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ECONOMIC GROWTH THROUGH TAX CUTS: WHAT'S THE BEST APPROACH?

HEARING

before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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ECONOMIC GROWTH THROUGH TAX CUTS: WHAT'S THE BEST APPROACH?

Thursday, March 4, 1999

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D. C.

The Committee met at 9:38 a.m., in Room SD-562 of the Dirksen Senate Office Building, the Honorable Connie Mack, Chairman of the Committee, presiding.

Senators present: Senator Mack, Brownback, Sessions, and Robb.

Representatives present: Representatives Stark and Hinchey.

Staff present: Shelley S. Hymes, Victor Wolski, Chris Edwards, Kevin Doyle, Colleen J. Healy, Stephen Schultz, Joseph Pasetti, Howard Rosen, Tami Ohler.

OPENING STATEMENT OF SENATOR CONNIE MACK, CHAIRMAN

Senator Mack. Good morning. I'm pleased to welcome our distinguished panelists before the Joint Economic Committee this morning.

I think we'll go ahead and get started. George Gilder is not here, and I don't know exactly where he is at this moment, so I think we'll go ahead and get started anyway.

There is a mark-up that is taking place this morning in the Banking Committee on financial modernization. I am on that committee.

I am hopeful that I won't have to be called away during our hearing this morning. But if I do, it will only be, hopefully, for a short period of time.

So if that does occur, I would ask your indulgence.

Well, again, I want to welcome all the panelists here this morning to our Joint Economic Committee hearing — *Economic Growth Through Tax Cuts: What's the Best Approach?*

I want to thank our distinguished panelists for arranging their schedules so that they would be able to join us today for a discussion on pro-growth tax policies.

On our first panel, we are joined by: Steve Goldsmith, Mayor of Indianapolis; Rebecca Matthias, President and Founder of Mothers Work, Incorporated; Hopefully, George Gilder; and Wendell Primus, Director of Income Security at the Center on Budget and Policy Priorities.

At our second panel, we will hear from Wayne Angell, Chief Economist at Bear Stearns and former Federal Reserve Board Governor;

Jim Miller, Counselor to Citizens for a Sound Economy and former Director the Office of Management and Budget;

John Wilkins, a Partner at PricewaterhouseCoopers and Co-Director of their National Economic Consulting practice; and William Gale, Senior Fellow at the Brookings Institute.

Again, I want to welcome all of you and, again, thank you for coming.

Congress will be looking at a variety of tax cut proposals this year. However, in all the recent debate and discussions, there has been little emphasis placed on a very basic reason tax cuts are important—even in a surplus economy.

And that is, tax cuts spur economic growth.

That's what I'd like to emphasize during our discussions today and I'd like to have a broad discussion with our panelists about how tax cuts spur economic growth, and what kind of tax cuts would be most beneficial in keeping our economy strong.

There are three issues I believe are important to keep in mind while considering pro-growth tax cuts and I'd like to touch on each one briefly.

Welcome, George.

Mr. Gilder. Hi.

Senator Mack. The first is: The economy's strong recent performance should not give us a false sense of security concerning future economic growth.

Some people may say, "When the economy is doing so well, why do we need tax cuts?"

Well, my answer is—look around the globe. Despite the strong economy, including an annual growth rate of 6.1 percent in the fourth quarter of last year, circumstances can change.

The Asian economic crisis, problems in Russia and South America, uncertainty in Europe, and the fact that many countries are now in recession, or even depression, all signal possible difficulties that may adversely affect the U.S.

Pro-growth tax cuts would provide a powerful insurance policy to prevent these negative forces from causing a slowdown in our economy.

Recent history has demonstrated that lower tax rates have resulted in higher economic growth rates. We have a powerful tool at our disposal to utilize before it becomes too late. And that tool is enacting pro-growth tax cuts.

The second point: We must avoid succumbing to the notion that tax cuts somehow will overstimulate the economy and cause inflation.

Some make the argument that cutting taxes might overstimulate the economy and cause inflation. But recent history disproves that theory.

During the last 16 years of nearly continuous economic growth, inflation has fallen to the point where it's almost nonexistent today.

The evidence is clear—economic growth does not cause inflation.

And the third point: Tax cuts spur innovation, entrepreneurship, and new technology, keeping our economy strong.

We have entered the era of the Innovation Economy. Today, more than ever, the idea is the engine of economic growth.

Let me give you one example.

Recently, Intel Corporation, the world's number-one maker of computer chips, said it expects e-commerce—that is, on-line buying on the Internet—to top one trillion dollars by the year 2002. This market didn't even exist ten years ago, and, already, they're projecting one trillion in economic exchange.

This is a testament both to the power of innovation and our free market system.

We should promote policies that encourage investment in new companies and new ideas by lowering the barriers to investment.

Tax cuts are not about numbers, they're about people. A tax system that punishes people when they save and invest doesn't just depress economic growth—it dashes the dreams of individual entrepreneurs. We need to ensure that the next generation of entrepreneurs will be able to achieve their American dream.

And now I will turn to my distinguished colleague for his opening statement.

[The prepared statement of Senator Mack can be found in the Submissions for the Record.]

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Representative Stark. Thank you, Mr. Chairman. I'm sitting here with a plugged ear, so I can't tell whether anybody can hear me. I feel like I'm talking in the bottom of a barrel, but I'll just proceed in what is a normal voice.

Senator Mack. I will inform you that they're hearing.

Representative Stark. You may be surprised to learn that I am, very much in favor of what all of the witnesses have to say today. I might have put them in somewhat different order.

I strongly wish to associate myself with your opening remarks, the basic question is simply, whom do we choose to punish? Unless we are able to assure the two-thirds or three-quarters of the lowest income elderly that we're able to preserve Social Security and Medicare, we will punish them mightily. Percentage-wise, we'll punish them more than any other group in this country, regardless of what happens on Wall Street.

So I join Alan Greenspan and Dr. Primus and say that the topic for this morning's hearing is excellent, although the hearing may be premature. First, before we can find any money for a tax cut, it seems to me, that we have to be able to deal with the question of Social Security and Medicare. In my mind, these are commitments which far transcend any of our commitments to the private capital market.

There is no shortage, by any measure, of venture capital in the United States.

In 1998, we did $170-billion-plus of initial and secondary stock offerings. There were almost 400 IPOs—valued at over $40 billion, and people are still lining up.

You can get a certificate-printer and print almost anything you want, as long as it's XYZ.com. I can assure you that Mr. Angell's firm can sell a million dollars' or a billion dollars' worth of that tomorrow, regardless of what it does or whether it's ever made any money.

So there's no evidence that we have a shortage of capital for the venturers or the venturesome. But there is real evidence in your home state, and in my home state, that elderly, and particularly elderly women, can't afford prescription drugs, that seniors are mightily concerned about living on their Social Security income.

If we do have a surplus, or if we do have any funds, I think it's absolutely paramount that we make sure that we don't punish those people who are the most fragile. And then, we can line up—and I'd like to be at the head of the line—to take the lead on cutting taxes.

Thank you for having this hearing. But I think we'll have to have it again in a year or two after we've all worked together to solve Social Security and Medicare.

Thank you.

Senator Mack. Senator Brownback?

OPENING STATEMENT OF SENATOR SAM BROWNBACK

Senator Brownback. Thanks, Senator Mack. I appreciate that.

I think we should have called the meeting a month earlier, Senator Mack. I look at this and ask myself, why are we where we are today?

We're at a surplus situation that, when I came into Congress in 1995, we were running about a quarter-trillion-dollar annual deficits with nobody in the country believing that we would ever get out of a deficit picture.

I campaigned on balancing the budget and people said, great idea, but it will never happen.

And I ask myself, how did we get to where we are today? Did we make such massive cuts in government spending programs that got us here?

Is that what happened? What happened?

And I think you have to come to the point and quickly realize that the reason that we're where we are today on some sort of surplus and being able to deal with the issues of Social Security and now debt reduction—not deficit, but debt reduction—and tax cuts is because of a strong economy.

Strong growth in this economy is what's produced the situation that we are in today.

We had some slowing down of our spending increases. We cut taxes a little bit. But we've got to maintain the economy. And if we're going to do that, the best thing that we can do is cut taxes and make a pro-growth tax cut because the worst thing that could happen to us is if we had an economic slowdown taking place.

That's the key thing.

We're now in our 96th month of an historic economic expansion. We've encouraged the Fed to have a fiscal policy that encourages economic expansion and growth. Yet, the best thing that we can do is cut taxes in a pro-growth fashion.

Now I'm proposing, in a pro-growth tax cut, that we widen the lowest bracket, the 15 percent bracket, for a tax cut, and over a period of years grow that to the level that we tax Social Security, the top end of Social Security taxes up to $72,600.

So you take that 15 percent bracket and expand it, grow it up to $72,600 over a period of years and then index it according to the nominal wage base that's calculated by Social Security, rather than the current one.

I think it would be more appropriate to index it to that wage base rather than what we currently have—the income tax code hooked into it.

And the reason for my tax cut proposal in that area is a couple.

One is it deals with the marriage penalty, which I think most of us agree is a bad place to tax. To tax people for being married is a bad idea. It's a bad social policy. It doesn't make any sense to people why we would tax you more if you're married.

This deals with most of the marriage penalty tax.

The other thing is it's targeted at the middle income, which most people would say, well, if you're going to cut taxes, let's hit it in at that category, and it's targeted more there.

And it's pro-growth, which I think is absolutely fundamental to what we need. And we had better get about the business of doing that because economic expansion is the reason we even have the opportunity to deal with these other items, of Social Security, of paying the debt down, and of looking forward for what things we can do for the rest of the population.

So, Mr. Chairman, I'm very pleased that you've got this panel. I wish you had done it a month ago. I think we're a little late in getting started.

We've got to have economic expansion.

I'm particularly looking forward to my constituent testifying, Wayne Angell, who is a good Kansan. He and I grew up in the same neck of the woods and I think view the world somewhat similarly on what we need to do to grow and to make sure that we keep the opportunities moving forward in some economic environment that the Chairman has noted could be very challenging to us in the near future.

Thank you.

Senator Mack. Thank you. Senator Robb?

OPENING STATEMENT OF SENATOR CHARLES S. ROBB

Senator Robb. Thank you, Mr. Chairman. I think we'll have a relatively full range of views just among the members of this Joint Economic Committee who are present this morning.

I'm reminded of the story of the group of folks who were blindfolded and each asked to describe an elephant based on the particular portion that they happened to come in contact with.

I use that particular example because I thought it would be reassuring to the Chairman.

(Laughter.)

But I do thank you for calling the hearing today. I look forward to hearing the witnesses' testimony and discussion.

I too have a mark-up in Finance that's taking place between 10:00 and 11:00 and I have to introduce two bills with my colleague from Virginia during the morning business period from 10:00 to 11:00.

So I will be here only part of the time and I'm going to try to get back as I can.

Mr. Chairman, you and I were both elected to the Senate in the late 1980s. And for those of us who were elected during that period, amid what tended to be chronic and large budget deficits, the end of the 1990s represents a sea change in the direction of our fiscal policy, from something in the range of a $290 billion deficit in 1992.

We made some tough choices to reduce deficits, which had the effect of lowering interest rates, increasing the private stock of capital, and raising productivity and incomes.

As a result of the economic cycle that this has helped to create, we have balanced the unified budget for the first time in 30 years, and current projections indicate budget surpluses well into the future.

The question that we're grappling with now is how to best allocate these resources, a question that is complicated by the fact that we know we will have a growing entitlement problem with Social Security, Medicare and Medicaid, as well as the retirement of the baby boomers.

Like a doctor approaching a patient, I think our first rule should be to do no harm.

In that vein, I would argue that we should resist the temptation to engage in either a mass tax cutting or mass spending spree, not only because it commits potential resources based only on projections, but also because it will reduce our flexibility to deal with the entitlement challenges presented in the next millennium, something that we should all be concerned about solving first, anyway.

Our second rule, Mr. Chairman, as far as I'm concerned, should be to continue to pursue policies that raise national savings, individual savings, and the productivity of our people.

As both the President and Chairman Greenspan have argued, using a majority of the surplus to reduce the public debt adds directly to national savings and will help continue the economic cycle of the last five years.

It also lowers future interest cost, providing additional capacity to deal with future contingencies.

We also need to be concerned about helping individuals save more on their own.

For the second quarter in a row, the nation's saving rate was actually negative. This manifests itself in the form of higher consumer debt and increased bankruptcies.

I have argued, along with others, that one of the biggest impediments to individual savings, particularly at the lower and middle-income levels, is the regressive payroll tax.

In any Social Security reform plan that addresses the liabilities in the system, I'd like to find a way to give workers the opportunity to build wealth outside the Social Security System.

We also need to find ways to increase the participation in the private pension system among these same individuals. We can also encourage new savings and simplify the Tax Code by exempting some of the first savings of dividends and interest from taxation.

Raising productivity can be done through devoting our resources both on the revenue side and the expenditure side to education and training, research and development, technology and infrastructure.

In that context, I'd like to argue for making the R&D tax credit permanent, extending and increasing educational and training tax initiatives, adding significantly to our basic research budget, and continuing to make priority investments in our infrastructure.

Our third area of focus should be to deal with the inequities in the current Tax Code.

On this front, I think it's fair to say that we need to address the alternative minimum tax before it captures more and more middle income taxpayers.

We need to explore methods to ameliorate the effects of the marriage penalty, as several have already suggested.

And we should look at methods for ensuring that family businesses don't have to be sold off to pay estate taxes.

Mr. Chairman, I look forward to the discussion today and I hope that the witnesses will address some of the points that I have mentioned, as we explore the possibilities to achieve growth and equity with our fiscal policies.

With that, Mr. Chairman, I thank you.

Senator Mack. Thank you.

Senator Sessions?

OPENING STATEMENT OF SENATOR JEFF SESSIONS

Senator Sessions. Thank you, Mr. Chairman.

I am honored to serve with you on this Committee and throughout the Senate. You set a good example for all of us every day on what it means to be a good and effective senator.

I would like to recall the first time I appeared on this Committee. I had just joined the Congress and Mr. Alan Greenspan was testifying.

I was kind of nervous. I didn't know what to ask him. People were joking about whether Mr. Greenspan or President Clinton deserved credit for the good economy.

I had just read an article in USA Today and in which business people from Germany, England and Japan were interviewed. They were asked why the American economy was doing better than their economies.

And they all agreed. They said, because we have less taxes, less regulation, and a greater commitment to the free market.

So I asked Mr. Greenspan, do you agree with that? And he looked at me and he said, I absolutely agree with that.

Senator Mack. It may be one of the most concise statements that the Chairman has had to make.

(Laughter.)

Senator Sessions. I liked it. And I thought it was interesting.

I missed my opportunity at that time. I should have said, well, Mr. Greenspan, I don't believe that the credit for this economy should go to you or to President Clinton. It ought to go to Ronald Reagan and George Gilder, perhaps, because that's what they've been committed to in their work.

So, ultimately, I do think that it's not a question of cutting taxes to see if we can give more money to somebody. It's because if by cutting taxes we can increase the growth and strength and vitality of our American economy, we can make the money to pay our Social Security obligations and do other things.

Thank you, Mr. Chairman.

Senator Mack. Thank you.

Congressman Hinchey, welcome back.

OPENING STATEMENT OF REPRESENTATIVE MAURICE D. HINCHEY

Representative Hinchey. Thank you very much, Mr. Chairman. It's very nice to have you back as Chairman once again.

Senator Mack. Thank you.

Representative Hinchey. I find myself, along with Senator Robb, being very conservative about this situation. I think it is wise, as the Senator admonished a little while ago, to be a little bit prudent about what we do in a period of abundance and budget surpluses, recognizing of course that a surplus is a function of the Social Security trust fund.

So I think that what we ought to be doing in this present climate is strengthening Social Security, protecting and preserving Medicare, making sure that those two programs continue to be effective on into the future, and beginning to pay down the national debt.

And I think that if we do those things, we will continue to create an economic circumstance similar to the one that we're currently living in which will provide opportunities for continued growth and advancement.

We're living in a period of disinflation, and in some places around the word, even deflation. I think we ought to keep this factor in mind as we move in these deliberations as well.

And if we're going to cut taxes, I would suggest that we look at the demand side of the ledger first. And in that regard, we might want to, for example, improve the earned income tax credit.

We'll see that tax cut reflected immediately in the economy because if we cut taxes for the working poor and put money in their pockets, you'll see that reflected in the economy immediately.

That money will circulate through the economy right away and that will help us to improve demand in this disinflationary period that we find ourselves in.

I also agree with Senator Robb that making the R&D tax credit permanent is a good idea. And that's something, if we're going to cut taxes, that's another area that we ought to look at.

So I thank you, Mr. Chairman, for providing us with this opportunity and I'm looking forward to hearing the testimony.

Senator Mack. Thank you. And I'd just say to the panel, I appreciate your indulgence as the members made their opening statements.

Four of us up here spent five weeks in the Senate without being able to say a word, so—

(Laughter.)

Again, welcome, members of the panel. Mayor, why don't we start with you?

PANEL I

STATEMENT OF THE HONORABLE STEVE GOLDSMITH, MAYOR, CITY OF INDIANAPOLIS

Mayor Goldsmith. Thank you, Mr. Chairman, and members of the Committee.

Let me start first by disclaiming any expertise in Federal taxation. I assume that's not why I was invited and I won't try to solve those problems.

