic Committee

March, 1995

U.S. SENATOR
Connie Mack
CHAIRMAN

ECONOMIC POLICY UPDATE

ISSUED BY:
Connie Mack (FL), Chairman
Jim Saxton (NJ), Vice Chairman
Dick Armey (TX), House Majority Leader

Class Warriors Claim Their First Victim: The Middle Class

For over a decade, the inaccurate criticism that family incomes fell during the Reagan years gained a certain currency in the press and among Democrats. A clear-headed look at the data, however, demonstrates not only that middle class families did well during the Reagan years, but that real family incomes have declined under President Clinton's policies of higher taxes and more regulation. This may be why these same critics appear uncomfortable as they try to explain the somewhat lackluster income record of the Clinton Administration.

". . . real family incomes have declined under President Clinton's policies of higher taxes and more regulation."

For years the critics of Reagan policies used inaccurate Congressional Budget Office (CBO) family income data which led the media and the public to believe that middle class family income was falling during the 1980s, and that Reagan Administration policies were at fault. This political argument was factually false as Census Bureau data show that real middle class family income climbed 13 percent during the Reagan expansion years. Under the Clinton Administration's high tax and regulation policies, however, real family incomes declined 1.9 percent in President Clinton's first year alone.

After the critics had based their "fairness" issue on inaccurate CBO data, Census Bureau data released for 1993 show that, viewed from their own standpoint, the Clinton Administration presides over more unfairness than in any of the Reagan years, or indeed in any year in the postwar period. As a Joint Economic Committee (JEC/GOP) report[1] released by Representative Dick Armey suggested before the election, the fall in middle class income offers "a reason why a majority of Americans disapprove of Clinton Administration economic policies." It has nothing to do with public relations or "getting the message out," and everything to do with the decline of middle class income and earnings under Clinton.

Reich Test for Policy Supports Republican Initiatives

In a January 5, 1995, speech entitled "The Choice Ahead," Secretary of Labor Robert Reich sidesteps the Clinton Administration's failure to improve the economic position of the middle class by offering a disingenuous presentation of household income data using 1979 and 1993 as endpoints. In a partisan attack on Republican economic policies and in defense of the Clinton agenda, Reich ends his speech by setting this test for policy: "Which do you believe will make working families better off?"

Given that the Republican "Contract with America" was a key issue for both Republicans

. . . *continued*

and Democrats in the 1994 election, the American people have already provided their answer. Real median family income grew at a 1.7 percent average annual growth rate during the Reagan expansion years, compared to a 1.9 percent decline in real median family income during the first year of the Clinton presidency. If the income statistics of the last "decade and a half" provide any evidence for guiding policy, as Reich suggested, the one conclusion that can be drawn is that the only growth in median family income occurred when Reagan Administration policies were in effect.

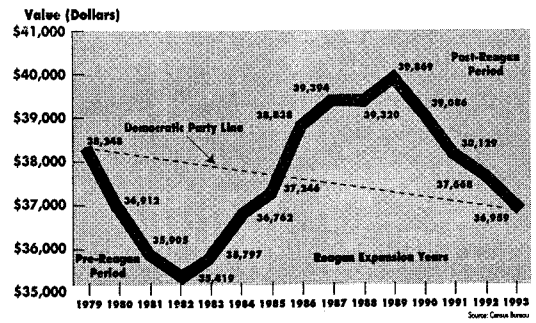
Middle Class Family Income Rises During the Reagan Expansion Years

"Real median family income increased 13% between 1982 and 1989."

Real median family income increased 13 percent between 1982 and 1989, referred to as the Reagan expansion years. However, the 1979-82 period had been a severe setback for family income growth, with 1980 documented as one of the worst years on record. This explains why critics almost always include 1980, the last year of the Carter Administration, in the Reagan 1980s. While a proper demarcation point between the Carter and Reagan Administrations is debatable, even the most partisan Democrats should find it hard to argue that Reagan policies were bad enough to cause income declines the year previous to their passage. Implementation of Reagan income tax cuts began in the middle of 1982.

It also is misleading to say, as Reich did in his speech, that "for a decade and a half, ordinary families have been working harder and getting less." There simply hasn't been the long, gradual, downward trend in family income as the graph indicates. Partisan critics typically include the severe 1979-80 decline in family income under Carter in the Reagan years to flatten apparent income growth during the 1980s. Nonetheless, middle class income started falling late in the Carter years and rebounded during the Reagan years.

Real Median Family Income Rises Under Reagan Policies



In other words, the Reagan expansion years, which Democrats and the media have repeatedly disparaged as the most harmful to the middle class, were actually the one and only time that progress occurred in middle class family income over the last 15 years. It was not until after reversal of the low tax and de-regulatory policies adopted in the 1980s did middle class income start slipping again. In 1993, moreover, even as most other data showed economic expansion, it was remarkable to see a $709 plunge in real median family income.

... *continued*

Other Census data show that in 1993 real median earnings of full-time, year-round workers fell 2.2 percent for male workers and 1.2 percent for female workers. In fact, 1993 accounts for more than half of the decline in earnings experienced by males since 1989. Furthermore, real hourly earnings declined during 1994, and real median weekly earnings fell between the fourth quarter of 1993 and the fourth quarter of 1994.

Who's the Unfairest of Them All?

"... 1993 accounts for more than half of the decline in earnings experienced by males since 1989."

According to the 1992 Clinton campaign, during the 1980s, "...the rich got richer, the forgotten middle class -- the people who work hard and play by the rules -- took it on the chin." The Clinton campaign also trumpeted the incorrect CBO data[2], which was used by economist and then-Clinton ally Paul Krugman, in an attempt to show that the majority of income growth accrued to the top 1 percent. This was all reported in a March 5, 1992, *New York Times* article that contained other factual errors[3]. In his speeches, Secretary Reich has recently returned to this discredited methodology in arguing that 98 percent of the income growth since 1979 accrued to the top fifth of households. However, even using their discredited data source and methodology, this would appear to be an improvement relative to the Carter years when 100 percent of the income gains accrued to the top 1 percent.

"... real hourly earnings declined during 1994."

First of all, this approach is very misleading because of the fluctuation of income over the 1979-93 period. A more accurate description of the data is to say that the income gains during the Reagan expansion years in the four bottom quintiles were virtually wiped out by the income declines occurring in the bottom three quintiles during the other years in the 1979-93 period. Obviously, this pattern in the income data cannot support the argument that neo-Reagan policies will have a negative impact on middle class family or household income growth, as Secretary Reich suggests, since the data clearly point to the opposite conclusion. Furthermore, if Secretary Reich's accounting is accepted, then virtually 100 percent of the total income growth is attributed to the top fifth for the simple reason that his approach means that there is practically no other net income growth.

The Labor Secretary's interpretation is invalid also because at any range of income, the income of some families will be rising while that of others is falling regardless of changes in average income. In contrast to the bleak picture reflected in Census Bureau data for the Carter years, the average family income of all quintiles increased during the 1980s whether 1980, 1981, or 1982 is used as the base year. If the last year or two of the Carter Administration is used as the base year, this indeed changes the picture, but this has nothing to do with Reagan policy.

Second, and most importantly, Secretary Reich's whole exercise is essentially meaningless for the simple reason that none of the quintiles is composed of the same people over time. As has been stressed in a number of JEC/GOP studies, this way of misusing the income data fundamentally misrepresents the American economy by wrongly assuming that families or households are cemented into specific income strata for 10 years or more.

As shown in one JEC/GOP report[4], there is actually a better chance that between 1979 and 1988 a household in the bottom fifth would move to the top fifth than remain in the bottom quintile (in this case defined as a tax filer). With well over 80 percent of this bottom fifth gone only nine years later, arguments such as Secretary Reich's have no relevance to this group. Their incomes have mostly gone up and are no longer in the caste that Secretary Reich has them assigned.