I would like to look at the issues that you're addressing from the perspective of cities and perhaps look at a couple of principles that cities have applied to see how that affects the conversation before the Committee today.

Until the early '90s, mayors tried to tax their way out of poverty. They had lots of problems. And the way they addressed the problems is they raised their tax rates so that they could take money from those who had it in order to redistribute it to those who didn't.

As they more aggressively raised the tax rates to do this, people more aggressively moved out of their cities, until we ended up in this downward spiral that took the populations of several Midwestern and Eastern cities down by 50 percent or more.

So as we've looked over the last five or six years and seen the resurgence of some cities, many cities in this country, I think that they have followed some basic principles.

One is that you can't redistribute wealth fast enough to solve your problems. You have to help build wealth.

The second is that cities, just like individuals, should accept some responsibility of their own. We should be responsible for making sure that our streets work and that our streets are safe and that our regulatory environment, tax environment, are correct.

And that we should work with the market rather than eroding the market.

So I remember one of my first opportunities to testify before the Senate Budget Committee in my first year as Mayor. And it was on the President's counter-cyclical investment program, which would have taken massive doses of money and given them to the cities from the Federal

Government in order to buy their way out of their problems with infrastructure investment.

I registered my anxiety because it didn't seem to be consistent with the direction we should be going.

The direction we should have been going is giving cities both more responsibility and more authority over where they're headed.

If you, from our perspective, address the Tax Code, and I endorse the income tax cut, there are some principles that I think should be applied.

First—and I know that these are obvious principles; but from my perspective, at the bottom of the political heap, these principles are relatively important.

One is that individuals know best what is in their interest. And most people most of the time make the best choices for themselves.

And when government takes too much money from people who are struggling or working, accumulates it in Washington and then gives it back, it's an arrogance that says, we can spend your money better than you can.

And even these micro-tax credits are designed to affect people's behavior, assuming that if they had the money themselves, they wouldn't make as good a decision about their own lives as Congress in Washington does.

And so, as we think about tax cuts, it's important to me to recognize that as government gets bigger, as it takes a higher and higher percentage of the gross national product, essentially what it's saying is that we can spend your money better than you can.

Secondly, and I know that all the members of the Committee agree with the next principle, but it's worth mentioning, is the concept of federalism.

There is a very important reason for federalism. It's that decision-making closest to the people is most accountable, most flexible, and often most creative.

When Washington takes massive amounts of money, even if they give it back to us, they erode the principles of federalism.

The effort that we see that's decentralizing the economy through technology and centralizing the economy through taxation is mutually inconsistent. And we can make better decisions, allocation decisions, revenue decisions, spending decisions, at home than we can through begging our way through Washington.

I had this wonderful opportunity with Secretary Cisneros to talk to the Banking Committee. It was during the period when there wasn't a lot of extra money in Washington.

His position was that we have to keep our house in order and therefore, we're going to give cities more responsibility over public housing and we're going to devolve the programs.

Today, I'm obviously here and not in my office, but I guarantee that over my fax today will come four new government programs that have been announced that I should apply for more money or lobby for more tax credits as the case may be.

We receive four or five of these every day.

So we've now gone from a period of devolving authority to a period where there's lots of money for new programs and new incentives and new tax credits, and we've actually moved back dangerously to prior to period where we believed that individuals had responsibility and federalism actually works.

There's also kind of a boring part of this which I just want to footnote, which is that large bureaucratic systems don't work very well. And if you tax more than you need to—and even if you give the money from a federal bureaucracy, from a Washington bureaucracy to a state bureaucracy to a local bureaucracy back to a person, it still is a bureaucracy.

And what that is doing, therefore, is creating large bureaucratic systems that, by definition, can't work very well.

And as you watch these incentives of the tax system, it is worth noting that most of these are cutting their taxes and cutting their regulations. We've done that four times in order to attract back investment, attract people back in.

The last issue, Mr. Chairman, and Senator Robb's comments are instructive in this regard.

I'm Mayor of the 12th largest city. It's our most prosperous period ever. And we have a large number of people who are barely making it. They're either working poor or they're poor.

These individuals are disproportionately affected by the payroll tax, which, if you add it all together, obviously is over 15 percent.

This week, we announced a homeownership program—$2 billion of Fannie Mae money designed to get the folks, the working poor and lower middle class, into homes.

We took their incomes—I declared a tax holiday because I didn't even want to take property taxes from these individuals because I want them to have an opportunity to own wealth.

The way to own wealth in this country is through the stock market, a small business or a house.

And as we looked at those issues, the payroll tax of all the taxes layered on, is a very regressive tax that is harming the opportunities of low income Americans to get to the future.

And for an income tax, this will create opportunity for investment.

But I think I would also encourage the Committee to look at ways that the payroll tax could be mitigated. The problem is either that people are paying too much or they're getting too little.

And one side of that has to be adjusted. Either they have to pay less or they have to have an opportunity to invest the money they have in the stock market to own in their own right and create wealth.

If you add all those together—simplicity, federalism, individuals know best, fairness in the tax code—I would encourage the Committee to look at both of these issues—income tax credits and ways to ameliorate the regressiveness of the payroll tax so that we can create wealth.

If we bring those together, I think we'll do a great thing for America.

Thank you very much, Mr. Chairman.

[The prepared statement of Mayor Goldsmith can be found in the Submissions for the Record.]

Senator Mack. Thank you.

Ms. Matthias?

STATEMENT OF REBECCA MATTHIAS, PRESIDENT AND FOUNDER, MOTHERS WORK, INCORPORATED

Ms. Matthias. Thank you. I appreciate the opportunity to be here and express my opinions on economic growth through tax cuts. And I applaud your initiatives in this area.

I believe that my varied experiences, which range from starting a company and growing it, to ultimately taking it public and running a mid-size corporation, touch on the issues facing thousands of your constituents.

And the difficulties that I encountered, specifically relating to taxes, are suffered by small- and mid-size companies everywhere.

I started Mothers Work 17 years ago out of my front closet as a mail-order company selling career maternity clothes.

Today, a public company with $300 million in revenue and 4000 employees, Mothers Work operates 600 maternity stores around the country.

We're vertically integrated, manufacturing substantially all of the merchandise that we sell in our stores and we are one of the few apparel companies still making a substantial amount of product in the United States.

The first three years of my business were financed entirely by my savings, and later, I obtained venture capital financing and bank loans to expand.

Ultimately, I took the company public in 1993.

I'd like to talk about excessive taxes and how I believe they stifle business.

Small business fuels our economy. The American dream of company ownership is very much alive and it is the heart and soul of our country.

Although many factors affect the success or failure of a new business, few are as challenging as excessive and complicated taxes. The tax-related impediments to business formation and growth that I have experienced fall into three major categories—taxes on profits, taxes on payroll, and taxes on capital gains.

And I'd like to talk about all three.

But before I speak to the taxes themselves, I'd like to say that the complexity of the myriad of taxes facing an entrepreneur may be an even bigger hurdle than the taxes themselves.

New business owners don't have the resources to analyze the tax code and take advantage of yet another targeted tax incentive or program.

Please don't help us with any more special, targeted tax rules. Reduce the number of special rules and decrease tax rates.

I'd like to speak on taxes on profits.

The profits in a growing business don't go into the bank. They go into working capital.

Therefore, taxing those profits is a huge disincentive for growth when it is already enormously challenging to obtain growth capital.

Many small businesses are structured as flow-through entities for tax purposes, that is, a subchapter-S corporation or sole proprietorship. And for those businesses, the personal income tax equals the business profit tax.

And the unfortunate result is that many small business owners pay taxes on profits at the higher personal rates. For example, profits over $150,000 would be taxed at approximately a 40 percent marginal tax rate versus the 34 percent for the top corporate rate paid by larger companies.

This is unfair and it discriminates against the small business that is structured as a flow-through entity.

Tax rates are not the only area of concern. The method and timing involved in the profit calculation can also be punitive to certain growth businesses.

For example, service businesses have an inherent tax shelter in that revenue is not taxed until it is collected, while the underlying expense of labor is deducted instantaneously.

Contrast this with a manufacturing or consumer goods business that must account on an accrual basis.

Those businesses must book revenue when the product is shipped out the door, but they collect the cash much later. They are taxed on phantom revenue, which generates book profit, but they have no funds to pay the tax because of the build up in receivables.

Having personally lived through this, I know that it becomes imperative to raise new money to pay taxes in this situation. And with access to capital virtually unobtainable for young companies, there's often no money to pay the tax collector.

In the case of retailers and other businesses which require large capital improvement expenditures, the tax equation becomes even more onerous due to the depreciation rules.

Opening a new store in a mall typically entails $100,000 or more in leasehold improvements. The money is spent up front, but for tax purposes the improvements are depreciated over 39 years, making it virtually a nondeductible expense.

Making matters worse, accounting rules for book profit require the depreciation of leasehold improvements to be taken over the life of the lease which is likely to be five or ten years.

So the potential investor sees the accelerated expense on the financial statements, yielding the most unflattering picture of the business while the tax collector acknowledges almost no expense at all, thus maximizing the profit tax.

I'd like to talk now about taxes on payroll.

The general area of payroll taxes which encompasses everything from Federal income withholding tax to shared payroll taxes such as the Social Security tax and the Medicare tax, has to be one of the most challenging to small business owners.

Again, the complexity of the reporting requirements alone is daunting to every entrepreneur.

But the unspoken reality is that there exists a very large cash society which competes for labor, and which has a big advantage to both the employer and the employee who are part of it because they don't pay taxes.

In the first few years of my business, I wasn't hiring college graduates with professional experience. I was scrambling to find entry-level street-smart workers who would work for low wages.

And in order to entice them to become legitimate and on the payroll, I had to explain to them why, for example, their $320 weekly paycheck would have as much as $50 deducted from it for taxes.

And usually, the employer is the one who makes up most of that difference in order to put someone on a legitimate payroll.

So in many ways, the payroll tax is a hidden tax on small business.

Taxes on capital gains.

Venture capitalists and angels who invest equity in new companies must be encouraged for the sake of the businesses they support. Obviously, they must anticipate a large reward to place their bets on untried new companies. Otherwise, their money will find a home elsewhere.

I believe the reduction in capital gains tax would go a long way in increasing the amount of venture money available to small business start-ups. Banks and other traditional sources of lending do not gamble on start-ups.

And in summary, why are we strangling small business?

Why not encourage the creativity and entrepreneurial drive that resides in our country?

Business creation is only encouraged by a risk reward function that has a significantly large upside potential. And the huge tax burden is one more hurdle thrown in front of the entrepreneur.

Women are arguably affected even more than men by excessive taxes, since the majority of businesses today are being created by women.

The SBA reported that women are starting new firms at twice the rate of all other businesses and own nearly 40 percent of all firms in the United States.

Furthermore, these 8 million firms employ 18.5 million—one in every five U.S. workers—and contribute $2.3 trillion to the economy.

Yes, many women have other motivating factors in starting a business besides financial ones. However, financial health is still the underlying requirement of all businesses.

Thank you for allowing me to speak to you today. I believe in the power of free enterprise and I'm happy to know that you're addressing the burden that taxation has put on it.

Thank you very much.

Senator Mack. Thank you very much. The purpose of the lights is to try to just keep people generally within the time constraints.

But thank you very much for your comments.

[The prepared statement of Ms. Matthias can be found in the Submissions for the Record.]

Mr. Gilder, welcome.

STATEMENT OF GEORGE GILDER, PRESIDENT, GLIDER TECHNOLOGY GROUP, INCORPORATED, AND SENIOR FELLOW, THE DISCOVERY INSTITUTE

Mr. Gilder. Well, thank you for inviting me.

I'd like to begin by telling a story of Gene Amdahl, who was the leading computer architect of the '60s and '70s.

He designed the 360-series at IBM, which was the most successful single product in the history of enterprise, virtually.

The Model T car might be a comparable example. But for the information age, the 360-series of computers at IBM built IBM into the world's greatest technology company.

Gene Amdahl was the key mind behind the 360-series. He left IBM Corporation to start Amdahl, his new company. And during the late '70s, when he made this decision, there was so little venture capital available, that Gene Amdahl had to sell out to the Japanese in order to get money to fund his new venture, which was the most exciting new venture in the entire range of the U.S. computer industry in the late 1970s.

This was the way it was. Venture capital had been entirely extinguished during the mid-1970s by the high tax rates and the bracket creep and the inflation and stagflation, all those phenomena we remember. High tax rates on capital gains were in fact over 100 percent, effectively, adjusted for inflation, because people were essentially paying capital gains tax on inflated gains.rather than on real gains.

So, in effect, it wasn't a tax. It was a confiscation of assets.

So that's the way it was. Mr. Chairman, do you remember "Stupendous Steiger?"

The Steiger Amendment was introduced by Congressman Bill Steiger, who died shortly afterwards. But he introduced the Steiger Amendment to drop the capital gains tax to 28 percent.

Within two years, the amount of venture capital rose about 100-fold. And the number of new public issues on the stock market also rose by a factor of four to five, from a thousand to 4000.

There was just a general explosion of entrepreneurial activity that laid the foundations for the economy that we currently experience in technology.

Following Steiger, of course, that was merely the first step in a whole series of tax rate reductions launched by the Reagan Administration and supported by both sides of Congress some of the time.

The result was this fabulous efflorescence of technology that's currently spearheading the U.S. economy and rendering the U.S. economy the dominant force in the world system.

And over the last several years, these tax rates have been effectively reduced again because what we've entered is a period of disinflation.

The effect of disinflation is further reductions in capital gains tax cuts. And as a matter of fact, I believe that there has been, certainly in the technology economy, there is a deflation of prices. I mean, a collapse of prices, as a matter of fact, at an astounding pace.

This in effect has imparted further tax cuts to this particular side of the U.S. economy. And capital gains tax cuts have continued to occur as a result of the steady decline in prices, which, in effect, means that the situation became the opposite of the experience that Gene Amdahl underwent.

So this is what we've experienced.

And I believe that today, that a lot of people are talking about Social Security or debt or some problem prohibiting further tax rate reductions. But I believe that governments can't choose their own revenue level any more than a business can.

Governments compete for tax money in an intensely competitive global environment. They compete for shares of the global tax base, for the world wide supply of taxpayers and of taxable income, wealth, sales and property.

And so, when we talk about Social Security as somehow being an obstacle to tax rate reductions, I see it the other way.

They are a mandate for tax rate reductions.

The Social Security System today is like a business with a profit problem. The financial officers crowd into the office of the chief executive officer and complain about low margins and demand increased prices. But businesses with profit problems go broke if they raise their prices.

They've got to lower their prices, expand their market.

It's only through the productive activities of the U.S. economy, people like Gene Amdahl before and thousands of entrepreneurs today on the Internet, that our Social Security burdens can be defrayed.

They can only be defrayed if we continue to lower our tax rates.

And the World Bank did a study of some 55 countries and discovered that the countries with the lowest tax rates increased their government spending most. And that country's in the entire world economy, that has been able to increase its government spending most over the last 30 years, 35 years, is Hong Kong.

It increased its government spending proportionately more than any other country in the world. And Hong Kong, throughout this period, had the world's lowest tax rate—16.66 percent, and no tax rate at all on capital gains and others.

So low tax rates lead to more revenues. It's only by lowering tax rates, releasing the energies of the American people, the creativity of American entrepreneurs, that the challenges of Social Security can be met.

They cannot be met by increasing Social Security tax rates or even maintaining them at their currently oppressive level on low income workers and earners.

Thank you, Mr. Chairman.

Senator Mack. Thank you, Mr Gilder.

Mr. Primus?

STATEMENT OF WENDELL PRIMUS, DIRECTOR OF INCOME SECURITY, THE CENTER ON BUDGET AND POLICY PRIORITIES

Mr. Primus. Thank you, Mr. Chairman, for the invitation to testify.

The projected surpluses present policy-makers with once-in-a-generation choice—you can spend those surpluses by cutting taxes or raising government spending and thus, boosting current consumption. Or you can save those surpluses by strengthening Social Security and Medicare, paying down the debt held by the public, raising national savings investment and economic growth.

I think the way you should think of it, Mr. Chairman, is that by reducing the public debt, you are putting more hands into the savers in the economy. They then can use these additional cash from the government to meet some of the needs that Mr. Gilder talked about.

The Administration projects unified budget surpluses of about five trillion over the next 15 years. Under their plan, about three billion would be used to reduce the public debt, about $600 billion would be invested in equities, and about $1.4 trillion would be spent.

The interest savings alone from this proposal as a percentage of GDP would more than offset the increase in Social Security costs that will occur over the first half of the next century.

Maybe you can see this best in the following.

Over the last ten years, the combined amount that we have spent on Social Security and net interest cost has averaged 7.7 percent of GDP.

If we could eliminate our net interest cost, Social Security cost alone as a percent of GDP will not exceed the 7.7 percent level until 2070, under the actuary's intermediate assumptions.

In addition, the Administration has proposed setting aside some of the on-budget surpluses to strengthen Medicare and also has proposed Universal Savings Account.

To the extent, for whatever reason, that you decide not to accept the President's proposals in this arena, I would urge that you transfer that money to Social Security and save it, rather than having it be used for consumption through the enactment of a larger tax cut or increased spending.

My generation, those born after World War II, are entering their peak earning years, and we know there will be budgetary pressures as the baby boom generation retires. The choice you face is whether to give my generation a tax break for the next ten to 15 years and let some future congresses raise taxes on my children and grandchildren to meet current Social Security and Medicare commitments.

I strongly urge you to save the surplus.

You also may need some of those surpluses that are provided today in order to fashion Social Security and Medicare solvency legislation.

If you consume those surpluses completely by, again, tax cuts or spending, those resources will disappear and it may be harder to reach agreement on Social Security and Medicare solvency bills.

Contrast these approaches to those currently being considered in Congress, where you would use on-budget surpluses to provide tax cuts and use a large portion of the Social Security surpluses to establish individual accounts.

These plans will not reduce the publicly-held debt very much, forcing Americans to pay higher interest bills than under a plan that largely reduces or eliminates publicly-held debt.

For example, the Feldstein approaches and those associated with Senator Gramm would increase our retirement income promises to the elderly, since it guarantees all of the elderly's Social Security benefits plus a portion of the retirement account.

I would urge you at this point as the baby boom generation is about to retire, that you fund the current promises before you make increased promises to the elderly, particularly in an across-the-board fashion.

To be sure, there is a need to improve benefits for widows as the President has suggested. But the cost of those improvements should be offset with other Social Security reforms.

I also think it's important that you continue to adhere to the pay-as-you-go rule. I think it was one of the reasons you now have budget surpluses. And I think that that rule should be continued.

In Fiscal 1998, the Federal Government as a whole ran its first surpluses in decades. But we're not projecting on-budget surpluses until 2002, three fiscal years from now. And over the next ten years, the CBO projects net surpluses of about $788 billion.

The CBO assumptions, though, assume that you will keep spending within the discretionary caps.

You recently passed a bill, the Military Pay and Pension Increase bill, that increased spending by $55 billion over the next ten years.

The reality is that the discretionary caps will be increased. The only question is when.

And if you adjust those discretionary caps, not including the emergency spending that you agreed to in 1999, just for inflation from here on out, the entire on-budget surplus disappears.

Another reason I think you should be cautious about tax cuts is the uncertainty of these estimates.

CBO did a study and looked at their projections. There's a deviation in their average estimate of $250 billion up or down—again, five years hence. So let's have these on-budget surpluses actually materialize before you should think about giving them away by increasing spending or taxes.

The final thing, and this is to Senator Brownback. I think the growing economy, the Federal Reserve policy, and the budget deals of 1990 and 1993 all contributed to changing that budget deficit.

And in those deals, taxes were raised and spending was constrained.

In fact, we now have taxes as a percent of our GDP at one of its all-time highs and economic growth is continuing.

Taxes on the median-family income, those in the middle of the income distribution, have not been increased. They are actually lower. We've lowered them over the past several years.

Moreover, the payroll tax rate is fixed over the next 75 years.

And actually, then, as a percent of GDP, it declines by almost a percentage point.

That is worth about $78 billion. And I just don't believe that you're going to be able to finance Social Security in light of the increasing number or percentage of the population over age 65, increasing longevity, what medical technology does to medical cost, with a tax base that is fixed and is declining as a percent of GDP.

So, in conclusion, Mr. Chairman, I think it is very important that you proceed with the needs of the country at hand, strengthening Social Security, enhancing Medicare, and lowering the public debt.

And then you should proceed with extreme caution before sizable tax cuts are enacted.

Thank you.

[The prepared statement of Mr. Primus can be found in the Submissions for the Record.]

Senator Mack. Thank you very much. You may have noticed a slight grin on my face as you began your comments speaking of the surplus.

I had the sense that we have seen George Orwell return, 1984.

The phrase that you used was we can spend it—speaking of the surplus—we can spend it by cutting taxes. Only in Washington could a tax cut be called spending.

(Laughter.)

In any event, let me start with Ms. Matthias. There has been a comment—you made some reference with respect to capital gains, venture capital.

There has been a comment this morning that there has been no shortage of venture capital. I'd just like to get a sense from you, you've been dealing with, I guess, both aspects of it in the sense of when you started your own business, it was difficult to find the capital to get it started.

And I understand now you're actually involved in helping others who are trying to start their business by trying to see that capital flows in their direction.

Could you tell me a little bit about what we need to do, to try to change the situation to increase the opportunities for people trying to get into business, as far as venture capital is concerned?

Ms. Matthias. Well, I was interested to know how much venture capital there was because I didn't find that when I was looking for venture capital.

My guess is that there is kind of a two level type of venture capital. There's a lot of money for big companies with high tech and dot coms at the end of their name. There's not a lot of money for little, small businesses that maybe are low tech and that don't have three companies behind them and really just want to start a business.

So my experience was not that I had a lot of money available to me. It was very, very difficult. It took me four years to find my first venture capitalist.

Once you get one, it's easier to get the second. I will say that. But it's hard for, I think, the smaller businesses to attract venture capital than larger businesses.

Senator Mack. And do you have a sense about what it is that we might be able to do to make that easier?

Ms. Matthias. That's a hard question. I think that, ultimately, it all comes from lowering capital gains tax because a venture capitalist has to have a return at the end of whatever he invests, or she invests.

And I think that the answer for small businesses is smaller venture capital funds.

In my case, my first venture capitalist was an angel, someone who was a business person that had money that wanted to invest. It wasn't a venture capital fund.

So he's responding to the same types of capital gain taxes that large funds are as well.

So I think it's the same answer. I really do.

Senator Mack. But what you're saying is that it's a different entity, in essence, that provides it. It may be an individual who's looking for some other investment opportunity besides, let's say, today's savings market.

If there is a lower capital gains tax, that individual might be willing to take greater risk for a greater return.

Ms. Matthias. Exactly.

Senator Mack. And if they had a lower capital gains tax rate, that would encourage that.

Ms. Matthias. Very much so.

Senator Mack. Mr. Gilder, let me address a question—and I'm going to try to put you into a little bit of a box in the sense of saying, you have to look at this only in terms of the next couple of years with the present Tax Code.

What kind of changes would you make within that structure that I've just created for you? What kind of changes would you make in the tax code to create more growth?

Mr. Gilder. I do an across-the-board reduction in rates.

Senator Mack. And why don't you explain—what you're saying is that you believe the lower the marginal tax rate, that is the greatest stimulus for growth.

Mr. Gilder. I think small businesses are more affected by the general business environment. They pay far more payroll taxes than they do capital gains taxes.

And so, to focus on capital gains taxes when talking about the general environment for growth across the whole economy, I think is a mistake.

All those other taxes you spoke about are much more significant in regard to the environment for small business entrepreneurship and initiative, which is critical to opportunities across the board.

So I think the simplest thing to do is to cut taxes across the board. Ultimately, I'd like to move to a flat rate tax.

But that probably has to wait. That can't happen in—that doesn't fit your parameters, I suspect.

Senator Mack. That's why I created the parameters.

Mr. Gilder. Yes.

Senator Mack. Because I wanted to get you to focus on where we are now.

Mr. Gilder. Right. In general, the environment across-the-board dwarfs the numbers of $250 billion surplus.

Cutting taxes across-the-board during the 1980s increased the total value of American assets from something like $17 trillion to $30 trillion.

They're now close to $50 trillion.

I mean, we're talking about trillions of dollars of increase in asset values across the economy as a result of tax rate reductions and deregulation.

These accounting analyses of a billion dollars here and a billion dollars there are almost irrelevant compared to the impact of tax reductions on the value of American assets.

Senator Mack. Very good. Mayor, did I hear you say that you cut taxes four times?

Mayor Goldsmith. Yes, sir.

Senator Mack. Tell us a little bit, again—do you believe—I assume that you also reduced regulation as well.

Mayor Goldsmith. Yes.

Senator Mack. Do you believe those two things gave you, in essence, a competitive advantage?

Mayor Goldsmith. That's what we sought to do,—to say that cities had a structural imbalance for capital formation and we would do whatever we could to make our community a friendlier place for capital to be invested.

Now you're the big stick in this, right, the Federal Government, in terms of tax rates. The cities are competitive inside their own tax rates.

So to the extent that we reduced property taxes, reduced regulatory burdens, made it easier for people to invest money, then that led to job creation.

That's why I don't view this good discussion that the Committee is having about whether it's on this hand to save Social Security or on this hand, cut income taxes. From our perspective, the more we stimulate the economy, businesses invested. That created jobs. People had jobs. And that helped the general economy.

So I would encourage the Committee to address both. That's what most of the successful cities have done. Whether you look at New York City's hotel taxes—right? How do you stimulate the convention business? You cut the tax rate.

How do you stimulate the investment of capital in older cities? You cut the tax rate.

We've done that and, predictably, it works.

Senator Mack. Good. Pete, why don't I turn to you?

Representative Stark. Thank you, Mr. Chairman. A lot of wonderful ideas.

The Chair mentioned the idea of tax expenditures being inside the beltway. I am curious—I just happen to have a booklet here entitled "Estimates of Federal Tax Expenditures." It says that these provisions are referred to as tax expenditures and may be considered to be analogous to direct outlay programs and alternative ways of accomplishing similar budget policy objectives. This booklet was published by a couple of left-wing loonies—Bill Roth, John Chaffee, and Charles Grassley.

Actually, we could go back to another kind of left-wing economist, Ronald Reagan, who came up with the idea of abolishing the corporate income tax, which I supported as part of a tax reform bill. He later switched signals and said, we ought to broaden the base, which let us get to lower rates.

So there's a whole book full of tax expenditures here that I would support exchanging for lower marginal rates.

I don't think there's any quarrel. The quarrel is that everybody wants their dessert before they eat their spinach. They are not willing to do away with these expenditures, as you claim. But that's really what they are. These tax exemptions give certain people special exemptions from an overall tax rate.

The question keeps coming back to, who do we intend to help?

The flat tax is an interesting idea. But in Mayor Goldsmith's state, they have a flat tax. And also one of the most regressive tax systems in the United States: Twenty percent of Indiana married couples with the lowest incomes, less than $30,000, pay almost 13 percent of their income in state and local taxes in Indiana. The richest percent of Indianans earning above $253,000, only pay 6.5 percent of tax revenue.

I don't think that we can sell that politically as an overall system. It's just unfair. Those who suggest a flat tax rate basically want to give all the benefits to the top one or two percent of rich Americans.

That's well and good. It would not have helped Mr. Amdahl, who must have been a Republican computer expert. He was clinging to the dim, dark past. The 360 in the 1970s, when I was helping to finance people like Wosniak and Jobs, was a turkey. But it wasn't that he couldn't get money. He just had a lousy product.

Those of us who were going to spend our own money and not money that we inherited or were given by the government, wouldn't invest in it. But we did see entrepreneurs like Jann Wenner, the creative publisher, or Apple Company, as being the vanguard, where a computer as big as this water pitcher replaced a 360, which could fill up a room this size.

You can blame your failures on the tax code. But very few people seem to claim their victories on it. That's something to keep in mind.

Mayor Goldsmith and I share an interest in making parents do the responsible thing. And I just want to ask you, Mr. Mayor, a question, while I have the chance.

Non-custodial parents do not receive the earned income tax credit. I know that this is something that you have some interest in. Assume we abandoned Social Security and had this big tax cut and I had a little money left over. What would you think about federally subsidizing a non-custodial parent's payment to children, as a replacement for the earned income tax credit? If we could give a bigger subsidy to the very lowest, say minimum-wage worker, and phase it out at a certain rate, in order to level the playing field, would this solve what I think you and I agree is a serious social problem?

I'm sorry to interject this here, but I don't get much of a chance to talk with Mayor Goldsmith.

I guess I'd ask, would that offend you, if we could find a way to do that?

Mayor Goldsmith. This is an enormously complicated subject and one that actually Wendell and I have some agreement on, despite our opposite ends at this table.

Let me try to think through it quickly here.

First of all, I would recommend some attention to the EITC as it applies to noncustodial parents. I think you can make an argument that it's as high as it can go for those who currently qualify.

But there is a group out here who don't qualify. And one of the problems from welfare to work is we're totally ignoring men, especially men without kids.

So we have this issue.

Representative Stark. We did it in California and we are getting penalized for it.

Mayor Goldsmith. So I think we should pay attention to that.

And secondly, I believe the way the child support system works today as it relates to your question is archaic. I would recommend we think about the working poor and ways that the mother can enjoy the full fruits of her work without the vagaries or offsets that come from the payment that the man makes that sometimes goes to the mom, sometimes goes to the government, sometimes go up, sometimes go down.

I think there's a lot of good work that can be done at the bottom of that marketplace with EITC. And I'd be open to the subsidization. I suspect we would disagree on the details, but the concept, I think, is certainly worth discussing.

Representative Stark. Well, assuming that we are subsidizing other parents who are not living there but—

Mayor Goldsmith. Right. Well, with Senator Mack's indulgence, I would just say, I think the mistake we made is we have a child we're trying to help.

From my perspective, if you help the man get a job or you help the woman get a job, whatever in you do to help build up the family, the household income is what's important.

And our system is currently distorted a little bit because it's aimed at the AFDC mom who came off.

If you add those things together, Senator, I would just say that I do think there's some positive things, whether this regard or helping the working poor individual own assets, whether it's a house or their own stocks in their pension fund.

Those things all together keep us from having a state where some people have ownership and money and some people don't. Anything that would encourage capital formation on the bottom end, and ownership, I'd be excited to support.

Representative Stark. Thank you. Thank you for indulging me that question.

Senator Mack. Absolutely.

Senator Brownback?

Senator Brownback. Thank you, Mr. Chairman.

Mr. Gilder, I was interested in your concept that governments compete for revenues around the world and I guess we can't set them any more than businesses can set them.

And then you cited to some of the countries that have been the most successful in competing with revenues, are those that have the lowest tax rates, if I'm understanding what you're putting forward.

Mr. Gilder. That's correct.

Senator Brownback. What countries are doing the best job today in adjusting their tax policy to compete for governmental revenues?

What are they looking at and doing today in the economic climate that faces us around the world?

Mr. Gilder. I think that the lower rates in general, the better. This is what the World Bank study showed, was over a huge range of countries, the countries that increased their government spending most, the countries that could succeed in increasing their government spending most were those countries with the lowest tax rates.

And the reason they could increase their government spending most was that they grew six times faster than the high tax countries did.

This study happened before the Asian crisis and crash and everything. And many of the best performers were in Asia. They did have the lowest tax rates, many of them did.

But across the board, in European countries with lower rates, increased their government spending faster than countries like Sweden, which actually couldn't increase their government spending at all.

Throughout the period that they had the world's highest tax rates, they had the lowest increases in government spending because they couldn't increase their spending because the rates were already topped out and their growth stagnated.

Today, the United States is outperforming the rest of the world. We are attracting capital from everywhere. We are the most successful model.

But I don't think that we can just take for granted that the rest of the world will ignore this example where we have offered them since the

1980s. And I think that further tax rate reductions are always needed, just as businesses have to constantly lower their prices or increase their value proposition in order to prevail.

So governments have to continually reduce their prices and increase their performance, and their value proposition to prevail.

Senator Brownback. Mr. Primus, are you familiar with that World Bank study that he was citing to, and do you agree or disagree with that?

Mr. Primus. No, I'm not familiar with the World Bank study.

Mr. Gilder. Keith Marsten was the initial author of it.

Mr. Primus. I would just add, when Mr. Gilder says that we're the model in some sense, the only thing that I would point out to the Committee is that, right now, our taxes as a percent of GDP are very high and we are still that model.

I think, being very simplistic, the federal budget and fiscal policy is an allocator of resources and the Fed has a lot to do with low interest rates and stimulation.

And I would still maintain that the most you can do right now, the best policy that would increase our economic growth and our national savings rate is to reduce the amount of publicly-held debt.

That is exactly the best policy because you're putting more in the hands of savers, people who have demonstrated they want to save, as opposed to an across-the-board cut which we know will just boost consumption.

Senator Brownback. Mr. Gilder, did you care to respond on that?

Mr. Gilder. Well, assets—it's a one-handed economist again—counts the liabilities but not the assets.

As a proportion of total assets, our government liabilities, our corporate liabilities are all lower than they've been in decades.

So it's just not a correct mode of analysis to focus on flows of funds without also recognizing the increase in asset values.

And that's why, even though it appears, if you measure GDP, that taxes are higher than they've been in the past, most of the increase has come in the capital gains accounting category. And capital gains aren't part of GDP.

Because capital gains tax rates have dropped while all other tax rates have gone up, all the increases have occurred in the capital gains category that's not part of GDP.

So it's just an example of when you reduce taxes in one area, all the activity migrates to that area.

Senator Brownback. It is an interesting point that the area that we have cut rates in has been the area where we have had the most increase in growth in government revenues.

Mr. Gilder. Yes.

Senator Mack. Congressman Hinchey?

Representative Hinchey. Well, thank you very much, Mr. Chairman.

This is a fascinating discussion. I'm struck by the propensity of some people to want to revisit that whole experience of supply-side economics that we went through in the 1980s. That was such a disaster for the economy.

The fact of the matter is—

Senator Mack. You're right. It is a matter of viewpoint.

(Laughter.)

Representative Hinchey. Well, it is a matter of viewpoint, obviously. But I think it's a viewpoint that is very well buttressed by the facts.

If you consider that during the 1980s, of course, we incurred that enormous debt—well, we did, didn't we, Mr. Gilder?

Mr. Gilder. No.

Representative Hinchey. We didn't?

Mr. Gilder. No. Absolutely. Debt dropped drastically as a share of national assets during the 1980s. A drastic reduction in debt during the 1980s.

Corporate debt, government debt, household debt—all debt dropped during the 1980s, as a proportion of assets. And if you're an economist with two arms, you don't just count liabilities and ignore assets.