The same is generally true of the middle quintile. Nearly half of the middle fifth had

... continued

moved to a higher strata by 1988, while only one-third remained. Furthermore, of households in the top 1 percent in 1979, over half had fallen to lower percentiles by 1988, replaced by others moving up from below. The argument that Americans are locked in economic strata is a caricature not rooted in reality.

". . . real median weekly earnings fell between the fourth quarter of 1993 and the fourth quarter of 1994."

Third, Secretary Reich's argument is designed to mask the fact that, as pointed out earlier, the Reagan expansion years were actually a period of solid economic progress for the overwhelming majority of Americans. Far from being a period of setback for middle class families, the Reagan expansion years were the one and only improvement for them in the last 15 years. Secretary Reich neglected to mention this important statistical fact about median family income central to the main test he has raised with regard to Clinton Administration versus conservative Republican policies: "Which do you believe will make working families better off? This is the choice before us."

As reported by the Census Bureau, in 1993, the share of total household income in the bottom fifth, at 3.6 percent, was lower under President Clinton than in any Reagan year, and indeed lower than in any year in the postwar period. On the other hand, the share of income in the top 5 percent, at 20.0 percent, was higher under Clinton than in any Reagan year, or any year in the post-World War II period. Under this Administration, income dispersion has become the most unequal on record.

In short, the increase in inequality is larger under President Clinton than in any of the Reagan years. For those who view everything through the lens of redistributionism, the first Clinton year would have to be seen as much more unfair than any of the Reagan expansion years. From this perspective, the Clinton Administration should be viewed as the most unfair in the postwar period. Even after consideration of a number of caveats about the core data related to income mobility and data limitations, the Clinton record is a very shaky platform from which to attack others on the basis of "fairness."

Conclusion

After years of partisan attacks immediately following the release of the annual Census Bureau data on family income, the class warriors were virtually silent following the 1993 income release. Upon reflection and judged on the same basis, the Democratic White House and Congress would have to be viewed as the unfairest of all, producing distributional results that far exceed even its worst caricatures of the allegedly unfair Reagan years. All this, and a decline in real middle class family income!

". . . real median family income fell in all the years chosen by Secretary Reich except the Reagan Expansion years."

Secretary Reich's use of income data of the last 15 years as the basis of support for the Clinton agenda and opposition to renewed Reaganism is disingenuous. According to Reich's policy test, the evidence supports the argument that neo-Reagan policies would increase middle class real family income, and the alternatives depress real family income. That real median family income fell in all the years chosen by Secretary Reich except the Reagan expansion years compellingly refutes his arguments.

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End Notes:

[1] See JEC/GOP report, *Middle Class Income Declines in Clinton's First Year*, October 18, 1994.
[2] See Republican Views of the *1994 Joint Economic Committee Annual Report.*
[3] For example, even the correct number of families was misreported.
[4] See JEC/GOP report, *Income Mobility and Economic Opportunity*, June 1992.

Chapter Four

Monetary Policy

Joint Economic Committee

U. S. SENATOR
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CHAIRMAN

Robert N. Mottice
Executive Director

ECONOMIC POLICY UPDATE

ISSUED BY:
Connie Mack (FL), Chairman
January 29, 1996

DON'T BLAME SLOW GROWTH ON THE FED

"Blaming the Federal Reserve for slow growth and economic problems is wrong. While the Fed has made mistakes in the past, it does not appear that the economy is suffering from a wildly misguided monetary policy;"

It has become commonplace for economists, politicians and journalists to blame the recent poor performance of the U.S. economy on the Federal Reserve. Chain-weighted real GDP has expanded only 2.5 percent at an annual rate since President Clinton took office, real median family incomes have fallen 4 out of the past 5 years and, in recent months, economic data has shown signs of weakness. Rather than understanding that these problems result from a overly burdensome federal government, many pundits lay the blame at the door of the Fed. The complaints take three specific forms:

- Federal Reserve interest rate increases in 1994 have led to the current signs of weakness in retail sales, housing and industrial production. The Fed must ease to avoid a recession.[1]
- The Federal Reserve believes that potential growth in the U.S. economy is 2 1/2 percent and moves to slow the pace of growth anytime that pace accelerates above 2 1/2 percent.[2]
- It is useless to pass pro-growth policies (such as the flat-tax) because the Federal Reserve will prohibit those policies from driving growth above 2 1/2 percent.[3]

IT'S THE FISCAL POLICY THAT MATTERS

Blaming the Federal Reserve for slow growth and economic problems is wrong. While the Fed has made mistakes in the past, it does not appear that the economy is suffering from a wildly misguided monetary policy; the culprits are a burdensome federal government, high taxes and onerous regulations. By focusing attention on the Fed, the real underlying problems of the economy are ignored.

The Federal Reserve controls only one principle policy tool -- money. Printing more money and artificially holding down interest rates may boost the economy in the short-run, but that boost cannot last. Real growth does not come from printing money; if it did, counterfeiting would be a positive force in the economy.

"Real growth is the result of entrepreneurial activity which boosts investment and the output of new goods and services. These goods and services represent the wealth of a country and originate with the creative ideas and hard work of individuals."

Real growth is the result of entrepreneurial activity which boosts investment and the output of new goods and services. These goods and services represent the wealth of a country and originate with the creative ideas and hard work of individuals. Wealth does not come from printing money to hold interest rates down.

WHAT DETERMINES POTENTIAL GROWTH?

The economy's potential to increase output depends on an individual's willingness to save, invest, risk, work and produce. Government policies of taxation, regulation and spending impact potential growth by influencing incentives. High tax rates and burdensome regulations reduce the potential of the economy, while low marginal tax rates, free markets, and a small government allow potential growth to remain high.

The potential growth rate of the economy is influenced by the Federal Reserve in only one way. The Fed can either provide an environment of stable prices, or not. Business decisions become more difficult in an environment wherein participants expect inflation and are uncertain about the level of future inflation. On the other hand, an environment of price stability enhances economic growth by reducing the risk of fluctuations in interest rates, currency values and input costs.

If the Federal Reserve is not focused on price stability, but rather on boosting economic growth, uncertainty about inflation increases. Attempting to push the economy faster than its potential causes stress in the system. When the Federal Reserve attempts to boost growth while the government smothers the economy under a wet blanket of taxes and regulation, inflation will move higher. The only way to boost growth and to allow the economy to grow faster, without increasing inflationary pressures, is to reduce taxes, regulations and government interference in the economy. The Fed should remain focused on price stability.

"Real growth does not come from printing money; if it did, counterfeiting would be a positive force in the economy."

Strong potential growth is essential to boosting living standards over time. During the mid-1980s, real GDP rose (on average) 3.9 percent and real median family incomes rose 1.4 percent annually. Since 1989, real GDP growth has averaged 1.8 percent annually and real median family incomes have fallen 4 of the last 5 years. Between 1989 and 1994, real median family incomes fell 1.4 percent annually.

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IS THE FED HURTING GROWTH NOW?

"When the Federal Reserve attempts to boost growth while the government smothers the economy under a wet blanket of taxes and regulation, inflation will move higher."

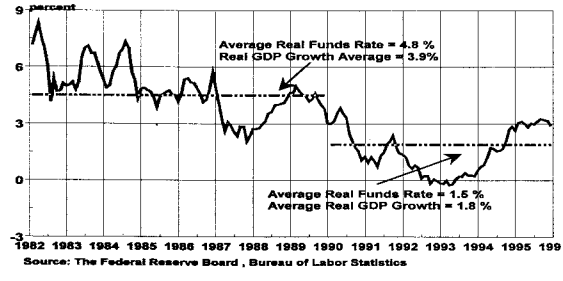
Pundits claim that the Federal Reserve is overly tight in its monetary policy. They suggest that a federal funds rate set at 5 1/2 percent today is too high when inflation is averaging near 2 3/4 percent. However, during the past 15 years, the economy has grown faster during periods of high real interest rates and slower during periods of low real interest rates.

As can be seen in the chart below, the real federal funds rate (fed funds minus the one-year change in the CPI) between 1982 and 1989 averaged 4.8 percent. Since 1989, the real federal funds rate has averaged 1.5 percent. In the past year, the real funds rate has averaged 2.9 percent. A number of conclusions can be drawn from this chart.

- Despite a real federal funds rate average of 4.8 percent between 1982 and 1989, the economy grew at an average annual real rate of 3.9 percent and real median family incomes rose.
- The economy has slowed since 1989, and real median family incomes have fallen, despite much lower real interest rates especially during 1992 and 1993.

"It is not the Federal Reserve that should be blamed for slow economic growth today, but policies of high taxes, regulation and government interference in the economy."

The Real Federal Funds Rate
(The Federal Funds Rate minus the 1-year change in the CPI)



Source: The Federal Reserve Board , Bureau of Labor Statistics

"The reason the economy appears to be struggling and incomes have stagnated is not the Fed, but the higher taxes, regulations and government spending that have characterized the Clinton Administration. In order to boost growth, these policies must be reversed."

- Industrial production, retail sales and housing activity have all slowed this year despite the fact that the real federal funds rate is lower than it was between 1982 and 1989.

From these data we can reasonably conclude that the real federal funds rate is not the sole determinant of the strength in real GDP. This suggests that many analysts are being short-sighted when they blame any current economic weakness on the Fed, or when they suggest that it is the Fed which keeps the economy from growing faster than 2 1/2 percent.

WHAT POLICIES MATTER?

In looking for the cause behind changes in the potential real growth rate, we must look further than the Federal Reserve. The policy changes during the past 15 years are easy to track and involve tax policy, regulatory policy, and government spending.

- The top marginal tax rate fell from 70 percent to 28 percent between 1981 and 1986. However, since 1989, the top marginal tax rate has climbed back to over 40 percent.
- The number of pages in the federal register (a measure of the regulatory burden in America) fell from 87,011 in 1980 to 47,418 in 1986, but rose back to 68,108 by 1994.
- Government spending fell from 22.3 percent of GDP in 1981 to 21.3 percent of GDP in 1989. Since 1989, government spending has remained essentially flat and in 1995 was 21.1 percent of GDP.

The direction of fiscal policies over the past 15 years is clear. Taxes, regulation, and government spending as a share of GDP fell between 1982 and 1989. In 1989, this trend reversed, with tax increases in 1990 and 1993 and regulatory expansion. In addition, government spending has remained essentially unchanged at just above 21 percent of GDP.

The strength in the economy and changes in family incomes have mirrored these movements in fiscal policy despite the level of real interest rates. The real federal funds rate was much higher during the 1982 - 1989 period than it is today, yet real growth was stronger during that period than it is today.

CONCLUSION

"If policies are enacted which boost real growth to 5 percent, the Fed must accommodate this growth or face the prospect of deflation."

It is not the Federal Reserve that should be blamed for slow economic growth today, but policies of high taxes, regulation and government interference in the economy. In the long-run the Federal Reserve cannot boost growth nor hold it back. The Fed can only influence economic activity in the short-run.

The real federal funds rate is lower today than it was in the 1982 to 1989 period. The reason the economy appears to be struggling and incomes have stagnated is not the Fed, but the higher taxes, regulations and government spending that have characterized the Clinton Administration. In order to boost growth, these policies must be reversed.

Any pro-growth policies enacted today will help the economy. If policies are enacted which boost real growth to 5 percent, the Fed must accommodate this growth or face the prospect of deflation. If we insist the Fed maintain price stability, then the Fed will ease the money supply, accommodate the higher economic growth and avoid deflation.

Currently, the Federal Reserve is providing enough liquidity to boost nominal GDP by between 41/2 percent and 5 percent per year. The reason real growth is slow and inflation remains above 2 1/2 percent is that fiscal policies are inhibiting the growth in real output.

Prepared by Brian Wesbury, Chief Economist. (202) 224-5171

ENDNOTES

1. "The economic risk is clearly on the downside ... there is now a somewhat greater risk of recession" Sung Won Sohn, Chief Economist, Norwest Corp.; "Look for a 50-basis-point preemptive strike [1/2 percent cut in interest rates by the Fed] to combat widespread layoffs." Richard Yamarone of Mountain Econometrics. -- Bloomberg Business News, 1/18/96.

2. Robert Kuttner. *Firing Line*, PBS, 12/22/95.

3. Robert Kuttner. *Firing Line*, PBS, 12/22/95.

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

August 1995

ISSUED BY:
Connie Mack (FL), Chairman

ECONOMIC
POLICY
UPDATE

GIVE THE FED INSIGHT, NOT AN INSIDER

"evidence shows that, as the number of members of the Federal Reserve Board that possess private sector experience increases, the U.S. rate of inflation rises at a slower pace."

When Federal Reserve Governor John LaWare resigned from the Federal Reserve Board on April 30 of this year, he urged President Clinton to appoint a representative of the private sector— specifically, a banker—as his replacement.[1] Why? Over the past 50 years, evidence shows that, as the number of members of the Federal Reserve Board that possess private sector experience increases, the U.S. rate of inflation rises at a slower pace.

If the President decides to nominate someone without private sector experience, that would leave only two Federal Reserve Board members with such qualifications. Since World War II, changes in inflation following the actions of a Federal Reserve Board with only two members that have private sector experience have been a full one percentage point higher than the changes following the actions of a Fed Board with three such members.

NO SUBSTITUTE FOR EXPERIENCE

"private sector experience may be more likely to bring a practical point of view to consideration of policy changes on financial markets and businesses."

The importance of Federal Reserve Board members' experiences and backgrounds has been recognized since the Fed's inception. The *Federal Reserve Act of 1913* states "the President shall have due regard to a fair representation of the different commercial, industrial and geographical divisions of the country."

Besides representing different geographical regions, board members with private sector experience may be more likely to bring a practical point of view to consideration of the impact of policy changes upon financial markets and businesses. Board members with only academic or government experience tend to approach policy from a strictly theoretical point of view. Theory may suggest that the economy is slowing because interest rates are too high, while practical experience tells us that the economy is slowing because businesses and consumers are taxed or regulated too heavily.

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ROUGH WATERS OR SMOOTH SAILING?

"practical experience tells us that the economy is slowing because businesses and consumers are taxed or regulated too heavily."

The Humphrey-Hawkins Act of 1978 governs much of the Fed's monetary policy activity. This law is the Federal Reserve Board's *Mission Impossible*, requiring the central bank to boost the economy through monetary action while simultaneously keeping prices stable.

While the Federal Reserve Board may boost economic activity slightly in the short term, the long-term price of the short-term enhancement is higher inflation. For example, interest rates may fall in the near term, but the resultant higher inflation from the Federal Reserve's ease will drive interest rates higher than they were before the whole process started. Such interest rate and inflation fluctuations make it difficult for businesses to realistically plan for the future.

This basic understanding is as obvious to those coming from the private sector as it is foreign to ivory-tower academics. The more theoretical the approach to the economy, the more likely the Fed will try to "fine-tune" the economy rather than simply keep our money sound and our financial system secure.

"the long-term price of the short-term enhancement is higher inflation."

Some theorists even argue that small amounts of inflation (say, 3 percent) do not adversely affect the economy. However, Federal Reserve Chairman Alan Greenspan has stated that "to encourage the greatest possible sustained advance in economic activity over time...requires that growth be noninflationary. Price stability...enables households and firms to concentrate on what they do best -- produce, invest, and consume efficiently."[2] In other words, the best inflation rate for growth is zero. Policy choices should therefore be directed toward methods that will not engender increases in inflation.