Assets hugely increased, tripled during the 1980s.

Representative Hinchey. Well, you need to do that in the same way when you look at the debt of the nation. You have to count the nation's assets as well, don't you?

Mr. Gilder. You do, absolutely. That's what I 'm doing.

You aren't.

Representative Hinchey. Well, I think I am. If you look at what happened in the 1980s in terms of fixed investment as a percentage of GDP, it actually fell. By 1992, nonresidential investment stood at less than nine percent of GDP.

And at that point, it was at its lowest level in 20 years.

Since 1992, it's been going in the opposite direction. And it's been going in the opposite direction precisely as a result of the actions that were taken here by the Congress in 1993. The 1993 Budget Act was designed to reduce the federal debt and to promote economic growth, which is exactly what happened. And we've experience the best, strongest economic growth over the course of the last six years that we've seen in—I don't know how long. At least since back in the 1940s.

So I'm really wondering how you can make the argument that you do that we ought to be going back to the situation that we created in the 1980s, when we got into so much serious trouble.

Mr. Gilder. I don't have any—capital spending—between 1992 and 1990, exports rose 92 percent. Capital equipment spending rose 76 percent. Manufacturing output, 48 percent. Nonfinancial GDP, up 38 percent. Led by high-tech, high-technology, capital goods went up from 28 to 38 percent of the U.S. industrial base and from 30 to 40 percent of exports.

We launched the global computer information revolution. We won the Cold War.

I mean, that's some bizarre world you live in where the '80s was a failure.

I don't even know what you're talking about.

(Laughter.)

Excuse me. I'm sorry. I apologize for my outburst there.

Representative Hinchey. Well, there were some people obviously who did well. We know that the price of Van Goghs went up and enough people were driving Mercedes Benz in the 1980s.

But the general effect of that economy for most people was not the way that you're describing it.

And in fact, the general economic situation that we found by the end of that decade was that you had very little investment. A small amount of money was going into investment. The economy was growing at a very slow rate. You had growth rates of less than two percent at the end of the 1980s, the beginning of the '90s.

Since then, of course, growth rates have gone in the opposite direction. And in 1993, we actually raised tax rates on the highest income people and that didn't seem to have a dampening effect on the economy.

In fact, it was quite the opposite.

Mr. Gilder. During the '80s, jobs increased by 19 percent, 18 million new jobs. 30 percent rise in black employment. Fifty percent rise in Hispanic employment.

Number of black businesses rose by 33 percent. Receipts doubled. I don't know. I could keep going.

Representative Hinchey. And you had some of the highest unemployment rates that we've had in recent history by the end of the 1980s.

Mr. Gilder. The employment is what counts.

Representative Hinchey. And you had a decline in real income of people in the middle-income range and people in the lower middle-income range.

So that's the decade I lived through. I know it's very different from the one that you see. But I think that the facts just speak for themselves.

Were you advocating a reduction in taxes for FICA, for Social Security?

Mr. Gilder. I think we could abolish the Social Security tax and just have a flat income tax covering everything.

Representative Hinchey. How would you finance the Social Security System?

Mr. Gilder. And appropriate exemptions for low-income people.

Representative Hinchey. How would you finance the Social Security System?

You'd do away with it?

Mr. Gilder. No. Well, I think various privatization options are attractive. But I'm not for abolishing it.

Representative Hinchey. Well, how would you finance it?

Mr. Gilder. I'd finance it by the fabulous growth of the U.S. economy that's in prospect provided we—

Representative Hinchey. That's taken place since 1993? You mean that fabulous growth that we've seen in—

Mr. Gilder. It really started in '78. It started with the Carter Administration and the deregulation of the late '70s and the reduction of the capital gains tax rate in 1978, and proceeded through all the tax rate reductions and deregulatory initiatives of the 1980s.

And it's continued through the 1990s, with the fabulous expansion of the Internet. That's the spearhead of U.S. economic growth today.

Representative Hinchey. So you see this history as a linear history that began in 1978 and just continued to grow uniformly from that point to the point where we are now?

Mr. Gilder. There were various setbacks, the budget deal being the prime one. But, in general, there has been a linear expansion in the high technology economy.

I'm the chairman of the Gilder Technology Group and I study the high-technology economy for a living. That is what has been the spearhead of economic growth.

And the chief forces in unleashing this fabulous efflorescence of creativity in the U.S. economy have been drastic increase in venture capital as a result of the collapse of the capital gains tax and deregulation of the set of industries.

Plus the value of immigration. We've benefitted heavily from immigrants from around the world.

Senator Mack. I'm going to exercise the prerogative of the Chair to disengage in this discussion.

Representative Hinchey. Well, thank you, Mr. Chairman. It's an interesting discussion and I very much appreciate listening to it.

Mr. Gilder. Thank you.

Senator Mack. Thank you. Senator Sessions?

Senator Sessions. Mr. Chairman, thank you very much.

That was indeed a most interesting discussion and I enjoyed hearing it.

Mr. Gilder, on that same discussion level, would you say that , while the United States economy in the late '70s never deteriorated to the level of England's, fundamentally, both nations made a historic turn at about that time in dealing with big business, big labor, regulations, taxes, and that that has clearly, without any doubt, been the prime factor in their economic vitality of the last decade or so?

Mr. Gilder. No question whatsoever. That's right.

Senator Sessions. Mr. Primus, would you have any dispute with that?

Mr. Primus. I see the 1980s somewhat differently. We had, I think, unemployment rates of 10.8 percent in 1982. And to some extent, President Reagan at that time was a Keynesian.

We had to run big, huge budget deficits to stimulate us and get us moving ahead.

And I come back to fundamentally that, it's not so much fiscal policy that's determining our macro economic growth. A lot of it has to do with the Fed and low interest rates. And we went through a wrenching time to force inflation expectations out of the economy.

That was very important.

And right now, I think the decisions you have to make are more about whether you want to fund Medicare and those Social Security promises and reduce public debt.

Senator Sessions. They're big problems. But wouldn't you say after the initial courageous action President Reagan took in leading us through a recession, that after that recession, the growth rates of the '80s were higher than the growth rates of the '90s?

Mr. Primus. I don't think that's true at all. I can't remember the historical record precisely, but I don't think that's—and we had real problems.

If you got to the end of the—and the Chairman remembers this well. We had budget deficits of $300 billion as far as you could project.

Senator Sessions. We didn't stop spending. There's no doubt about that.

But would you not also agree that income to the government went up through those years?

Mr. Primus. It did.

Senator Sessions. So it wasn't just a question of cutting taxes. We cut taxes and we cut spending.

Mr. Primus. Senator, I think if you now go back and look, discretionary spending is at an all-time low. Defense spending as a percent of GDP is very low.

You have constrained spending.

Yes, we're continuing to spend lots of money. It's a big dollar amount. But as a percentage of our GDP, it's very low.

Senator Sessions. Well, I think you indicated it was higher earlier as a percentage of GDP.

Mr. Primus. No. Taxes right now are at an historical high. But spending is not at an historical—that's why we have the differences of surplus.

Senator Sessions. Well, all that's most interesting.

Let me ask you—here we're debating the '80s again. But I really do think that England and the United States made some historic and tough decisions at that time to commit to a market economy and lower taxes, and I think that is wonderful. We would not be in a position to bring in the money to balance Social Security had we not opted for growth over state control.

Can you imagine, Mr. Primus, a system in which we could perhaps cut taxes in a way to encourage savings to supplement Social Security for individuals, something like the federal thrift plan where the Federal Government matches an employee's contribution and maybe even more than matches for a lower income person, to encourage them to start savings for that retirement for the future and harness the power of compound interest?

Mr. Primus. I have two comments. One is I think when we see the details of the President's proposal on universal savings account, that clearly is tempting. The idea is to do that.

I think they have a very tough time getting all the details to make it work.

The other thing, I want to come back to a conversation between the mayor and Congressman Stark.

I think that one of the most important things you can do is help low-income men at the bottom get into the labor force. I think we've put too much emphasis on getting the female into the labor force and not enough emphasis on the male side.

I would like—and I am not for high tax rates. And between our tax and transfer system right now, we have 100 percent tax on child support payments made by low-income dads.

That's a tax rate I wish you would lower.

I would like to have most children live with two parents. But that doesn't always happen. And when it doesn't, I would like to have that father pay child support. But I don't like the idea that none of it gets to his child. When a father pays child support, almost all of the non-custodial parent's payment goes to reimbursing federal and state governments for the welfare that the custodial family is receiving.

I think that if we like that activity of paying child support, we ought to subsidize it.

Senator Mack. Well, I frankly want to thank the panel and particularly George Gilder and the Congressman in engaging in a stimulating debate.

I thought it was interesting as hell, to tell you the truth.

(Laughter.)

It reminds me of a comment that Richard Nixon made to me back in the mid-1980s, in asking me what I speak about when I got out on the stump.

He would say, "Connie, what do you speak about when you're out on the stump?"

(Laughter.)

And I would say, well, Mr. President, I'm on the Budget Committee and I love to talk about economics.

And he looked at me and he said, "Connie, economics is boring. Boring."

(Laughter.)

I don't think this morning was boring at all. So I thank you all for the participation.

Thank you all very much.

I might just add, the last point that I think I would just kind of drop out here, though, is that it's been mentioned several times that the revenue level of the Federal Government, as a percentage of GDP, is the highest it's ever been.

Isn't it interesting, though, that it's the highest it's ever been with lower tax rates relative to where we have been in the past?

So it makes the point that there is some value to lower tax rates stimulating the economy and producing revenues to the Federal Government.

I thank you all for participating.

If the next panel would take their seats.

(Pause.)

I'll say to the members of the panel that I introduced you in my opening statement. So I will not go back through that again.

But, again, I thank each of you for coming and for your willingness to participate this morning. And I think that maybe we'll just reverse this and maybe let Mr. Gale go first and then work our way down the panel.

Mr. Gale, welcome.

PANEL II

STATEMENT OF WILLIAM G. GALE, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. Gale. Thank you. Let me just get my notes right-side up.

Senator Mack. Sure.

Mr. Gale. All right. Thank you, Mr. Chairman, for the invitation to testify at this hearing.

I chose to focus on the issue of whether we should use the budget surplus to finance large-scale tax cuts. In particular, across-the-board tax cuts, but much of what I'll be saying will relate to any large-scale tax cut, whether it applies to capital gains or marriage penalty or anything else.

There's rather a lengthy testimony attached, but I'll try to just stick to the highlights.

I think that the right place to start out is to note that the federal surplus is a major achievement. Some backs should be patted for that. But it's only the first step toward a longer-term fiscal sustainability.

And in fact, one can argue that the short-term surpluses are really only an accounting illusion and that in the long-term, we have a large fiscal deficit due primarily to Social Security and Medicare.

But I think it also helps to carve up the surplus a little it. CBO has projected $2.6 trillion in surpluses over the next ten years.

Of that $2.6 trillion, $1.8 is in the Social Security trust fund and I think there's general agreement to leave that alone, to carve that out to pay for Social Security.

And the main issue, then is what do we do with this other $800 billion in accruing on-budget surpluses?

The President has proposed to spend it on USA accounts, Medicare and discretionary spending and a variety of leading congressional Republicans have proposed across-the-board tax cuts.

What I want to do is highlight some aspects of the short-term and long-run situation, highlight some aspects of the across-the-board tax cut, and highlight some other issues that I think all weigh heavily against across-the-board tax cuts.

Just to be clear, I think it would be a very bad idea to spend the on-budget surplus on across-the-board tax cuts.

Let me tell you about why.

The first question is whether the surpluses will materialize, let's deconstruct the $800 billion surplus to begin with.

Six hundred billion of that $800 billion is due to the assumption that we will have real cuts in discretionary spending over the 2000 to 2009 period.

Those to me seem unlikely. If that would occur, discretionary spending would fall by a quarter relative to the size of the economy. There's a New York Times article a couple of days ago that Speaker Hastert has suggested that maybe the caps will be lifted this year.

Well, if you just lift the caps a little bit this year and just lift them a little bit next year, pretty soon you're talking about $600 billion.

If we actually held discretionary spending constant as a percentage of GDP the next ten years, that would cost $1.4 trillion.

That is, it would eat up the whole on-budget surplus, plus another $600 billion.

So that's one key assumption in thinking about whether these surpluses will actually materialize.

The second issue is that we have had a gigantic rise in income tax revenues relative to the economy. The surplus forecast assumes that about 85 percent of those revenues will prove permanent.

The only way that that can happen is if the stock market continues to grow at about 20 to 25 percent per year.

So if you don't think that the economy is going to continue to grow at the 6.1 percent rate that it saw last quarter or that the stock market is going to grow at 20, 25 percent a year, you ought to be worried about whether the revenue forecast will materialize.

If, for example, only 75 percent of the surge is permanent, that would cost between $300 and $400 billion over the next ten years.

So you can go from $800 billion to zero very quickly in these on-budget surplus forecasts and you can go way below zero—that is, back in the deficit territory—on the on-budget surplus without making strenuous assumptions about spending or revenue.

The second question is, if the surpluses arise, should we use them for tax cuts?

Over half of the $800 billion in surplus, $418 billion, are projected to be increases in the Medicare part A trust fund and in government pension reserves.

Now there's a general agreement that Social Security trust funds should not be used for tax cuts. I would submit to you that the same argument applies to the Medicare trust fund and to pension reserves.

That is, these funds represent promises made to future workers and we should not squander them on tax cuts.

In the long-term, of course, we face sizable fiscal deficits ranging from one to three percent of GDP, which I won't go through, but are in my written testamony.

Turning specifically to the ten-percent across-the-board cut, let me just note a few things.

One is, as proposed by Representative Kasich, it would cost $200 billion more than on-budget surplus. So it would in fact raid Social Security funds over the next ten years.

The second is it would provide no benefits at all to 48 million taxpayers. Many of them do pay Federal taxes. They just don't happen to pay income taxes.

And the third is it provides benefits of $9000 per household for households from the top 1.8 percent.

Another aspect of the cut that doesn't get discussed much is that it would force a waiver of the budget rules. If you recall, we put the budget rules in place in 1990 to reduce the amount by which deficits increase.

But it's important to realize that a lower surplus has the same effect as a higher budget deficit. It increases burdens on future generations. It raises government interest costs. It reduces national saving.

Let me make one more point and then conclude.

You often hear from people like Representative Dunn, Representative Kasich, Newt Gingrich, Majority Leader Lott, that the typical family pays 40 percent of its income in taxes.

That figure is just flat-out wrong. It's based on a Tax Foundation study that overstates taxes. It understates income.

A variety of estimates from Treasury, CBO, the Joint Tax Committee suggests that a more reasonable number for all these taxes is about 26 or 28 percent, and up to half of that is payroll taxes.

So I conclude that, on the one hand, we have a rare confluence of good fortune. We have a short-term surplus. We have a sound economy. And we have the lowest tax rates for most households in more than 20 years.

That good fortune should not be squandered on a tax cut that would have little gain in economic growth. In fact, no gain in economic growth when the economy is already full employment.

That good fortune should instead be used to address the long-term fiscal problems relating to Social Security and Medicare.

Thank you very much.

Senator Mack. Thank you, Mr. Gale.

[The prepared statement of Mr. Gale can be found in the Submissions for the Record.]

Mr. Wilkins, welcome and thank you for coming.

STATEMENT OF JOHN G. WILKINS, PRINCIPAL, NATIONAL ECONOMIC CONSULTING, PRICEWATERHOUSECOOPERS L.L.P.

Mr. Wilkins. Thank you very much, Mr. Chairman. It's a pleasure to be here today to give my views on economic growth through tax cuts. Given historically high effective tax rates, and an economy strong enough to yield unexpectedly large budget surpluses, it is quite appropriate that tax cuts are being considered.

My statement today draws upon information generated by PricewaterhouseCooper's proprietary economic model. This model produces dynamic revenue estimates that not only take into account taxpayer behavior, but also take into account the impact of tax changes on macro economic variables, such as real growth, interest rates, corporate profits, labor force participation and the like.

The economy is very strong, as we all know, continuing an expansion that began eight years ago. Real growth has run 4 percent for the last three years. Excellent. The unemployment rate is the lowest it has been since 1969. The number of working people is at an all-time record high, inflation is the lowest it has been since the mid-1960s.

But most importantly, productivity gains were about 2.2 percent in 1998—strong, but not setting any records. In 1996, they were 2.7 percent; in 1992, 3.4 percent. Going back to 1986, productivity gains were 2.6. Indeed, although the last three years have been very strong years for productivity gains, there's no discernible upward trend over a longer period of years.

And productivity growth is fragile, but extremely critical to sustained economic growth, particularly given our changing demographics.

I would like to turn now to some of the alternative tax measures under consideration. I'll examine first across-the-board tax rate cuts like the Grams-Roth-Kasich plan.

Based on earlier analysis that we did at PricewaterhouseCoopers using our model, I would estimate a potential overall revenue offset to this tax cut primarily as a result of three things:

First, willingness of wage-earners and entrepreneurs to forego a portion of their tax-preferred fringe benefits and deferred compensation in favor of currently taxed compensation.

Second, a willingness of workers to work more hours.

And third, a willingness of marginal workers who may not even be counted in the labor force to seek jobs.

A Heritage Foundation paper released today suggests that this kind of tax cut would generate enough feedback revenue to lower the static cost by about 21 percent.

Evaluation of similar proposals using our model produces similar results.