MORE PRIVATE SECTOR IS LESS INFLATION

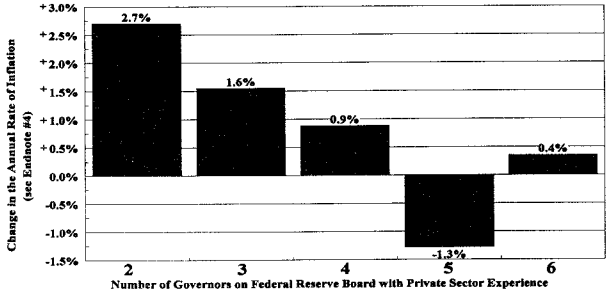
"the best inflation rate for growth is zero."

Governor LaWare's former seat on the Federal Reserve Board remains vacant, and no one has been appointed to that post. In considering the Fed's future, we should look to the past for guidance, so as not to repeat mistakes. The history of the Federal Reserve Board clearly shows that the composition of the Board is closely related to inflation.

"as the number of Fed Board Governors without private sector work experience rose, so did the rate of inflation."

Since World War II, the findings are striking: as the number of Fed Board Governors without private sector work experience rose, so did the rate of inflation.[3]

INFLATION AND THE COMPOSITION OF THE FEDERAL RESERVE BOARD OF GOVERNORS



Source: Federal Reserve Board; Bureau of Labor Statistics; Joint Economic Committee

"Perhaps those without private sector experience do not believe that inflation is a primary focus of monetary policy..."

On average, when only two Fed Governors had private sector experience, the **annual** inflation rate rose by 2.70 percent.[4] When three had private sector experience, the annual rate of inflation rose 1.55 percent.

With four members from the private sector, the increase was only 0.88 percentage points. With five, the average change was a *drop* of 1.28 percentage points (these were the Boards that tackled the inflation of the late 1970s and early 1980s). With six private sector members on the Board, the average increase in the rate of inflation was 0.35 percentage points. Even if the two outliers in the early 1980s (when inflation plummeted) are removed, boards with five private-sector members produced annual inflation rate increases of only 0.28 percentage points.

"the composition of the Board has important implications for monetary policy, inflation, and the economy in general."

Because of the five-year time horizon used in analyzing the inflation performance of the different boards, the last Board studied was the Greenspan-led Board of June 1990. It had five members with private sector experience (Greenspan, Kelley, Seger, Angell and LaWare) and two without. In the last five years, inflation fell 1.5 percentage points below what it was in the three previous years.

"there appears to be a bias on the part of Board members without private sector experience to treat inflation with greater tolerance."

Before LaWare's resignation, two other members with private sector experience had left the Board, cutting the number of Board members with private sector experience to only three by 1994 and two currently. Accordingly, inflation bottomed out in 1994, and has risen again in 1995. Inflation rose from 2.6 percent in 1994 to a 3.2 percent rate through the first half of 1995.

IMPLICATIONS FOR THE FUTURE

Why would this relationship exist? Perhaps those who have worked in the private sector and have seen what inflation does to long-term planning and preparation are more vigilant in the battle against it. Perhaps those without private sector experience do not believe that inflation is a primary focus of monetary policy, since they have not seen its effects on the economy up close. Whatever the reason, there appears to be a bias on the part of Board members without private sector experience to treat inflation with greater tolerance.

"a nominee without critical private sector experience might well cost us 1 percent in higher inflation."

Without a doubt, the composition of the Board has important implications for monetary policy, inflation, and the economy in general. Right now, the Federal Reserve Board of Governors contains only two members (Alan Greenspan, Edward Kelley, Jr.) who have worked in the private sector.

President Clinton's next appointment to the Federal Reserve could lead to higher inflation in the near future. If the past is a prologue, a nominee without critical private sector experience might well cost us 1 percent in higher inflation.

Prepared by: Brian Wesbury, Chief Economist, and Jeffrey Given, Economist

ENDNOTES:

[1] Wall Street Journal, March 28,1995.

[2] Greenspan speech before the Board of Directors of the National Association of Realtors in Washington, D.C. on May 16, 1995, p.1.

[3] Private sector experience is defined as having worked outside of academia or government.

[4] This analysis covers major changes in the composition of the Board, and each change was calculated once that Board was sitting and together. In each case, the inflation rate in the five years following the formation of each particular board was compared to the inflation rate in the three previous years (including the year in which the Board was formed). Some of the time periods overlap, but the changes in the Board were significant enough to consider each case separately.

Joint Economic Committee

ECONOMIC POLICY UPDATE

ISSUED BY:
Connie Mack (FL), Chairman
March 1996

U.S. SENATOR
Connie Mack
CHAIRMAN

Robert N. Mottice
Executive Director

A PRO-GROWTH MONETARY POLICY

"...The President is right about the need for debate, but wrong about the location. That debate needs to happen at the White House and in Congress, not the Federal Reserve."

After a three-year record of stagnating incomes and weakening job growth, President Clinton's attempted metamorphosis into a champion for economic growth should come as no surprise. Saddled with an economy that he oversold as the healthiest in three decades during his State of the Union address, he now argues that the Federal Reserve has been depressing economic growth.

As usual, there is a wide gulf between the President's rhetoric and reality.

RIGHT DEBATE, WRONG LOCATION

The Clinton party line is that America needs a debate within the Federal Reserve on how fast the economy can grow without igniting inflation. The President and his congressional supporters describe as overly pessimistic the conventional wisdom that the economy can grow at most by 2.5 percent annually.

Unfortunately for the President, the "wisdom" that growth is limited to 2.5 percent has become "conventional" largely because Democrats in government have handcuffed the economy with taxes and regulations over the years.

The President is right about the need for debate, but wrong about the location. That debate needs to happen at the White House and in Congress, not the Federal Reserve.

THE PRESIDENT GOES FOR GROWTH?

"We should be growing faster, no question."

The President's lament that we're not growing fast enough is on target. If 1996's forecasts are borne out, the last two years of President Clinton's term will be the slowest two-year period of growth since the mid-1950s, except for times of recession.

We should be growing faster, no question. The President, however, had hoped to stack the Federal Reserve with easy money advocates in hopes this will give the economy a boost. But if easy money were the answer, counterfeiting would be legal. The road to growth is ***not*** paved with easy money and high taxes.

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WHERE DOES GROWTH COME FROM?

In the 1960s and '70s, America was engaged in another debate. At the time, many academics questioned whether economic growth brought with it too many undesirable side-effects, odd as that may seem. Today, such concerns seem remote and utterly disconnected from reality.

"...if easy money were the answer, counterfeiting would be legal."

Real economic growth is unambiguously good. It provides the opportunity for all Americans -- unlike any government program in theory ***or*** in practice -- to better care for themselves and their families, their communities, and their country.

All that remains of that old debate is the confused rhetoric of the political left that growth comes from a big, active federal government spending and taxing freely, while the Federal Reserve furiously pulls levers in an attempt to manipulate every modest turn in the business cycle.

The evidence leaves no doubt. Real economic growth comes when taxes, spending and regulations are low, and people are confident that the prices they pay tomorrow will be little changed from those they pay today. Even President Clinton is forced to admit the "era of big government is over." His reappointment of Alan Greenspan as Chairman is an acknowledgment that price stability should be the Fed's main focus.

A PRO-GROWTH MONETARY POLICY

If Mr. Clinton ***really*** wanted a pro-growth policy at the Fed, what would it be? Here are three steps the Federal Reserve can, and should, take:

*"...a Federal Reserve focus on inflation **is** a focus on growth."*

- Get inflation out of people's minds.

Economic growth is the translation of creative ideas and entrepreneurial efforts into real goods and services that people want to buy. Anything that hampers the translation of those ideas and efforts will hurt economic growth.