Although there does appear to be a general agreement to set aside a major portion of the Unified Budget surplus to retire the debt in order to help the Social Security trust fund, there does not appear to be a consensus on across-the-board tax cuts at this time. This suggests that targeted tax cuts may be the way Congress decides.

Whenever a list of targeted tax reductions is drawn up, it's very important to rank the potential measures according to how great a salutary impact they are going to have on the economy. It's also important as a selection criteria to consider whether they are going to add complexities to an overly complex tax structure.

This is a point made earnestly by Rebecca Matthias this morning.

Corporate income tax rate reduction would be very high on my list of pro-growth tax cuts and may be the best broad-based general provision with no added complexity. However, a permanent R&D tax credit would top my list of targeted provisions. And this importance has been recognized by nearly a hundred members of the House and 22 members of the Senate; and there may already be more who support legislation to make the credit permanent.

Making the credit permanent obviously does not add complexity because we've had this credit for the past two decades. The main complexity comes from our taking it off and putting it back on again so businesses do not know whether they can rely on it when they make long-term investments.

Almost all of the G-7 countries provide government incentives for private investment in R&D, and these incentives do seem to pay off. Since 1981, when the Unite States credit was first enacted, the U.S. has experienced a 3.8 percent annual rate of increase in real nondefense R&D spending. But both Japan and Canada have beaten that mark.

And both Japan and Germany devote more GDP to R&D than we do in the United States. So we can't sit back and continue to let R&D be exported to other countries. We need to continue to invest in it here.

I want to take a moment to explain the rationale as to why this makes good sense as tax policy, and that rationale goes like this.The benefits from R&D spending are sometimes very short-lived for the innovator, but they're very long-lived for the economy as a whole because subsequent research builds upon prior research carried out by those who may never enjoy the benefits themselves. These so-called spill-over benefits far outweigh the direct benefits to the original innovator.

Consequently, without government intervention, there may be many risky projects that will never get started even though their benefits to society are far greater than their costs.

The credit is designed intentionally to stimulate R&D spending and it does a terrific job. Most researchers conclude for every tax dollar given up for the credit, there is a dollar or more of increased R&D spending.

A PricewaterhouseCoopers study shows that about $41 billion in new R&D spending would be added to the economy over 13 years if we made the credit permanent.

As the baby boom generation reaches retirement age and the work force continues to shrink relative to the retired population, the only way to achieve continued economic growth is through productivity gains. And the R&D credit does just that.

Our studies show that these benefits would occur first because more than half of the gains would not go to the people making the R&D investment. They would go to other sectors.

Second, the rate of return on investment would be extremely high, 31 percent, about twice what you would typically get from plant and equipment investment. And third, all of these benefits come about through productivity gains.

Because of the unusually high return on R & D spending, reflows of revenue are strong. They take a while to really build up to their full peak. They start with 18 percent the first five years. Thirty nine percent gets reflowed in the next five years. And by the 13th year, we showed 81 percent of that year's credit cost being reflowed, so it virtually pays for itself after about ten or 15 years.

In the long run, it can be demonstrated that the R&D credit will pay for itself on a present-value basis. For every dollar the government puts into the credit, it gets about two dollars back.

In conclusion, Mr. Chairman, just to take one moment longer, we've reached a unique period in our history. At no time in memory, have we had a budget surplus ready to be returned to taxpayers responsible for creating it, and, at the same time, had such a strong economy that perhaps a broad-based tax cut may not be the required medicine.

These conditions create an unusual opportunity for Congress to enact pro-growth tax measures that may take several years before they mature and pay dividends. Although the economy may not require attention right now, we need to make the investments now that will keep it strong. And this, Mr. Chairman, is right in line with your opening comment that we can't let a strong economy now give us a false sense of confidence.

We need an insurance policy, if you will, that may kick in two, three, or maybe four years from now when the economic engine may begin to slow. And there's no better way to guarantee continued growth than with an R&D tax credit.

Thank you very much.

Senator Mack. Thank you Mr. Wilkins.

[The prepared statement of Mr. Wilkins can be found in the Submissions for the Record.]

Jim, welcome.

STATEMENT OF JAMES C. MILLER III, COUNSELOR, CITIZENS FOR A SOUND ECONOMY AND FORMER DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET

Dr. Miller Thank you, Mr. Chairman. Thank you for holding this hearing and thank you for inviting me to testify.

I want to applaud you on a number of things. But let me single out this publication that you are responsible for having the CEA provide every month—Economic Indicators. It's a very, very good one.

I have submitted a written statement for the record. But I'd like to just summarize it briefly, if I might.

Taxes are very important in terms of their effects on the economy overall. There's a burgeoning research on this issue. And what this research concludes is that at very low levels of government, the economy is shackled because there are no property rights, or no enforcement of those rights. Other infrastructure is lacking.

And so the economy grows as the size of government increases.

But past some point, additional government again shackles, retards the economy. Growth is lowered.

If you look at the figure attached to my testimony, this summarizes the point that I'm making, that economic growth is maximized at some point and then falls.

Now there have been cross-section studies by Professor Gwartney and others. There have been time-series studies by Professor Scully and others. And they conclude that, basically, economic growth is maximized when government accounts for only about 20 percent of total gross national product, instead of the 35, 40, or 45 percent of gross national product that it presently accounts for.

And I think that should give us some pause.

There have been proposals for tax cuts, for reducing the tax burden.

Professor Gale mentioned a few. Dr. Wilkins suggested an investment tax credit.

Let me suggest that it's time for bold colors, not pale pastels. I think you ought to reform the whole Tax Code and lower the tax burden.

And if I might, let me suggest several principles to follow in making such a reform.

First, the Tax Code should be used to raise the money that the government needs—no more, no less.

Second, the Code should minimize collection costs, the sum of collection costs by the Federal sector and the private sector.

Third, the Code should minimize the micro economic distortion costs associated with tax avoidance.

Fourth, the Code should minimize the macro economic growth cost—for example, it should not penalize saving and investment.

Fifth, the Code should be capable of being well-understood by taxpayers.

Sixth, the Code should be considered fair, both horizontally and vertically.

And seventh, the Code should make plain to voters the cost of government.

Now overcoming opposition to a tax cut or tax reform is hard because, in my judgment, the forces antagonistic to the tax cut have captured the language and the perspective.

Both of the previous witnesses are brilliant people. But they have fallen into the trap. They have referred to a tax cut as a cost.

A tax cut may be a cost to government. That's government-centric language. But it's a benefit to taxpayers.

If you adopt the perspective that's included in the Constitution of the United States—we the people grant to the Federal Government limited powers—what's ours is ours and we choose to give up certain resources to the government.

Or as Amity Schlaes says in her new book, The Greedy Hand, we should resist the greedy hand of government.

Now, part of the problem is that people say, well, we don't pay that much in taxes. We have a growing economy and federal taxes amount to only about 20 percent of GDP.

They also say, well, the government's tax take is a lower proportion of the tax take than in other developed countries.

Let me point you to the two tables that I have in my testimony.

The first table points out that the real tax payment per capita from U.S. citizens—and I'm talking about adjusted for inflation—increases almost every year.

And in fact, since 1980 and through 1998, estimated figures, per-capita payment to the Federal Government increased by 177 percent in nominal terms and 48 percent in real terms.

Why should we have to give the government more and more every year? Isn't the Cold War over?

Now I just put a little asterisk here. I think that defense spending has been reduced to dangerous levels. With an economy so healthy, with welfare reform, the need for the safety net, isn't it less?

These are good times. Why do we have to give the government more and more money every year?

Finally, with respect to the OECD, I bet you didn't know this. It surprised me: We Americans give our government more money every year than do the citizens of the other developed countries of the world give theirs.

Of all the OECD countries, with the exception of teeny little Luxembourg, which is very service-oriented, we give more money to our government than all these socialist countries, all these developed socialist countries.

Why?

I think the argument that we are undertaxed is plain baloney. I think we pay too much in taxes. And reducing taxes, reforming the tax code, would result in a substantial increase in the long-term material well-being of our citizens.

Thank you.

Senator Mack. Thank you.

[The prepared statement of Dr. Miller can be found in the Submissions for the Record.]

Mr. Angell?

STATEMENT OF WAYNE D. ANGELL, CHIEF ECONOMIST AND SENIOR MANAGING DIRECTOR BEAR, STEARNS & COMPANY, INC.

Mr. Angell. I am delighted to have the opportunity to testify before the Joint Economic Committee on the subject of tax policy.

The good news is our extraordinary combination of near-perfect monetary policy and a New Era economy that generates rising profits and a soaring equity market.

The bad news, in my opinion, without an increase in the national savings rate, the growing reliance of the U.S. economy on foreign capital could prove to be a significant problem down the road.

Tax rates play a critical role. The current tax system heavily penalizes saving versus consumption, and it should not come as a surprise that the savings rates in the United States are low.

With low domestic savings rates, the U.S. is forced to rely more heavily on the willingness of foreigners to finance our capital spending.

In effect, high tax rates on saving and low tax rates on consumer spending is a public policy choice that guarantees to lead to a trade deficit and an inflow of capital from abroad.

This inflow obligates the U.S. to future interest dividend and profit payments.

1998 is the first year that we've had a deficit in our income accounts and that deficit is going to be growing from a $5 billion level to a $30 billion level if we do not do something.

As the U.S. increasingly relies upon foreign capital, there would be a tendency for U.S. interest rates to rise relative to those abroad. Such a situation can already be seen.

The yield on 10-year U.S. Government bonds at around 5.4 percent is higher than Germany's 4.1 or Japan's 1.9.

Unfortunately, the tax rate changes of the 1990s did not increase national savings. Increasing marginal tax rates on high income/high saving households simply transferred the savings from the household to the government sector.

Without a huge inflow of foreign saving, interest rates in the U.S. would necessarily rise until the after-tax, after-inflation rate of return on savings motivated more savings or choked off capital spending.

It seems very appropriate that we consider ways to improve our tax system while we are still in the lee of the currency devaluation storm that has sent world savings to our capital market.

I think it's very important for us to account for the recent economic performance of the United States.

First, real government spending, the taking of real resources by our government—state, Federal and local—has declined from 20.7 percent of GDP in 1990 to 17.1 percent in the fourth quarter of 1998.

That reduction in the percentage of real spending has been an enormous contributor to our growth rate.

Second, the impact of higher tax rates and personal incomes has been offset by a much larger reduction in inflation-adjusted rates on capital gains.

The decline in the inflation-adjusted capital gains tax rate has come about from a reduction in the statutory rate from 28 to 20 percent, and even more important, in inflation expectations in recent years from 4 percent to 1 percent.

As a consequence, I estimate that the effective tax rate on real capital gains has fallen from about 56 percent in the early 1990s to around 27 percent today.

This decline in the capital gains tax rate has resulted in a post-war record high of investment to GDP of 12.7 percent last year from an average of 9.2 percent in the early 1990s.

Thus, we're getting a 4 percent growth rate over the last three years. And by the way, that's not as high as we've seen in the past. But that growth rate is dependent upon this increased stimulus from lower capital gains.

But I want to mention very clearly here that sometimes the 1980s are misunderstood.

We had a 13-percent inflation rate as we began the 1980s. The Federal Reserve had to slam on the brakes. The Federal Reserve would never have had confidence to take the inflation rate down so rapidly from 13 percent to 4.5 percent if we had not reduced those personal income tax rates from 70 percent to 31 percent.

It was the Federal Reserve slamming on the brakes that caused the budget position to change.

The Federal Reserve had to do it. Otherwise, we wouldn't have the growth that we have now.

I want to move along further to talk about the current tax system. But in the light of time, I want to mention that we still have some very high tax rates on savings.

The tax rate on dividends passed through corporate income, dividends that pass through households, the rate is 61 percent for the high-income individual. And for the 15 percent tax bracket, it's 44.8 percent.

Capital gains tax rates still are at a 48 percent rate. When you have corporate income tax, stock buy-back, the rate is 48 percent.

Now, moving forward, let me suggest that we need to replace our income tax base system with a national retail sales tax.

I've included for the record my article on the 23 percent solution.

I would point out that by abolishing the payroll tax, a regressive tax, abolishing the personal income tax, abolishing the corporate income tax, and going to national retail sales tax, with a rebate of that tax up to the top poverty line, an income earner of a family of four last year that would have made $16,000, ended up paying last year a tax rate of 7.7 percent.

Under the fair tax proposal, that tax rate would be zero.

A family of four earning $32,000 last year paid a 14-percent rate. If they saved nothing under the fair tax proposal, their tax rate would go down to 11.

We must shift our tax system to place the burden upon those who take from the economy by an appetite for consumer spending and never tax those who produce more, those who save more.

We ought to understand that a four-percent real growth rate can be maintained if we get the savings rate up.

And a 4 percent real growth rate produces 8 percent rises in Federal tax rates. And I think we ought to keep doing the right thing. And that is to make real tax reform.

[The prepared statement of Mr. Angell and an article entitled: *Tax Americana: The 23 Percent Solution* can be found in the Submissions for the Record.]

Senator Mack. I thank you all for your comments.

Mr. Gale, I will say, listening to your comments with respect to the caps, I might make the argument that, frankly, that makes my argument about why we need to do something with respect to returning the overpayment of taxes to the people who paid those taxes.

Because as long as that revenue flows through the hands of the Congress, and I'll include all of us in that—it's not Democrat versus Republican—there is an incredible tendency and pressure to spend that money.

So I understand your point. I know that there are people out there talking about lifting those caps. But that is because there are surpluses today, and that's what's driving it.

If I could address a question to Wayne Angell.

There are those who really put us in a box and say that if you lower tax rates and stimulate the economy further, that's going to create a problem with respect to inflation.

Would you address that?

Mr. Angell. Yes. Thank you, Senator Mack.

Inflation is a monetary phenomena. It has nothing to do with the amount of the government surplus or deficit.

The Federal Reserve has done, as I told Alan Greenspan when I visited him last September, I said, Alan, you really are doing so well. You make it embarrassing to me that you do so well without me.

But the Federal Reserve is committed to stable money. And that stable money, that's what's generated this enormous growth.

So those are two separate questions. If you have sound money, then the Congress decides what to do.

But the benefit of sound money is very, very high tax receipts. And all of us ought to be very grateful for that.

Senator Mack. Now I know that there is a tendency for people to want to talk about tax reform, and I understand that.

But I think that the environment that we find ourselves operating in is one in which there's not going to be tax reform in the next couple of years.

At least I don't see it.

I believe that we're going to have a proposal in the Congress this year that is going to cut taxes. The question is what is the best way to do that?

I think the emphasis ought to be placed on a tax proposal, tax cut proposal that increases growth, that creates more jobs.

And so, what I'd like for particularly Dr. Angell and Dr. Miller—Mr. Wilkins, you were fairly specific. You said that, given the circumstances, you would go for the targeting, thinking that the across-the-board tax cut wouldn't do it.

You mentioned R&D and corporate taxes.

But I'd like to hear from the other two for just a moment about what you think we ought to do given this environment.

Mr. Angell. Well, it seems to me that we have one factor out there that has the potential to derail this New Era economy. And this New Era economy is flying high. And if we derail it, and that potential to derail it comes from the fact that we do not, under our tax system, save enough money.

I believe that if we didn't have an inflow of funds from abroad, we would probably have with the present tax system, we would probably have to have a seven percent funds rate in order to get savings higher and capital spending lower, so as not to rely upon the rest of the world.

Senator Mack. I understand that point. But what would you do to increase the saving rate, is what I'm getting at?

Mr. Angell. What I'd do, first of all, is I would look at the highest marginal tax rates out there. And the highest one out there is the 61 percent tax rate on the pass-through of corporate income to a household through dividends.

That's the highest one out there. So you've got to take that one down.

I would say the next highest one is the effective capital gains tax rate. That tax rate comes about with a 35-percent corporate income tax. You've got 65 cents left. You've had to take the capital gains tax rate to ten percent in order to be the same as the pass-through of interest.

And that would mean then we'd have a much less risky economy.

So those items, in my mind, have to come first.

Senator Mack. Jim?

Dr. Miller Well, following on the point that you made, there is a danger that any surplus will be spent. And that translates into larger government. For the reasons I suggested, we want smaller government, not larger government.

I think the algorithm ought to be, any time you get a chance to cut a tax, cut it.

Now, in terms of a package, if I'm not able to reform according to the principles I outlined, I would suggest, number one, there are two freebies.

The evidence is pretty clear that certainly in the long run, a cut to zero in the tax on capital gains and a cut to zero on the tax on inheritance would generate more revenue than is lost in static modeling.

Those are freebies. Those are what economists call Pareto moves, which means that it helps everybody. It doesn't hurt anybody. And you ought to do that.

Secondly, I think Dr. Angell's point about cutting marginal tax rates is a good one.

So in addition to those two changes—I would propose some across-the-board cuts, which would be perceived to be somewhat more equitable.

Let me just mention something that I have in my testimony. And that has to do with the perspective that present tax rates are fair.

I don't think they are fair. When you do have an across-the-board tax cut, some say the so-called rich do get the major benefits. But they pay the majority of taxes.

The top one percent of income tax filers pay a third of total income taxes. The top ten percent pay two-thirds of total income taxes.

And so, I don't think you should be reluctant to have an across-the-board tax cut, even if the returns benefit the so-called rich.

It's like Willy Sutton. Why did he rob banks? He robbed banks because that's where the money is.

Well, what we've done is we've taxed the rich because that's where the money is.

Senator Mack. Congressman Stark?