Uncertainty about future prices threatens growth just like high taxes. It reduces the potential rewards and increases the risks of implementing creative ideas. Simply put, a Federal Reserve focus on inflation ***is*** a focus on growth.

- Forget about manipulating the economy.

Despite President Clinton's temptation to use the Fed to fine-tune the economy, this kind of monetary manipulation has failed time and time again. Ultimately, printing money can do nothing but affect prices. Using monetary policy to accomplish other goals courts disaster.

Easier money cannot prod the economy to grow faster, except in the short term by fooling people. The consequences are higher inflation and fewer jobs. Real growth, productivity and employment can't be touched by monetary policy in the long run.

- Emphasize that fiscal policy, not monetary policy, is the key to growth

It's common to say that "inflation comes from more money chasing fewer goods." Today, taxes and regulations keep the economy's goods-producing potential depressed. As a result, the money supply cannot grow quickly without generating the stresses and strains that produce inflation.

"...the blame for faltering growth lies squarely at the doorstep of the White House."

DON'T BASH THE FED -- CUT TAXES INSTEAD

Faced with the prospect of a listless economy during an election year, President Clinton first accused the American people of being in a "funk" last October. Then, he reversed directions and proclaimed this the "healthiest economy in three decades." Now, he's decided to blame the Fed for slow growth. It's time for the President to face reality. With his veto of the Republican economic plan that cut taxes on American workers, the blame for faltering growth lies squarely at the doorstep of the White House.

Prepared by Robert N. Mottice. (202) 224-5171

Joint Economic Committee

May, 1995

ECONOMIC POLICY UPDATE

U.S. SENATOR
Connie Mack
CHAIRMAN

ISSUED BY:
Connie Mack (FL), Chairman
Jim Saxton (NJ), Vice Chairman

Freeing the American Economy

"How could the economy look so good but feel so bad?"

In 1994, the economy grew by a robust 4.1%, outperforming 1993's growth rate of 3.1%.[1] Unemployment remained moderately low, and the Dow Jones Industrial Average reached a series of all-time highs. Yet, despite this apparently vigorous economy, Americans were uneasy and felt themselves falling behind in the struggle to improve their financial situation. November 1994 produced the largest political realignment in 40 years, confounding historical data showing that when voters approve of the economy's performance, little electoral turnover is likely.[2] How could the economy look so good but feel so bad?

The key to this paradox is a decline in the standard of living. Despite gains in real gross domestic product (GDP), real median family incomes fell by 1.9% in 1993.[3] (Data are not yet available for 1994.) To put the rarity of this paradox in perspective, the last time real median family incomes fell while real GDP rose by more than 2.5% was 1979, during the stagflation and malaise of the Carter Administration.[4]

"[S]ince 1966, the U.S. economy has underperformed its long-run growth potential to a staggering degree."

In trying to understand how standards of living can fall even as economic growth appears strong, it is useful to note that since 1966, the U.S. economy has underperformed its long-run growth potential to a staggering degree (Chart A). During this time, government grew much faster than the economy. Looking at government spending plotted against total economic growth (Chart B), two important trends become clear. First, from 1947 to the mid-1960s, government spending increased at the same rate as nominal GDP. Second, government spending began to outstrip economic growth with the imposition of the "Great Society" programs of the Kennedy-Johnson era.

Between 1965 and 1994, nominal GDP grew at an average rate of 8.1%,[5] while total federal government spending averaged 9.1% growth.[6] Of course, government spending did not exceed economic growth in every year: between 1982 and 1988, the economy outpaced government spending.[7] But in 1988 the trend reversed, and since then government spending has again grown faster than GDP. Like federal spending, state and local government spending has also outpaced GDP.[8]

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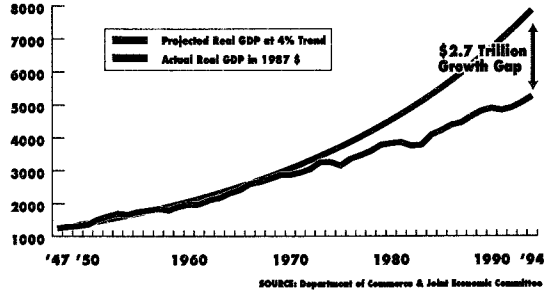
"The impact on American families has been terrible."

The impact on American families has been terrible. Milton Friedman has calculated the aggregate cost of direct and indirect government expenditures at a staggering 50% of national output.[9] It should surprise no one that the economy is showing signs of stress from dragging so much dead weight.

Chart A.

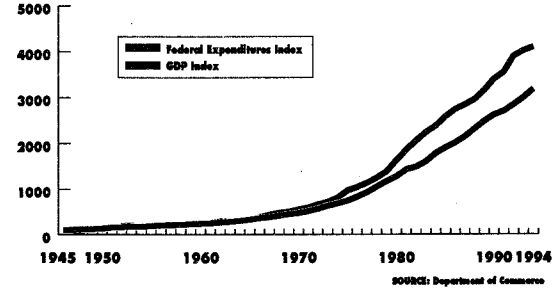
Actual vs. 4 Percent Trend Real GDP Growth



Real GDP measures the total supply of goods and services produced in the economy. Entrepreneurs will supply those goods and services only as long as there is a chance for profit. Through confiscatory taxes, onerous regulations and mandates, and other impediments to entrepreneurship, government makes profits harder to come by, and, in turn, slows economic growth and the creation of wealth. Thus, because total government spending drains resources from the marketplace, it is a worthy measure of the disincentives to wealth creation.

Chart B.

Government Grows Faster than the Economy

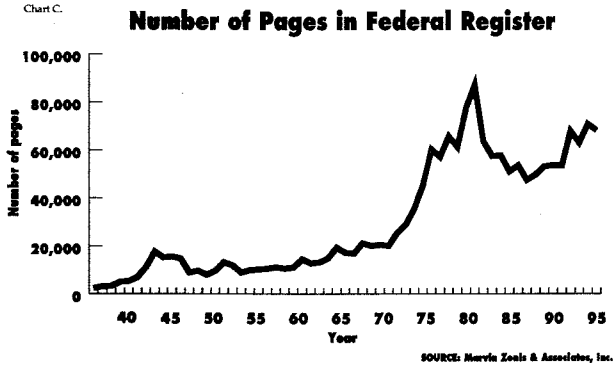


In addition to government spending, the assault on the American economy has been waged from a second front: government regulations pose a further impediment to the economy's potential. According to Thomas D. Hopkins of the Rochester Institute of Technology, government regulation costs the economy over $600 billion annually and, on average, costs each American household $5,000 every year.[10]

"The size of the Federal Register is a good gauge of the expansion of federal regulations and of overall government growth."

The size of the Federal Register is a good gauge of the expansion of federal regulations and of overall government growth. As noted in Chart C, the Federal Register exploded from roughly 17,000 pages in 1965 to 87,000 pages in 1980. Regulations were brought under control in the Reagan years, and the Federal Register shrank to 53,480 pages in 1985. But it grew to nearly 70,000 pages by 1994.[11]

Chart C.



Since the mid-1960s, the economy has fallen farther and farther behind. Department of Commerce statistics show that real GDP grew at an average annual rate of 4.0% between 1947 and 1966, but since then growth has only averaged 2.6%.[12] This 1.4% percentage point gap has led to a huge shortfall in real output. Had economic growth merely continued at the pace established between 1947 and 1966, the economy would be $2.66 trillion stronger today, meaning that 1994, inflation-adjusted, per-capita GDP would have been $10,300 higher![13]

While some have suggested that it is unfair or impractical to judge the growth of today's economy against the historical 4% average, not long ago such growth was considered entirely plausible. In January 1962, John F. Kennedy wrote in the *Economic Report of the President*, "Increasing our [real potential] growth rate to 4 1/2 percent a year lies within the range of our capabilities during the 1960's."[14] In 1965, Lyndon Johnson wrote in his

Economic Report of the President, "...our potential [real output] is also speeding up. Estimated at 3 1/2 percent a year during most of the 1950s, it is estimated at 4 percent in the years ahead; and sound policies can and should raise it above that...."[15]

Even so, since the early 1960s, 4% growth has never been sustained for long. Instead, growth has cycled between periods of extreme malaise (such as the late 1970s through early 1980s) and relative vigor in which the economy came very close to the 4% goal (1982 through 1989).[16] Over time, the United States has consistently lost ground to the 4% pace, and expectations have diminished. Unless fundamental changes are made, the future looks no brighter. As Alan Greenspan and other economists have noted, the estimated non–inflationary growth potential of the U.S. economy is now "appreciably" below 4 percent, and most likely near 2.5%.[17]

"Even with tremendous gains in productivity and technology, real median family incomes have not made any dramatic or sustained improvement."

Even with tremendous gains in productivity and technology, real median family incomes have not made any dramatic or sustained improvement. The average manufacturing–sector work week has lengthened dramatically. Workers are working harder for little or no real improvement in their incomes.[18] Slower economic growth has impeded efforts to help the truly needy. Congress has responded counterproductively, intervening even further while claiming to provide things individuals can no longer afford for themselves. Despite massive efforts by the government to promote jobs, unemployment has risen from an average of 4.9% from 1948 to 1965 to an average of 6.3% from 1966 to today.[19]

So government programs have piled up, each promising prosperity, while Americans' standards of living have stagnated or even worsened. This slow deterioration of incomes can be difficult to see and has often been intentionally obscured for political purposes. The Federal Reserve may lower interest rates to induce artificial growth, but when rates climb back up and a recession occurs, "greedy" business people or indebted consumers get the blame.

"[G]iven the courage to fulfill its mandate for change, America stands poised to reclaim the strong, long–term economic growth of its not–so–distant past."

Without the political will to restrain and restructure government, and without replacing the failed welfare state of the 1960s with explicit pro–growth economic policies, the United States will continue down a path of diminishing expectations. But given the courage to fulfill its mandate for change, America stands poised to reclaim the strong, long–term economic growth of its not–so–distant past. Since government has created the barriers to growth, Congress can remove them by reducing spending, balancing the budget, eliminating onerous regulations, and reducing tax rates so that the private sector can again grow faster than government, incomes can improve, and standards of living can increase for all Americans.

Prepared by Joint Economic Committee Chief Economist Brian Wesbury.

Endnotes:

1. Department of Commerce, Bureau of Economic Analysis, annual averages.
2. Milton C. Cummings and David Wise, *Democracy Under Pressure*, Harcourt Brace Javanovich Publishers, 1985, pp.349-350.
3. Department of Commerce, Bureau of Economic Analysis; also Bureau of the Census.
4. Ibid.
5. Department of Commerce, Bureau of Economic Analysis.
6. Ibid.
7. Ibid.
8. Ibid.
9. Milton Friedman, PhD., "Statement before the U.S. Congress Joint Economic Committee," January 20, 1995.
10. Thomas D. Hopkins, PhD., "Statement before the U.S. Senate Committee on Governmental Affairs," February 8, 1995, based upon and updating Hopkins' "Federal Regulatory Burdens: An Overview," RIT Public Policy Working Paper, Rochester Institute of Technology, 1993.
11. Victor A. Canto and Arthur B. Laffer, "The Ubiquitous Regulatory Wedge," published by A.B. Laffer, V.A. Canto & Associates, La Jolla, California, March 13, 1992, and updated with data from Marvin Zonis and Associates, Chicago Illinois.
12. U.S. Department of Commerce, Bureau of Economic Analysis, 1947 3Q to 1966 Q1 then Q1 1966 to Q4 1994.
13. U.S. Department of Commerce, Bureau of Economic Analysis; Bureau of the Census, *Current Population Reports*.
14. *Economic Report of the President 1962*, p.9.
15. *Economic Report of the President 1965*, p.4.
16. U.S. Department of Commerce, Bureau of Economic Analysis, Quarterly Statistics 82:4 to 89:1 = 3.9%.
17. Federal Reserve Chairman Alan Greenspan, "Statement before the U.S. House of Representatives Banking Committee," February 22, 1995.
18. Department of Labor, Bureau of Labor Statistics.
19. Ibid.

Joint Economic Committee

U.S. SENATOR
Connie Mack
CHAIRMAN

PRESS
RELEASE

FOR IMMEDIATE RELEASE
SEPTEMBER 21, 1995

CONTACT: SHELLEY HYMES
202-224-7683

CHAIRMAN AND VICE-CHAIRMAN OF THE JEC INTRODUCE BILL TO REPEAL HUMPHREY-HAWKINS AND GIVE THE FED PRIMARY GOAL OF PRICE STABILITY

Today Senator Connie Mack (R-FL), and Congressman Jim Saxton (R-NJ), Chair and Vice-Chair respectively of the Joint Economic Committee, introduced legislation entitled **The Economic Growth and Price Stability Act.** This legislation repeals the multiple goals dictated by the Humphrey-Hawkins Act, and replaces it with the primary goal of allowing the Fed to concentrate on price stability.

According to **Mack**: "This legislation repeals the archaic command-and-control policies codified in the Humphrey-Hawkins Act, and replaces them with the principles of **free markets, low taxes, a respect for private property, and stable money."**

Mack continued: "We believe that the best way to promote economic growth and jobs is to create an environment that fosters a stable and prosperous economy. With the Fed concentrating on the only goal that it can honestly achieve - price stability - and Congress focusing on a balanced budget through lower taxes and less spending, we will be **creating an economy conducive to growth, entrepreneurship and freedom."**

Saxton added, "This bill will encourage the Federal Reserve to **reduce inflation, and thus lower long-term interest rates.** Over the longer term, the bill lays a foundation for steady economic growth and reduces the danger of sharp increases in unemployment resulting from stop-go monetary policies."

Co-sponsor Senator Al D'Amato, Chairman of the Banking Committee which will be taking up this legislation, said: "The multiple goals of Humphrey-Hawkins, however laudable, are conflicting and unattainable. This bill recognizes that the appropriate goal for the Federal Reserve is maintaining price stability in the long term. In an atmosphere of assured price stability that this bill fosters, **American families and corporations would be better able to budget and plan for the future**, which is essential for economic growth."

Mack: "This legislation allows the Federal Reserve to do what it should have been able to do all along - concentrate on price stability. If the Fed focuses on long-term price stability, then **we will get the lowest possible rate of inflation.** As we all know, the financial markets are harsh taskmasters, and if in their view the Fed fails to adequately define price stability, long term interest rates may rise."

Mack concluded, "By advocating a policy of stable prices for the Fed, and returning the responsibility for the consequences of fiscal policy squarely back on Congress' shoulders, our economy will be well on the way toward a climate of **lower interest rates, lower inflation, higher economic growth, and higher employment."**

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Joint Economic Committee

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Connie Mack
CHAIRMAN

PRESS
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SEPTEMBER 21, 1995

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The Economic Growth and Price Stability Act

What it was...	What it will be...
The Full Employment and Balanced Growth Act of 1978	**The Economic Growth and Price Stability Act of 1995**
• Mandated that the Fed labor under multiple policy goals	• Gives the Fed the primary goal of long-term price stability
• Implemented archaic command-and control Keynesian economic policies	• Focuses government policies toward the goals of low taxes, free markets, a respect for private property and stable money
• Required the Fed to achieve numerical goals for employment and unemployment, production, real income, productivity and prices	• Places responsibility on the Fed to define price stability and set the timetable for achieving it
• Mandated that it was the purpose of this act to achieve a balanced Federal budget	• Requires the Fed to report to Congress semiannually and provide numerical progress toward their goal of price stability
• Set unattainable and historically ignored numerical goals for the Fed to achieve	• Lets the markets be the real taskmasters on the Fed's definition of price stability

"Although monetary policy receives less public attention than fiscal policy, make no mistake - the effects of monetary policy can have critical effects on our country's economic well being. By employing a policy of stable prices for the Fed, and returning the responsibility for fiscal policy squarely back on Congress' shoulders, our economy will be well on the way toward a climate of lower interest rates, lower inflation, higher economic growth, and higher employment." *Senator Connie Mack, September 21, 1995*

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104th CONGRESS

Issue Brief : Humphrey-Hawkins Act

Background

The Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins Act) charges the Federal Government with promoting full employment, maximum production and reasonable price stability. It requires the President to set specific numerical economic goals for the country and to improve government's coordination of economic policy. The Act aims to improve the country's employment and economic conditions through increased government intervention and economic fine tuning. It is based upon a fundamentally flawed premise – that government is the source of prosperity. Yet evidence shows that governments cannot legislate prosperity. The Act disregards the basic economic reality that businesses create jobs and free markets lead to prosperity.