Representative Stark. I know it's hard just to agree with the whole panel.

Dr. Gale warns us, and I am sure, that this surplus is elusive at best. I would like to take a piece of each from you. I know Jim Miller recalls that it was his former boss who suggested just what Dr. Angell is suggesting to us today. We had it in Jim Baker's first proposal before the Ways and Means Committee, which included corporate integration. This proposal would have done away with the corporate income tax. As a matter of fact, it would have done away with the deductibility of interest, brought interest and equity into parity.

You would only pay the corporate tax if you retained the earnings.

The sales tax that you suggest, Dr. Angell, is attractive. Yet I don't think we'll do away with the whole tax system, as the Chairman suggests. There's one danger and it's a danger that I'm sure Dr. Miller will understand. It is the danger of taking the public out of the loop.

I don't know what kind of a sales tax Kansas has. In California, when I first moved there from Wisconsin—where we had no sales tax—the sales tax was maybe 2 or 3 percent. It's now 8.5 percent. And never once in my 26 years in public service have I had a letter of complaint about it, although it would be misdirected. I suspect the same thing is true of my state legislators. And I think you would do the same. Unless one puts in some kind of feedback mechanism, politicians will ratchet up that little sales tax a quarter of a point here and a quarter of a point there. This is a very serious problem, and if you can find a solution to it, you can put me at the head of your list to endorse it.

I would accept a consumption tax, but not the value-added tax, because I don't think it would work under our commercial conditions. I would start by taking the revenue and dedicating it to health care. I think the public would support that. Then you could do away with the Medicare tax and probably get us to universal health care. I have no trouble with that. I have no trouble with doing away with the inheritance tax if, once in a lifetime we tax that capital gain. I don't care when it is. But I don't see going from generation to generation to generation, allowing only really well-to-do people to pass on their gains forever. If we get one crack at it, I think that's fair. After a person dies, we could collect capital gains with no step-up basis; That's okay with me. Then we can do away with the inheritance tax. It's not fairly applied, anyway.

I think there are a lot of things that we could do to make it simpler, fairer, and encourage savings. But we can't do it a piece at a time. We can't, Mr. Wilkins, just take the R&D credit. There isn't much there. The credit costs something like two or three billion dollars a year. Expensing accounts for $12 billion of R&D. And yet, the pharmaceutical companies spend four times as much advertising as they do on research.

Now, it's hard for me to say that they need that to improve my quality of life. But, on the other hand, if we did away with the corporate income tax, probably a lot of your clients would complain. Many of them use it despite good economic theory to gain their bottom line. That's not your fault, and it's not their fault. It's probably our fault for creating that morass and putting an incentive to do it.

So there's a lot to gain from lowering rates. But you can't do it without some reform or change. And I think the panel this morning has brought us a lot of excellent ideas and I thank you for them. I want to particularly thank Dr. Gale, before I rush for a vote. The Senate is intent on saving Social Security, as we all are. But there is some question as to whether just giving the trust fund to Wall Street will do that, or whether the very lowest income people will ever have the incentive to save when they are living at the margin. If you look at life insurance, nobody owns enough life insurance, in this country, on average to provide enough savings. Left completely alone, I think the average face value of life insurance in this country is around $8000.

If you could take care of the lower income people -those who don't have that marginal incentive to save, and they just barely have enough money to make a deposit on a house or rent it—then I think you might even get Dr. Gale on your team. But we must protect that fragile group. And it's getting more fragile as we enjoy the success of technology. Jobs for the college educated only account for a small percentage of Americans. Somehow we have got to bring the rest of them along in order to be politically feasible.

We won't be able to get where you want to go if you don't include the people of my district. There aren't two or three people in my entire district who are in that group that you talk about up there in the one or two percent income group. And so, unless I can take something home to those families who earn $30,000 to $40,000 to $60,000 who are working with their hands, I can't join you.

Help us help them and we'll put a package together.

Dr. Miller I think the answer to that in part is that with these tax cuts of the sort I described, the sort that Dr. Angell described, you are giving them higher assurance that they're going to have job opportunities and prospects of progressing.

It may not be that they have a substantial cut in their recorded tax liability. But they will have greater opportunities.

Representative Stark. Excuse me. We have ten minutes left on a vote and I have to head to the floor.

Mr. Wilkins. I just wonder if I could respond to a couple of points you made, Mr. Stark.

One, I haven't asked any of my clients if they want to have a zero corporate tax rate. But we have asked them how much they would like to see the corporate rate go down. And universally, I haven't met one yet that would not like to see a substantial cut and think that that would be great for the economy.

On the R&D credit, it is small amounts. Two billion dollars each year.

The point is, Jim said there's some pareto answers. They're also what I call a no-brainer answer and this falls in that category.

It actually makes money for the country. It doesn't lose any tax money and it helps the economy grow.

And as Chairman Greenspan has stressed in his testimony, if we don't have productivity, we're not going to be where we are today, tomorrow. And that's the one proposal that I see that directly impacts productivity very quickly.

Thank you.

Representative Stark. Package that with a broader version of your income tax credit and we've got a deal.

(Laughter.)

Senator Mack. Wayne, did you want to respond?

Mr. Angell. Yes. I wanted to suggest that we have a low national savings rate.

To increase that national savings rate, if consumers spend less and save more, that would tend to slow the economy's growth.

That's why we need at the same time a stimulus in regard to exporting and a stimulus in regard to taking the cost of government out of our domestic-produced goods.

A Boeing airplane has all the cost of government in it. And an Airbus, that's rebated.

I want a level playing field. And that's what we need to do.

The sales tax is so important because it's the only way to both boost our savings, which slows the economy, at the same time that we stimulate our economy on the net export side by removing the cost of government from exports.

And I just think Americans will be more favorable to free trade if we take this tremendous burden of taxes away from American workers and American corporations.

Senator Mack. Well stated.

Mr. Gale. Can I make one comment, Mr. Chairman.

Senator Mack. Okay.

Mr. Gale. First of all, there are costs to tax cuts despite what has been said earlier. And the costs are imposed onto future generations.

The question isn't whether the revenue the government has belongs to the American people. Of course it belongs to the American people.

The question is which American people? Today's people or tomorrow's people?

If you cut taxes now, that's the same thing as increasing budget deficits. That's the same thing as imposing higher burdens on future generations.

There is no escaping that arithmetic, except possibly for the huge dynamic effects that are purported to occur.

However, that leads me to my second point. We are in an economy that has full employment, low inflation. That is a completely different situation from 1981, where we had high inflation and high unemployment.

That growth that occurred in the 1980s—

Senator Mack. Let me just hop in there for a second.

There are people who have been making that statement for the last three years or so, saying that we are at full employment and low inflation.

Mr. Gale. They may well be correct. It's technically possible for the economy to move beyond full employment. But that's a technicality.

The unemployment rate in 1981 was 10, 11 percent. Now it's about 4 percent.

Inflation was probably double digits at that time. Now it's one percent. We're in a very different situation.

Senator Mack. Three years ago, though, we heard exactly the same argument.

Mr. Gale. Okay. At least let me make the point, all right?

Senator Mack. Okay.

Mr. Gale. The growth that occurred in the 1980s occurred from increases in capacity utilization. It occurred from falls in energy prices. It occurred from lower inflation.

It did not occur from this whole vast discussion of entrepreneurial activity and more investment in venture capital, for the simple reason the saving rate went down after the 1981 tax cuts.

So all these stories about how we were generating more entrepreneurship and soon have to confront the basic fact that there was less saving and less net investment after the 1981 tax cuts than before.

So think about that in the context of the current economy. We already have a high capacity utilization rate. We have a very high employment rate, the highest employment rate in history. We have very low inflation. We don't have the easy ways to increase growth right now.

That's because the economy is going so strong.

The only way we're going to increase growth is by increasing the supply-side. And any reasonable estimate, even using Michael Boskin's 0.4 saving elasticity, which is higher than almost anyone else in the academic literature, will tell you that a 10 percent across-the-board tax cut would raise saving by about two percent.

I don't mean 2 percentage points of GDP. I mean 2 percent.

So if the savings rate were 5 percent, it would go up to 5.1 percent.

That is the supposed great boost in economic growth that we're talking about and, again, this is based on Michael Boskin's estimates, which are generally thought to be too high.

So the best way to raise national saving and with it, economic growth, is to use the surplus to pay down the debt. If you squander the surplus on tax cuts, it's going to be spent on consumer goods. It's not going to be saved. You can't raise consumption and saving at the same time.

It's important if you want to help future generations, if you want to stimulate economic growth.

Alan Greenspan said it himself yesterday. The best way is to pay down the debt, not to squander it on tax cuts.

Senator Mack. Jim, did you want to respond?

Dr. Miller Well, I would just say that I disagree with Dr. Gale. I suspect we won't be able to resolve that in the timeframe that you have.

Senator Mack. That's true.

Dr. Miller But I think his characterization of the early 1980s and the fact that we didn't grow—

Mr. Gale. No. We did grow. But the savings rate did not rise.

That's a fact.

Senator Mack. Dr. Gale, if you will hold, you'll get a chance.

Dr. Miller The savings rate fell, but we also had the question of the phasing in of the tax cuts over years. And secondly, we did have a marked recession that was primarily a hold-over of the Fed's action to restrict the growth of the money supply in a very substantial way that brought the rate of inflation down.

There are lots of complicating factors at work.

I think that Dr. Angell underestimates our potential growth. I think it's more like 5 or 6 percent per year. We've had an extraordinary burst of economic activity, despite the fact that we've had high taxes and burdensome regulations.

Why? In part because of what Dr. Gilder was talking about this morning—the information revolution.

I think we're capable of growing at much faster levels, at very low rates of inflation. And if we do reform the Tax Code, that is going to be a major step towards our achieving the potential growth path, and it's something that our progeny deserves.

On the question of burdening future generations, goodness, if we do it right, our future generations are going to be better off.

Tax cuts today do not necessarily mean increased debt overhang for future generations. You have to do it right.

Mr. Gale. It is an undisputable fact that the personal saving rate, the private saving rate, the national saving rate fell over the course of the 1980s, not just in the early '80s with the onset or the passage of ERTA '81, but as it was phased in, the saving rate fell.

So whatever the effects of the '81 Tax Act, all I'm saying is it did not fuel a supply-side expansion.

It probably fueled a Keynesian expansion.

Remember, the supply-side story is that tax cuts make saving go up, investment goes up, that makes the economy grow.

If you look at the data, net investment did not go up. Personal and private saving did not go up.

Now you might have gotten a huge boost in the economy from the traditional fiscal stimulus of more government spending than revenue. That's a traditional Keynesian story. And you certainly got a huge boost from the increase in consumption, which is also a traditional Keynesian story.

But there was not the supply-side increase in saving and investment that was promised.

That's just a fact.

Senator Mack. Okay. Now we're going to finish it this way.

Wayne, I think you wanted to respond. And then Mr. Wilkins and I are going to get the last word.

(Laughter.)

Mr. Angell. It seems a little strange to me that somehow or other, government spending, government deficit spending in the '80s was an economic stimulus and yet a surplus accounts for a stimulus today?

We're having stimulus today because government budget surpluses actually provide more stimulus through lower interest rates than we would otherwise have.

But that comes about because of a reduction in real government spending as a percentage of GDP.

Savings rates fell whenever you have a tremendous equity market boom that increases the wealth of people.

People save because they want to be wealthier. They want to have more economic power.

Now the fact of the matter is that the Bush and Clinton tax rate increases simply took household savings and it moved it over to government savings. But it did not increase national saving.

Personal household savings rates have fallen more in the '90s than they fell in the '80s.

Senator Mack. Okay. Mr. Wilkins, I want to go back to the R&D tax credit.

It sounds to me like you put that as a very high priority.

I happen to agree with you. I think that the amount of money that we're talking about with R&D—of course, we've been renewing the R&D tax credit year after year after year. It causes uncertainty, I suspect, with a number of your clients.

Just give me a few more thoughts with respect to what kind of priority you place on the R&D tax credit.

Mr. Wilkins. Well, the reason I place so much priority on that is because I think there's a fairly widespread agreement that the only way that we're going to keep economic growth going is through productivity increases.

And as many have warned, the supply of labor is just not going to continue to increase in the future. Baby boomers start retiring. We're going to have a shrinking supply, and that is going to put even more pressure on seeing those productivity increases in the future in order to keep the economic engine going.

The R&D credit is, in my view, probably the most efficient way to achieve some of those productivity increases. And that's because it has such a huge 31 percent return, much higher than normal investments in plant and equipment. And it has the direct impact, therefore, on productivity, and our studies have shown that, as others have, too.

Alan Greenspan has warned last week in his testimony—I can't cite it precisely—but that the labor pool of people out there that are looking for jobs because they're in the labor force or they're willing to take jobs, is just as small as it's ever gotten.

And because that's so small, he says, and I endorse the fact that the whole key to our continued economic growth is going to be productivity increases.

And my point is that it does take a while to develop. They take a while to mature.

So I would make the investment now while the economy is strong so that we will have those in place when we need them in the future, one or two or three years down the line.

Senator Mack. Very good. You had the last word. I appreciate again the participation of all the members of the panel.

Thank you very much.

Dr. Miller Thank you, Mr. Chairman.

Mr. Wilkins. Thank you.

Senator Mack. Hearing adjourned.

(Whereupon, at 12:10 p.m., the hearing was adjourned.)

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF SENATOR CONNIE MACK, CHAIRMAN

Good morning and welcome to the Joint Economic Committee hearing: "Economic Growth Through Tax Cuts: What's the Best Approach?" I want to thank our distinguished panelists for arranging their schedules so they would be able to join us today for a discussion on pro-growth tax policies.

On our first panel, we are joined by Steve Goldsmith, Mayor of Indianapolis, Rebecca Matthias, President and Founder of Mothers Work, Inc; George Gilder, noted expert on future technologies and author of Microcosm and Wealth and Poverty, among others; and Wendell Primus, Director of Income Security at the Center on Budget and Policy Priorities. On our second panel, we will hear form Wayne Angell, Chief Economist at Bear Stearns and former Federal Reserve Board Governor; Jim Miller, Counselor to Citizens for a Sound Economy and former Director of the office of Management and Budget; John Wilkins, a partner at PricewaterhouseCoopers and co-director of their National Economic Consulting practice; and William Gale, Senior Fellow at the Brookings Institute. Welcome and thank you again for coming.

Congress will be looking at a variety of tax cut proposals this year, However, in all the recent debate and discussion, there has been little emphasis placed on a very basic reason tax cuts are important - even in a surplus economy- and that is: tax cuts spur economic growth. That's what I'd like to emphasize during our discussions today. I'd like to have a broad discussion with our panelists about how tax cuts spur economic froth and what kind of tax cuts would be most beneficial in keeping our economy strong.

There are three issues I believe are important to keep in mind while considering pro-growth tax cuts, and I'd like to touch on each one briefly.

1. The economy's strong recent performance should not give us a false sense of security concerning future economic growth.

Some people may say, "When the economy is doing so well, why do we need tax cuts?" My answer is . Look around the globe. Despite the strong economy, including an annual growth rate of 6.1% in the fourth quarter of last year, circumstances can change, The Asian economic crisis, problems in Russia and South America, uncertainty in Europe, and the fact that many countries are now in recession or even in depression, all signal possible difficulties that may adversely affect the US.

Pro-growth tax cuts would provide a powerful insurance policy to prevent these negative forces from causing a slowdown in our economy. Recent history has demonstrated that lower tax rates have resulted in higher economic growth rates. We have a powerful tool at our disposal to utilize before it becomes too late - and that tool is enacting pro-growth tax cuts.

2. We must avoid succumbing to the notion that tax cuts somehow will "overstimulate" the economy and cause inflation

Some make the argument that cutting taxes might "overstimulate" the economy and cause inflation. Recent history disproves this theory. During the last 16 years of nearly continuous economic growth, inflation has fallen to the point where it is almost nonexistent today. The evidence is clear: economic growth does not cause inflation.

3. Tax cuts spur innovation, entrepreneurship, and new technology, keeping our economy strong.

We have entered the era of the Innovation Economy. Today more than ever, the idea is the engine of economic growth.

Let me give you an example: Recently, Intel Corp., the world's number 1 maker of computer chips said it expects E-commerce - online buying on the Internet - to top $1 trillion by 2002. This market did not even exist ten years ago, and already they're projecting $1 trillion in economic exchange! This is a testament both to the power of innovation and our free market system.

We should promote policies that encourage investment in new companies and new ideas by lowering the barriers to investment. Our tax cone punishes savings and investment, which leads to less capital formation and fewer resources for firms, especially unproven start-up companies. High taxes trespass on our freedom - our freedom to work, our freedom to invest, our freedom to support our families.

Tax cuts are not about numbers, they are about people. A tax system that punishes people when they save and invest doesn't just depress economic growth – it dashes the dreams of individual entrepreneurs. We need to ensure that the next generation of entrepreneurs will be able to achieve their American dream.

CITY OF INDIANAPOLIS
STEPHEN GOLDSMITH
MAYOR

TESTIMONY

BEFORE THE JOINT ECONOMICS COMMITTEE

March 4, 1998

Achieving Economic Growth Through

Tax Cuts

THE HONORABLE STEPHEN GOLDSMITH

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Tax Cuts

Joint Economic Committee
Congress of the United States
Thursday, March 4, 1999
Mayor Stephen Goldsmith

I come before you today not as an expert of Federal Taxation, which I am not, but as a Mayor concerned that valuable lessons learned over the last decade, which helped cities succeed are now at risk.