Role of the Federal Reserve

The Act tasks the Federal Reserve to use its monetary authority in a way consistent with keeping unemployment rates low. This promotes fine tuning of monetary policy by the Fed in response to current economic trends. While this policy may lead to short term jumps in employment, in the long term, such Fed interventions lead to higher inflation and higher interest rates. The net result is a negative impact on the economy and job creation. The Fed should focus solely on controlling inflation.

By following a sound money policy, the Fed will give businesses a more certain environment in which to make decisions. The certainty that inflation will not erode the value of incomes, savings, or investments will lead to stronger economic growth and permanent increases in employment.

Conclusions

The Humphrey-Hawkins Act injects politics into a process which should be non-political. The wrong ideas about economic growth have led government to increase taxes and increase spending, and then when negative consequences result from these flawed policies, government asks the Fed for a bailout. Easy money policies cannot fix irresponsible fiscal policies. Short term boosts lead to a long term bust.

Like an athlete on steroids, the drug may enhance short-term performance, but it's at the expense of permanent damage. Adjusting monetary policies to address employment fluctuations will damage the economy by leading to more volatility in interest rates, higher inflation and a weak dollar. Congress needs to repeal the Humphrey-Hawkins Act and leave the Federal Reserve to do what only it can do: keep inflation under control.

Prepared by the Joint Economic Committee

Questions about Mack-Saxton

- *Inflation doesn't seem to be a problem for the economy now. Why is this legislation timely?*

HH deals with much more than just inflation. The many goals and conditions established by HH have not been met and, indeed, cannot be met. This causes confusion and ambiguity about the appropriate role of monetary policy.

What's more, the multiple policy goals leads to greater volatility in economic activity and financial markets than would otherwise be the case. That volatility costs workers' jobs and hurts economic growth. The time to get rid of HH is now.

- *Why aren't there hard targets for inflation? Doesn't their absence let the Fed off easy?*

This bill is not designed to micro-manage the Fed. In fact, its purpose is just the opposite. Price stability is the goal, but there are many different ways of measuring it -- *and mis-measuring it.* This bill allows the Fed -- the experts -- to determine which measure(s) are best, but then holds the Fed accountable for its performance.

- *How is the Fed held accountable?*

Just like today, the Chairman of the Federal Reserve would be required to testify before Congress twice a year and justify the Fed's actions. But the real taskmaster for the Fed will be the markets. If the Fed defines price stability too loosely, or presents a plan for achieving price stability that is not credible, the markets will react by raising long term interest rates.

- *Won't a focus on price stability cause unemployment to rise? How do you get from today's inflation to price stability without hurting jobs?*

Permanent job and economic growth can only be created in an environment of price stability. Congress' responsibility to conduct pro-growth and pro-job fiscal policy will be emphasized, in contrast to the way things are under HH where Congress can always blame the Fed for fiscal policy mistakes.

Getting to price stability is not a problem. The bill specifically requires the Fed to develop a time frame for reaching price stability which takes into account any potential short-term effects on employment and output.

II

104TH CONGRESS
1ST SESSION

S. 1266

To require the Board of Governors of the Federal Reserve System to focus on price stability in establishing monetary policy to ensure the stable, long-term purchasing power of the currency, to repeal the Full Employment and Balanced Growth Act of 1978, and for other purposes.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 22 (legislative day, SEPTEMBER 5), 1995

Mr. MACK (for himself, Mr. DOLE, Mr. LOTT, Mr. D'AMATO, Mr. KYL, Mr. SHELBY, Mr. BENNETT, Mr. GRAMM, Mr. NICKLES, Mr. ROTH, Mr. FRIST, Mr. CRAIG, Mr. SANTORUM, Mr. BOND, Mr. FAIRCLOTH, and Mr. COCHRAN) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To require the Board of Governors of the Federal Reserve System to focus on price stability in establishing monetary policy to ensure the stable, long-term purchasing power of the currency, to repeal the Full Employment and Balanced Growth Act of 1978, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Economic Growth and Price Stability Act of 1995".

SEC. 2. FINDINGS; STATEMENT OF POLICY.

(a) FINDINGS.—The Congress finds that—

(1) during the 25 years preceding the date of enactment of this Act, the United States experienced a deterioration of potential economic growth;

(2) there is sufficient evidence to suggest that increased Government spending, deficits, high taxes, and regulation have significantly contributed to slower economic growth, higher inflation, and diminished expectations;

(3) micromanagement of the economy and fine tuning have not alleviated economic hardship;

(4) the conditions and goals established by the Full Employment and Balanced Growth Act of 1978, have not been and could not be met, and continue to cause confusion and ambiguity about the appropriate role of monetary policy;

(5) the multiple policy goals of the Board of Governors of the Federal Reserve System, stipulated in the Full Employment and Balanced Growth Act of 1978, have created uncertainty about the aims of monetary policy, which can add to volatility in economic activity and financial markets, costing workers jobs and harming economic growth;

(6) there is a need for the Congress to clarify the proper role of the Board of Governors of the

Federal Reserve System in economic policymaking, in order to achieve the best environment for long-term economic growth and the lowest possible interest rates;

(7) recognizing the dangers of inflation and the appropriate role of monetary policy, political leaders in countries throughout the world are directing the central banks of those countries to institute reforms that focus monetary policy on the single objective of price stability, rather than on multiple policy goals; and

(8) because price stability leads to the lowest possible interest rates and is a key condition to maintaining the highest possible levels of productivity, real incomes, living standards, employment, and global competitiveness, price stability should be the primary long-term goal of the Board of Governors of the Federal Reserve System.

(b) STATEMENT OF POLICY.—It is the policy of the United States that—

(1) the principal economic responsibilities of the Government are to establish and ensure an environment that is conducive to both long-term economic growth and increases in living standards, by establishing and maintaining free markets, low taxes, re-

spect for private property, and the stable, long-term purchasing power of the United States currency; and

(2) the primary long-term goal of the Board of Governors of the Federal Reserve System should be to promote price stability.

SEC. 3. MONETARY POLICY.

(a) AMENDMENT TO THE FEDERAL RESERVE ACT.—Section 2A of the Federal Reserve Act (12 U.S.C. 225a) is amended to read as follows:

"SEC. 2A. MONETARY POLICY.

"(a) PRICE STABILITY.—The Board of Governors of the Federal Reserve System (hereafter in this section referred to as the 'Board') and the Federal Open Market Committee (hereafter in this section referred to as the 'Committee') shall—

"(1) establish an explicit numerical definition of the term 'price stability'; and

"(2) maintain a monetary policy that effectively promotes long-term price stability.

"(b) CONGRESSIONAL CONSULTATION.—Not later than February 20 and July 20 of each year, the Board shall consult with the Congress at semiannual hearings before the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking and Financial Services of the House of Representatives, about

the objectives and plans of the Board and the Committee with respect to achieving and maintaining price stability.

"(c) CONGRESSIONAL OVERSIGHT.—The Board shall, concurrent with each semiannual hearing required by subsection (b), submit a written report to the Congress containing—

"(1) numerical measures to help assess the extent to which the Board and the Committee are achieving and maintaining price stability in accordance with subsection (a);

"(2) a description of the intermediate variables used by the Board to gauge the prospects for achieving the objective of price stability; and

"(3) the definition, or any modifications thereto, of 'price stability' established in accordance with subsection (a)(1)(A).".

(b) COMPLIANCE ESTIMATE.—Concurrent with the first semiannual hearing required by section 2A(b) of the Federal Reserve Act (as amended by subsection (a) of this section) following the date of enactment of this Act, the Board of Governors of the Federal Reserve System shall submit to the Congress a written estimate of the length of time it will take for the Board and the Committee to fully achieve price stability. The Board and the Committee shall take into account any potential short-term effects on

employment and output in complying with the goal of price stability.

SEC. 4. REPEAL OF OBSOLETE PROVISIONS.

(a) FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978.—The Full Employment and Balanced Growth Act of 1978 (15 U.S.C. 3101 et seq.) is repealed.

(b) EMPLOYMENT ACT OF 1946.—The Employment Act of 1946 (15 U.S.C. 1021 et seq.) is amended—

(1) in section 3—

(A) in the section heading, by striking "**AND SHORT-TERM ECONOMIC GOALS AND POLICIES**";

(B) by striking "(a)"; and

(C) by striking "in accord with section 11(c) of this Act" and all that follows through the end of the section and inserting "in accordance with section 5(c).";

(2) in section 9(b), by striking ", the Full Employment and Balanced Growth Act of 1978,";

(3) in section 10—

(A) in subsection (a), by striking "in the light of the policy declared in section 2";

(B) in subsection (e)(1), by striking "section 9" and inserting "section 3"; and

(C) in the matter immediately following paragraph (2) of subsection (e), by striking "and the Full Employment and Balanced Growth Act of 1978";

(4) by striking section 2;

(5) by striking sections 4 through 8; and

(6) by redesignating sections 3, 9, 10, and 11 as sections 2 through 5, respectively.

(c) CONGRESSIONAL BUDGET ACT OF 1974.—Title III of the Congressional Budget Act of 1974 (2 U.S.C. 631 et seq.) is amended—

(1) in section 301—

(A) in subsection (b), by striking paragraph (1) and redesignating paragraphs (2) through (8) as paragraphs (1) through (7), respectively;

(B) in subsection (d), in the second sentence, by striking "the fiscal policy" and all that follows through the end of the sentence and inserting "fiscal policy.";

(C) in subsection (e), in the second sentence, by striking "as to short-term and medium-term goals"; and

(D) by striking subsection (f) and inserting the following:

"(f) [Reserved.]"; and

(2) in section 305—

(A) in subsection (a)(3), by inserting before the period at the end ", as described in section 2 of the Economic Growth and Price Stability Act of 1995";

(B) in subsection (a)(4)—

(i) by striking "House sets forth the economic goals" and all that follows through "designed to achieve," and inserting "House of Representatives sets forth the economic goals and policies, as described in section 2 of the Economic Growth and Price Stability Act of 1995,"; and

(ii) by striking "such goals," and all that follows through the end of the paragraph and inserting "such goals and policies.";

(C) in subsection (b)(3), by inserting before the period at the end ", as described in section 2 of the Economic Growth and Price Stability Act of 1995"; and

(D) in subsection (b)(4)—

(i) by striking "goals (as" and all that follows through "designed to achieve," and inserting "goals and policies, as described in section 2 of the Economic Growth and Price Stability Act of 1995,"; and

(ii) by striking "such goals," and all that follows through the end of the paragraph and inserting "such goals and policies.".

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Future Policy Must Trust the Individual

President Clinton's policy promises continue to reaffirm his belief that government, not individuals, builds the bridge to the future. His initiatives do not build a "bridge to the future," but rather attempt to preserve the crumbling and failed policies of the past. His list of new and expanded government-sponsored initiatives would cost tens of billions of dollars.

The bottom line is clear - President Clinton doesn't trust individuals - he reserves his trust for government. This is evident in his expanded efforts to micromanage resources for education, job training, health care, adoption, etc. Social engineering at its best. Simply stated, Bill Clinton continues to use the federal government to tell people how to spend their own money. His new code word for government micromanagement is "targeted." As long as individuals act according to the federal government's master plan, they get "targeted" subsidies.

Unfortunately, President Clinton's "targeting" only continues the unfairness of taking from one family to subsidize another family down the street. Worse yet, it further entrenches special interest spending. "Targeted" simply means that Bill Clinton's favorite groups are allowed to take full advantage of government spending and subsidies while everyone else pays higher taxes. It's no wonder his proposed fiscal year 1997 budget contains more the $60 billion in new and expanded taxes and fees.[1]

Allowing President Clinton to "target" people's behavior jeopardizes their individual liberty and their freedom to decide how best to use their own money. Targeted subsidies mean that decisions are not made solely on their economic merit but on their tax consequences. President Clinton has done little to lower today's steep tax rates and his targeted subsidies will do little to boost economic growth. This is unfortunate since Clinton's anemic 2.4 percent economic growth rate has the dubious distinction of being the slowest expansion in more than a century. Bill Clinton's policies are robbing America of its full growth potential.

History shows us that reducing tax rates, cutting wasteful government spending and allowing individuals more freedom to make their own decisions fosters greater work effort, increased saving, investment and economic growth.[2] President Clinton preserves today's high tax rates that take a huge bite out of paychecks. This allows him to then bribe workers with their own money through his "targeted" government schemes.

Conversely, cutting tax rates across-the-board would simply allow all people to keep more of their own money as they earn it. It would reduce the use of inefficient bureaucrat-managed subsidies that greatly reduce economic efficiency. With an up-front tax rate reduction, business owners, individuals and families could then decide for themselves how best to spend or invest their own money without having to bend to the dictates and whims of the federal government. With an across-the-board tax rate cut, the "targeting," dictated by Clinton, income-redistributors, social engineers, lobbyists, and special interests, becomes inconsequential. Lowering tax rates would give all people greater independence to manage more of their own money.

The potential economic growth from lowering marginal tax rates across the board would trump any government "targeted" tax schemes. Lowering marginal tax rates worked for Presidents Kennedy and Reagan, resulting in two periods of our nation's most robust economic growth.[3] And this higher growth meant higher wages, more jobs and improved living standards for all income groups, as well as increased revenue for the Treasury. President Kennedy's tax rate cuts led to a 5.1 percent economic growth rate. President Reagan's tax rate cuts were followed by 4 percent real growth. By comparison, President Clinton delivered a record tax increase and has an anemic 2.4 percent average growth rate to show for it.

In the final analysis, President Clinton's vision for the future preserves the status quo of high tax rates and more "targeted" government experiments. For too long government promises have stifled the dreams of hard working Americans. Clinton's economic agenda relies on the government's ability, not the individual's ability to make wise choices. President Clinton has not offered any grand new vision or "bridge to the future," but merely more government micromanagement. The arrogance of the Washington bureaucracy believing it can best solve every problem by controlling more of individuals' hard earned money must come to an end. Free individuals, through their creative ideas, risk taking, and hard work are best able to build the bridge to a more prosperous future.

ENDNOTES

1. Office of Management and Budget, *Fiscal Year 1997 Budget of the United States Government*, 1996.

2. Joint Economic Committee Report: "*The Growth Debate: How Fast Can We Grow*," August 1996.

3. Joint Economic Committee Report: *"Tax Cuts, Economic Growth, and Tax Revenue,"* August 1996.

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