Wealth creation, as contrasted to massive wealth redistribution, and individual and local sufficiency characterized the resurgence of cities. Now with federal taxes consuming almost 22 percent of our gross domestic product, Washington's claim on the American economy is at an all time high and so it seems are the lists of new programs, grants, tax credits and intiatives. When we account for state and local taxes of all sorts, many Americans, not just the wealthy, hand over 40 or 50 percent of their income to the various public treasuries.

Regardless of who gets credit for today's strong economy, it should be clear that in an increasingly competitive world, America cannot enter the 21st century with a federal government that takes more than one out of every five dollars (approaching one out of every four dollars) produced by American workers. We should also refute the widely held belief that surplus taxes paid by American workers and businesses should be hoarded in Washington instead of being returned to those wage-earners and business owners who have been overcharged.

I believe there are several principles we should keep in mind as we discuss various options to reduce the tax burden on Americans and their families.

1. Individuals Know Best

Most people, most of the time, will make the decisions that is best for them: Trust people, not government, to make the best decisions for themselves. The budget surplus leads to a proliferation of well intended programs that centralize decisions about what is good for people in the hands of Washington bureaucrats. Under this approach Washington taxes our citizens, more than it should, than sets up programs to resolve the problems it thinks afflict citizens. Worse, this approach of dozens of small grants and innumerable highly targeted tax credits undermines individual responsibility and reduces the choices citizens, especially poorer ones, have over their own lives.

Higher than necessary tax rates assume an arrogance, that government can spend a families money better than the family can itself. The only way to make government efficient is to limit its consumption of others money.

2. Federalism

Federalism is at the core of our constitutional republic, and it is the principle I will spend the most time on because it is the area in which I believe I have the most expertise. Simply stated, federalism is the philosophy that government and civic activities should be carried out at the most local level possible. Above all, we want individuals to have the freedom to make choices; from there, families should have the opportunity to solve problems and pursue dreams; then onto neighborhoods, cities, counties, states, and so on.

Federalism works because it keeps decision-making close to real people. It requires leaders in government and civic institutions to be accountable to the citizens. It allows for and, indeed, fosters creativity, flexibility, experimentation and cooperation on public policy issues.

Although we usually talk about devolution with regard to welfare reform or other social programs, the principles of federalism hold especially true for taxation. What could be more emblematic of the federalist philosophy than allowing individuals to spend hard-earned wages the way they see fit and letting communities allocate precious local resources. Although we abandoned some of our federalist principles during this century, the 1980s and 1990s have brought a return to federalism in some areas of government responsibility. Today's tax code, however, does not reflect our federalist roots.

The federal tax code which consumes one-fifth of the nation's economy encourages Washington to develop programs and bureaucracies to creatively justify its high tax rates. Witness this week's news from the Department of Agriculture. USDA representatives are concerned that the number of Americans receiving food stamps has fallen from 28 million to just 19 million. Instead of celebrating the measurable increase in reliance on local, private charities, the federal agency has commissioned a study to figure out how to regain old food stamp customers. Federal welfare funds are also now piling up in state accounts because the states simply aren't using the money.

Instead of taxing Americans just enough to provide for critical public goods like national defense, the federal government takes much more than it needs from everyday workers and businesses, and then finds creative ways to spend all the extra money. This approach, by definition, usurps authority from states and localities both in matters of taxation and general welfare policy. But most of all, the current tax code says to working Americans that Washington knows how to spend their wages and salaries better than they do.

Because the United States is such a diverse and dynamic country, it is impossible for centralized lawmaking bodies and bureaucracies to micromanage the affairs of individuals and communities. High federal individual income and payroll taxes betray what certainly will be a 21st century where technology and many other factors will lead to an increasingly decentralized government and society. If we don't make substantial changes, we will end up with a federalist society but a highly centralized tax system, requiring Americans to send great portions of their wealth to Washington even as more and more civic activities are performed outside of Washington.

Federalism in taxation is also important because of the competition it fosters among localities to enact policies friendly to job and wealth creation. As any governor or mayor will tell you, tax rates matter to businesses and residents. Just look at the number of businesses who in the 1970s and 1980s fled New York to New Jersey or Connecticut because of New York's onerous tax policies. In the 1990s, New York has reduced several taxes and has seen immediate results. Mayor Guiliani cut the hotel tax and New York enjoyed a resurgence of convention bookings, and revenues from that tax surged, even though the rate was lowered. We cut property taxes in order to stimulate more inner-city investment.

These are a few small examples of how policy competition encourages lower tax rates, and, therefore, economic growth.

Unfortunately, federal taxation in the United States has overwhelmed many of the positive effects of competition among cities and states.

3. Incentives

As we can see from several of the examples I mentioned when talking about federalism, incentives are extremely important. People and businesses are rational when it comes to their economic behavior.

When making decisions about where to live or where to establish a business, individuals and firms clearly take into account the government policies of the jurisdictions in question. For families, taxes and schools are probably the two most important factors. For businesses, it's mainly taxes and regulations.

For many years, cities failed to realize the power of incentives when crafting public policy. High tax rates and heavy regulation drove residents and businesses and investment outside the cities' city-limits.

That's one problem with centralizing so much of our taxation: It is much easier for families and businesses to move across the county line than it is for them to move to another country.

4. Simplicity

One of the things I've learned as a mayor is that nothing Washington does is simple. It seems that every day, I receive a dozen or so notices for new federal programs, grants, or tax credits. We have to hire consultants who spend hours and hours trying to figure out how to match our city's problems to Washington's definitions. And just as every other city across the country does, we then must lobby the federal government for favorable treatment when the grants or projects are allocated. All of this for programs whose efficacy is in great question much of the time.

Similarly, today's federal tax code exudes complexity and a Washington-knows-best attitude.

5. Fairness

Conservatives are, and should be, concerned about how taxation affects low-income Americans. Reducing income tax rates and taxes on capital formation are important to low-income Americans, even though these taxes may not *directly* affect their pocketbooks *today*. Economic growth and job creation clearly benefit those at all income levels. We can't forget, however, about the most onerous direct tax on low-income Americans, the payroll tax. Unlike the income tax, every American worker, with few exceptions, pays the 15.3 percent payroll tax (12.4 percent of which is for Social Security). Millions of Americans pay more in payroll taxes than in individual income taxes.

One positive factor in evaluating the efficacy of the payroll tax it that it is much easier for us to measure the real benefits individuals receive in return for their payroll tax dollars than it is to measure what people get in return for other tax payments.

And it has become clear to policy-makers and average taxpayers alike that the payroll tax doesn't make much sense. The high payroll tax rate makes it almost impossible for low-income workers to save and invest on their own. After paying for food, shelter, clothing, and taxes, there usually isn't much left. The rate of return beneficiaries earn upon retirement is dramatically lower than what long-term investment strategies could produce if workers were allowed to invest in private debt and equities. This is especially so for low-income Americans and minority Americans who tend to have shorter than average life spans, many of whom never recoup the money they paid to the federal Treasury over a lifetime of work. A tax reduction plan should address the regressivity of the payroll tax whether by facilitating individual asset ownership, or reducing the tax itself.

Conclusion

Tax credits continue the counterproductive of centralizing power in Washington.

Considering today's high tax burden, I would conclude that the economy has performed well in spite of our current tax code, not because of it. There is much room for improvement.

Rebecca Matthias
President, Mothers Work, Inc.

Economic Growth Through Tax Cuts
Joint Economic Committee
Congress of the United States

Length: 1300 words

I appreciate the opportunity to be here and express my opinions on economic growth through tax cuts and I applaud your initiatives in this area. I believe that my varied experiences ranging from starting a company and growing it, to ultimately taking it public and running a mid-size corporation, touch on the issues facing thousands of your constituents. The difficulties that I encountered, specifically relating to taxes, are suffered by small and mid-size companies everywhere.

I started Mothers Work 17 years ago out of my front closet as a mail order catalog selling career maternity clothes. Today, a public company with $300 million in revenue and 4,000 employees, Mothers Work operates 600 maternity stores around the country. We are vertically integrated, manufacturing substantially all of the merchandise that we sell in our stores, and we are one of the few apparel companies still making a substantial amount of product in the United States. The first three years of my business were financed entirely by my savings, and later I obtained venture capital financing and bank loans to expand. Ultimately I took the company public in 1993.

Excessive taxes stifle business

Small business fuels our economy. The American dream of company ownership is very much alive and it is the heart and soul of our country. Although many factors affect the success or failure of a new business, few are as challenging as excessive and complicated taxes. The tax related impediments to business formation and growth that I have experienced fall into three major categories: taxes on profits, taxes on payroll, and taxes on capital gains. I would like to address all three.

Before I speak to the taxes themselves, I would like to say that the complexity of the myriad of taxes facing an entrepreneur may be an even bigger hurdle than the taxes themselves. New business owners do not have the resources to analyze the tax code and take advantage of yet another targeted tax incentive or program. Please don't help us with any more special, targeted tax rules. Reduce the number of special rules and decrease tax rates.

Taxes on Profits

Profits in a growing business do not go into the bank. They go into working capital. Therefore, taxing those profits is a huge disincentive for growth when it is already enormously challenging to obtain growth capital. Many small businesses are structured as flow through entities for tax purposes, that is, sub-S corporations or sole proprietorships. For those businesses, personal income tax = business profit tax. The unfortunate result is that many small business owners pay taxes on profits at the higher personal tax rates. For example, profits over $150,000 would be taxed at approximately a 40% marginal tax rate, vs. the 34% for the top corporate rate paid by larger companies. This is unfair, and discriminates against the small business that is structured as a flow through entity.

Tax rates are not the only area of concern. The method and timing involved in the profit calculation can also be punitive to certain growth businesses. For example, service businesses have an inherent tax shelter in that revenue is not taxed until it is collected, while the underlying expense of labor is deducted instantaneously. This type of business effectively measures profit on a cash basis. Contrast this with a manufacturing or consumer goods business that must account on an accrual basis. Those businesses must book revenue when product is shipped out the door, but they collect the cash much later. They are taxed on "phantom" revenue which generates "book" profit, but they have no funds to pay the tax because of the buildup in receivables. Having personally lived through this I know that it becomes imperative to raise new money to pay taxes in this situation. And with access to capital virtually unobtainable for young companies there is often no money to pay the tax collector.

In the case of retailers and other businesses which require large capital improvement expenditures, the tax equation becomes even more onerous due to the depreciation rules. Opening a new store in a mall typically entails $100,000 or more in leasehold improvements. The money is spent up front, but for tax purposes the improvements are depreciated over 39 years, making it virtually a non-deductible expense. Making matters worse, accounting rules for "book" profit require the depreciation of leasehold improvements to be taken over the life of the lease which is likely to be 5 to 10 years. So the potential investor sees the accelerated expense on the financial statements, yielding the most un-flattering picture of the business while the tax collector acknowledges almost no expense at all, thus maximizing the profit tax.

Taxes on Payroll

The general area of payroll taxes, which encompasses everything from Federal income with-holding tax to shared payroll taxes such as the social security tax and the medicare tax, has to be one of the most challenging to small business owners. Again, the complexity of the reporting requirements alone is daunting to every entrepreneur. But the unspoken reality is that there exists a very large cash society which competes for labor, and which has a big advantage to both the employer and employee who are part of it because they don't pay taxes. In the first few years of my business, I wasn't hiring college graduates with professional experience. I was scrambling to find entry level street smart workers who would work for low wages. In order to entice them to become legitimate and "on the payroll", I had to explain to them why, for example, their $320 weekly paycheck would have as much as $50 deducted from it for taxes. Usually, the employer is the one who makes up most of the difference in order to put someone on a legitimate payroll. So in many ways the payroll tax is a hidden tax on small business.

Taxes on Capital Gains

Venture capitalists and "angels" who invest equity in new companies must be encouraged for the sake of the businesses they support. Obviously they must anticipate a large reward to place their bets on untried new companies, otherwise their money will find a home elsewhere. I believe the reduction in capital gains tax would go a long way in increasing the amount of venture money available to small business start-ups. Banks and other traditional sources of lending do not gamble on start-ups.

Taxes, In Summary

Why are we strangling small business? Why not encourage the creativity and entrepreneurial drive that resides in our country? Business creation is only encouraged by a risk reward function that has a significantly large upside potential. And the huge tax burden is one more hurdle thrown in front of the entrepreneur. Women are arguably affected even more than men by excessive taxes since the majority of businesses today are being created by women. The SBA reported that women are starting new firms at twice the rate of all other businesses and own nearly 40 percent of all firms in the U.S. Furthermore, these 8 million firms employ 18.5 million - one in every five U.S. workers - and contribute $2.3 trillion to the economy. Yes, many women have other motivating factors in starting a business besides financial ones. They may want to combine work and family, they may want a more flexible lifestyle, or they may be frustrated by a lack of upward mobility in corporate America. However, financial health is still the underlying requirement of all businesses.

Thank you for allowing me to speak to you today. I believe in the power of free enterprise and I am happy to know that you are addressing the burden that taxation has put onto it.

TESTIMONY OF WENDELL PRIMUS
Director of Income Security, Center on Budget and Policy Priorities
before the Joint Economic Committee
March 4, 1999

Mr. Chairman and Members of the Joint Economic Committee:

I very much appreciate your invitation to testify on the subject of tax cuts. My name is Wendell Primus and I am Director of Income Security at the Center on Budget and Policy Priorities. The Center is a nonpartisan, nonprofit policy organization that conducts research and analysis on a wide range of issues affecting low- and moderate-income families. We are primarily funded by foundations and receive no federal funding.

ONCE-IN-A-GENERATION CHOICE

The projected surpluses present policymakers with a once-in-a-generation choice. You can spend those surpluses by cutting taxes or raising government spending and thus boosting current consumption. Or you can save those surpluses by strengthening Social Security and Medicare, paying down the debt held by the public, and raising national saving, investment and economic growth.

The Administration projects unified budget surpluses of $4.85 trillion over the next 15 years. Under the Administration's plan, $2.87 trillion of these surpluses would be used to reduce the public debt, about $580 billion would be invested in equities and about $1.4 trillion would be spent. The interest savings alone from this proposal (as a percentage of GDP) would more than offset the increase in Social Security costs that will occur under current law over the first half of the next century.

This can best be illustrated in the following way. Over the last 10 years, the combined amount that we have spent on Social Security and net interest costs has averaged 7.7 percent of GDP. If we could eliminate our net interest costs, Social Security costs alone as a percent of GDP (and hence the burden that these expenditures will place on future generations) will not exceed the 7.7 percent level until about 2070 under the actuaries' intermediate assumptions. This proposal also would increase national saving and thus, over time, probably lead to somewhat higher levels of GDP.

In addition, the Administration has proposed setting aside 35 percent of the on-budget surpluses to strengthen Medicare and Social Security over the next 15 years. (The President has proposed crediting the Medicare Hospital Insurance fund with 14 percent of the total surplus (and about a third of the on-budget surplus), which would result in Medicare holding $686 billion of additional Treasury securities and the public debt being paid down by that amount.) In addition, $536 billion over 15 years would be used to create Universal Savings Accounts, which would, to a substantial degree, also raise national saving. To the extent that you do not accept the President's proposal to transfer monies to Medicare or to enact universal savings accounts, that money should be transferred to Social Security and saved, rather than being used for consumption through enactment of a larger tax cut or increase spending.

My generation — those born after World War II — are entering their peak earning years, and we know there will be budgetary pressures as the baby-boom generation retires. The choice you face is whether to give my generation a tax break for the next 10 to 15 years and let some future Congresses raise taxes on my children and grandchildren to meet current Social Security and Medicare commitments. I strongly urge that you save the surplus, including a significant portion of the on-budget surplus, to strengthen Medicare and Social Security.

SAVE SOCIAL SECURITY AND MEDICARE FIRST

Plans to restore long-term Social Security and Medicare solvency may require more resources than are provided by the Social Security surplus itself; some temporary general revenue transfers from the non-Social Security surplus to the Social Security and/or Medicare trust funds may be needed if solvency legislation that can pass is to be fashioned. If the non-Social Security surplus is consumed by tax cuts before legislation restoring Social Security and Medicare solvency is approved, resources that may prove to be needed as part of solvency legislation may disappear. That could make it more difficult to secure an agreement on Social Security and Medicare legislation. (It also could mean that whatever Social Security and Medicare solvency legislation ultimately was enacted it would have to contain larger benefit reductions than might otherwise be the case, because resources that could have been used to bolster the trust funds would be gone.)

The best thing we can do for both our elderly and younger generations is keep the promise we as a society have made under the Social Security and Medicare programs. Lowering interest burdens also is one of the best things we can do for younger generations.

Contrast these suggestions to some of the approaches being considered in Congress. I have serious reservations about approaches that would use on-budget surpluses to provide tax cuts and use a large portion of the Social Security surpluses to establish individual accounts. These plans will not reduce the publicly held debt very much, forcing Americans to pay higher interest bills than under a plan that largely reduces or eliminates the publicly held debt.

For example, the Feldstein approach would *increase* our retirement-income promises to the elderly, since it guarantees all of the elderly's Social Security benefits *plus* a portion of the retirement income they would receive from government-funded individual accounts. Under this plan, government funds would have to be deposited in individual accounts on an ongoing basis, not just for 15 years. Yet federal interest costs would not have been appreciably reduced to help make room for these costs. The fiscal burden on future generations would increase. While we should, to the best of our ability, fund the promises we have made to the baby-boom and succeeding generations, the last thing we should do is to increase those cash retirement promises, particularly to the more affluent elderly, as the Feldstein plan does. To be sure, there is a need to improve benefits for widows, as the President has suggested, but the cost of such improvements should be offset with other Social Security reforms.

SOCIAL SECURITY SURPLUSES SHOULD BE WALLED OFF AND NOT USED FOR TAX CUTS OR SPENDING INCREASES

It is extremely important that all of the Social Security surpluses be walled off in a manner that precludes their being used for tax reductions or spending increases. These surpluses should be used solely for Social Security solvency. In addition, the pay-as-you-go rule should continue to apply until Social Security is solvent for 75 years. After that, the pay-as-you-go rule should be modified so on-budget surpluses that remain after any transfers to Social Security and Medicare are made may be used for spending increases and revenue reductions. This rule should be enforced with both a sequester and a 60-vote point of order.

ON-BUDGET SURPLUSES DISAPPEAR IF DISCRETIONARY CAPS KEEP UP WITH INFLATION

In fiscal year 1998, the federal government as a whole ran its first surplus in decades. CBO expects that without new tax cuts or program expansions, these surpluses will continue and grow over the course of the next ten years. Further, CBO projections indicate that starting in fiscal year 2002-- three fiscal years from now-- the federal government will be running on-budget surpluses (i.e., non- Social Security).. Excluding Social Security, CBO projects a net surplus over the next ten years of $788 billion.

The forecast of this sizable surplus in the non-Social Security budget has led many policymakers to believe there will be substantial amounts of money available to the federal government even after they have enacted a plan to fix Social Security's long-term funding problems. The President and many Members of Congress have put forward proposals to use the part of the surplus not used for Social Security reform to pay for tax cuts or increased spending on programs.

The CBO projections, however, assume that policymakers will keep spending within the discretionary caps.[1] The bill the Senate has just passed on military pay and pensions increases both discretionary spending and entitlement costs. According to CBO, the legislation increases discretionary spending by $40.8 billion over the next 10 years, with the costs rising each year. The costs reach $6.5 billion a year by 2009 and would continue to rise for a number of years after that. This requires Congress and the President to agree to make even deeper cuts in other discretionary programs (possibly including other defense programs). Including entitlements and revenues, the bill's total cost is $55 billion over 10 years. The reality is the discretionary caps will be increased; the only question is when Congress will adjust the caps.

In fact, if discretionary spending is allowed to grow just enough to preserve the same inflation-adjusted amount of resources available to discretionary programs as is available to them this year, not including the emergency spending in fiscal year 1999 — that is, if discretionary spending is allowed to grow just enough to counteract the effects of inflation, without expanding any program — discretionary spending would be $671 billion higher over the next ten years than assumed in the CBO baseline projections. *That would use up $6/1 billion — or 85 percent — of the non-Social Security surplus.*[2]

In addition, by using up part of the surplus that would otherwise pay down some of the federal government's debt, this additional discretionary spending would make federal

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[1] More precisely, the CBO projections assume that discretionary spending will fit within the caps for as long as they are in place. After 2002, when the caps are no longer in place, the projections assume that discretionary spending will grow with inflation.

[2] These figures assume that the funding designated for emergency purposes in fiscal year 1999 is not repeated in subsequent years. If the emergency funding is repeated in subsequent years and if all discretionary spending is allowed to grow by enough to counteract the effects of inflation, discretionary spending over the next ten years would be $752 billion higher than if it fit within the caps. This would use up 96 percent of the surplus.

debt somewhat higher than CBO's projections assume. As a result, the amount of interest on the debt the government would need to pay out each year would also be somewhat higher than CBO assumes. Over the next ten years, the extra spending on interest payments that would occur if discretionary spending were allowed to grow by just enough to counteract the effects of inflation would total $167 billion.

Thus, continuing to provide discretionary programs with merely enough resources to maintain their current levels of service would cost the federal government $838 billion over ten years — $671 billion in discretionary spending and $167 billion in interest payments. *That is more than enough to wipe out the entire $788 billion in non-Social Security surpluses expected over the next ten years.* In other words, if policymakers prove unable to make the tough decisions as to what areas of discretionary spending to cut — even if they don't expand any particular discretionary program — there may be no non-Social Security surplus for other purposes.

You should also bear in mind that government spending as a share of the economy is now at its lowest level in recent decades and would continue to decline under the Clinton budget.

- In 1998, federal expenditures equaled 19.7 percent of the Gross Domestic Product (GDP), the basic measure of the size of the economy. This was a smaller share of GDP than federal spending has constituted at any other time in the past quarter century. Under the Administration's budget, federal spending would decline to 18.5 percent of GDP by 2004, which would be its lowest level since 1966.

- Non-defense discretionary spending now equals 3.4 percent of GDP, tied for the lowest level in any year since 1962. Under the Clinton budget, non-defense discretionary spending would keep pace with inflation, but would fall relative to the size of the economy, edging down to 3.1 percent of GDP by 2004.

It would be prudent to address discretionary program needs (in both defense and non-defense areas), strengthen Medicare and Social Security and reduce our public debt for the next several years and then consider tax cuts.

UNCERTAINTY IN ECONOMIC FORECASTS

In its annual report estimating outlays, revenues and budget surpluses, CBO devotes an entire chapter to a discussion of the uncertainty in these budget projections. Its projections represent CBO's best estimate of the most likely path of the economy and the budget in light of past and current trends and assuming current policies are not changed. CBO states "that considerable uncertainty surrounds these estimates, however, because the U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to predict."

There are many factors which affect these budget estimates: GDP, income, employment, and inflation, to name a few. In addition, there are many other technical factors such as the distribution of income among tax payers, realization of capital gains, and medical technology and its impact on Medicare expenditures.

CBO compared actual surpluses for 1988 to 1998 with the first projection of the surplus 5 years earlier. The average deviation was 13 percent which implies that the projected outlays in 2004 would produce an increase or a decrease in the surplus of about $250 billion.

This again suggests that the prudent path is to wait and see if significant on-budget surpluses materialize before enacting huge tax cuts.

TAX BURDENS AND THE ECONOMY

A growing economy, Federal Reserve policy, and the budget deals of 1990 and 1993 are all contributed to changing the budget deficit as far as the eye can see to budget surpluses as far as we can project. Despite the gloomy forecasts from supply siders when tax rates were increased, there is no evidence that tax revenues, which as a percent of GDP are now at their highest level over the last 35 years, are hindering economic growth. From a macro-economic standpoint, there is little reason to lower taxes, especially at a time where the economy certainly does not need stimulus.

Some who argue for a tax cut would have you believe that tax burdens on the average wage earner are rising. This is simply not true.

- The Congressional Budget Office estimates that a median-income family — a family exactly in the middle of the income distribution — will pay 18.9 percent of its income in federal taxes in 1999. The CBO analysis includes the effect of income taxes, Social Security and other social insurance taxes, excise taxes, and corporate income taxes. The median-income family in the CBO analysis has income of approximately $39,000.

- CBO analyses show that the federal taxes paid by the 20 percent of families in the middle of the income scale equaled 19.5 percent of their income in 1977 and 19.2 percent of their income in 1985. Taxes on the middle 20 percent of families are estimated to equal 18.9 percent of income in 1999, a level lower than in any year for which CBO data are available (These data go back to 1977) with the exception of 1983.

- A Treasury Department analysis shows that a middle-income family of four with two children will pay a smaller percentage of income in federal individual income tax in 1999 than in any year since 1966.

CONCLUSIONS

Any bipartisan solution that would restore solvency to Social Security over the next 75 years and Medicare solvency for at least 25 years is likely to involve increased revenues to the system and benefit reductions. The current payroll tax that finances Social Security and Medicare is a fixed rate for the entire 75 year period. In light of increasing longevity, the increasing percentage of the population that is over age 65, the decreasing amount of total compensation received as cash wages, and rising medical cost, it is unrealistic to expect the amount of payroll tax revenues to finance Social Security and Medicare over this entire period should decline as a percentage of GDP. But that is exactly what occurs under current law — there will be about a 0.9 percentage point decline. That decline would be worth about $78 billion a year in today's dollars. This fact must also be kept in mind as you consider Medicare and Social Security reforms.

Mr. Chairman, with the foregoing discussion in mind, it is important to proceed with the needs of the country at hand-- strengthening Social Security, enhancing Medicare, and lowering the public debt. Congress should proceed with extreme caution before sizable tax cuts are enacted.

Testimony of William G. Gale[1]

Joint Economic Committee
Hearing on "Economic Growth Through Tax Cuts"

March 4, 1999

Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify at this hearing.

My testimony provides perspectives on the emerging federal budget surpluses and examines the case for and against using the surplus for tax cuts versus other goals. My principal conclusions are as follows:

o The federal surplus is a major achievement, but it is only the first step toward long-term fiscal sustainability. The short-term surpluses are an accounting illusion, and the long-term forecast shows a significant fiscal deficit, due primarily to social security and medicare.

o Recent CBO estimates project large surpluses over the next 10 years in both the on- and off-budget portions of the federal budget. Although there is general agreement that the $1.8 trillion in accruing balances in the social security trust funds should be allocated to shoring up social security, there is significant disagreement about how to allocate the other $800 billion in surpluses, with the main candidates being debt reduction, government spending, and tax cuts.

o There is little in the short-term surplus estimates that justifies a tax cut. Over 50 percent of the projected on-budget surpluses are due to accumulations in government pension reserves and the medicare trust fund. These accumulations, like social security, represent resources owed to current workers when they retire, and so should not be spent on tax cuts. Over 75 percent of the on-budget surplus arises from projected cuts in real discretionary spending. These cuts are unlikely and may not be advisable either. The surplus forecasts also assume that almost all of the recent revenue surge will prove permanent, which may prove optimistic.

o The long-term fiscal situation provides even less justification for a tax cut. Over the next several decades, the government is projected to incur large fiscal deficits, not surpluses, due to the rising costs of social security, medicare and medicaid. The long-term fiscal gap is at least 1.5 percent of GDP, even if the entire surplus materializes and is saved over the next 10 years.

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[1]Joseph A. Pechman Fellow, The Brookings Institution. The testimony presented here is based on collaborative work with Alan Auerbach. However, the views expressed are my own and do not necessarily reflect the views of the staff, officers or trustees of The Brookings Institution.

- o The proposed 10 percent across-the-board cut in income tax rates would require using about $200 billion of the social security trust fund to finance general tax cuts, would provide large benefits to high-income households, but meager benefits to middle- and low-income households, and would require an ill-advised waiver of the budget rules.

- o Although aggregate federal revenues are near an all-time high relative to GDP, the evidence shows that families at most points in the income distribution will pay a smaller share of their income in federal taxes in 1999 than in any year since at least the 1970s. The reconciliation of these two facts is that both tax rates and income have risen for high-income households.

- o I conclude that the combination of a short-term surplus, a sound economy, and the lowest tax rates for most households in decades provides a rare confluence of good fortune that should be used to address the nation's pressing long-term fiscal problems related to social security and medicare, rather than being used to finance tax cuts.

In January of this year, the Congressional Budget Office (1999) announced projected federal budget surpluses of almost $2.6 trillion for fiscal years 2000 to 2009. Although budget forecasts have been improving rapidly over the last few years, the most recent forecast is notable for at least two reasons: the magnitude of the estimate surpassed by more than $1 trillion a similar estimate made last August, and, for the first time, the forecast contained a significant surplus in the non-social security portion of the budget.

This forecast, coupled with the release of the president's long-awaited proposals for social security reform, have led to a veritable explosion of ideas about what to do with the surplus. While there is general agreement that the $1.8 trillion in surpluses accruing in the social security trust fund should be preserved for future social security obligations, views differ considerably about how to allocate the $800 billion in "on-budget" surpluses. Broadly speaking, there are three approaches: use the funds for saving, government spending, or tax cuts. The president has proposed a mixed set of uses that weighs heavily toward saving the surplus. He would allocate to the Social Security system that portion of the unified budget surplus that is attributable to it (although making use of an extremely confusing accounting mechanism to do so) and devote some of the remaining surplus to providing resources for Medicare and government-sponsored 401(k)-like saving plans. He also would allocate some of the surplus to increased defense and domestic discretionary spending.

In sharp contrast, leading Congressional Republicans, including House Budget Chair John Kasich (R-OH), Senate Finance Chair William Roth (R-DE), and Senate Budget Chair Pete Domenici (R-NM) weighed early in with proposals to use the entire on-budget surplus to finance 10 percent across-the-board cuts in income tax rates. Senate Majority Leader Trent Lott (R-MS) then announced a campaign of 150 Republican "town meetings" to popularize the idea (Edsall 1999). Shortly after the first meeting, and in the face of mutinies among fellow Republicans, Republican leaders backed down from advocating the across-the-board cuts (Stevenson 1999a, Pianin 1999).

Nevertheless, the prospect of a large-scale tax cut financed by the surplus is hardly a dead issue, for several reasons. First, tax cuts are a perennial topic, and the debate about the surplus is unlikely to disappear anytime soon. Just as the federal deficit dominated fiscal policy discussions in the 1980s and early 1990s, choices concerning how to allocate the emerging budget surpluses will be the centerpiece of tax and spending debates for the next several years. Second, despite the Republican Congressional leaders' abandonment of across-the-board cuts, none of the Republican Presidential candidates have abandoned support for the proposition (Harwood 1999). Although George W. Bush has not advocated such a cut, his chief economic adviser, Larry Lindsey, is a strong proponent of across-the-board cuts (Novak 1999, Lindsey 1999). Finally, many of the issues that arise in financing across-the-board tax cuts also arise in the analysis of targeted tax cuts, which have been proposed on both sides of the aisle.

This paper examines the appropriate use of the projected on-budget surpluses, with a particular emphasis on whether the existence of the surplus justifies large-scale, across-the-board tax cuts. We draw several sets of conclusions:

First, the existence of the short-term surpluses provides little justification for across-the-board tax cuts. The case for tax cuts assumes that it is appropriate to use all of the (on-budget) surpluses for tax cuts and that the forecasted surpluses will actually be available for tax cuts. Both assumptions are questionable. For example, over 50 percent of the projected on-budget surpluses over the next 10 years is due to accumulations in the Medicare trust fund and in government pension reserves. The general agreement that the social security trust fund should not be squandered on new spending or tax cuts has implications for the use of the pension and Medicare trust funds. Like social security, pensions and Medicare balances represent resources owed to current workers when they retire. This implies that, like social security, these trust fund reserves should not be raided to finance tax cuts.

The on-budget surplus also depends critically on the assumption that discretionary spending will fall in nominal terms between 1999 and 2002, and will fall by 2009 by 25 percent of its current value relative to GDP. Under reasonable assumptions about the composition of the decline, domestic discretionary spending would fall to its lowest share of GDP since 1962 and defense to its lowest share since 1940. Such drastic cuts already seem unlikely to occur for political reasons (Stevenson 1999b) and may not be appropriate in any case. But even modest adjustments will cost plenty. Just holding discretionary spending constant in real terms--which would still reduce such spending by more than 20 percent relative to GDP--would cost over $600 billion between 2000 and 2009.

The on-budget surplus also depends on the apparent assumption that at least 85 percent of the recent surge in income tax revenues relative to GDP will prove permanent. This assumption may be too optimistic. Taking into account all of these factors suggests that there will be no surplus left over the next 10 years that would be appropriate to use for tax cuts.

Our second set of conclusions relates to the long-term fiscal situation. The short-term surpluses are a highly misleading indicator of the underlying fiscal position of the federal government. Current surpluses exist only because the government's accounting methods ignore the enormous accruing liabilities of future entitlement benefits. In the long term, when these liabilities begin to mature, the government faces the prospect of sizable deficits as an aging population puts pressure on social security, Medicare, and Medicaid expenditures. The appropriate allocation of the short-term surplus hinges on whether the short-run surpluses outweigh the long-run deficits. Indeed, it is difficult to see how intelligent policy choices can be made at all in these circumstances without an understanding of the longer-run fiscal situation.

Over the next several decades, even if the entire 10-year surplus materializes and is saved (used for debt reduction), the federal government faces a large fiscal deficit. The Congressional Budget Office (1999) estimates that it would require an immediate and permanent increase in taxes or reduction in spending of about 0.6 percent of GDP, or roughly $50 billion in current terms, to maintain the same debt/GDP ratio in 2070 as currently exists. This "fiscal gap" rises to 2.2 percent of GDP if the on-budget surpluses over the next 10 years are returned to households via tax cuts or increases in spending. CBO's estimates, however, understate the long-term problem because the government in 2070 would be running large deficits. Using a methodology developed by Auerbach (1994, 1997), we find that a permanent and immediate tax increase or spending cut of at least 1.5 percent of GDP is required to maintain fiscal balance in the long-run, even if the surpluses are used for debt reduction. Thus, the long-term fiscal situation provides no justification for a large-scale tax cut.

Our third set of conclusions results from direct examination of the proposed 10 percent rate reduction. We show that the tax cut would cost more than 100 percent of the projected on-budget surplus--that is, it would allocate about $200 billion from the social security trust funds for tax cuts. It would also provide very large benefits to the wealthiest households but very small benefits to low- and middle-income households, and would require what we view as an ill-advised waiver of the budget rules.

Finally, we show that recent claims that American taxpayers are laboring under heavier tax burdens than ever are not correct. While it is true that aggregate federal revenues are close to an all-time high relative to GDP, families at most points in the income distribution will have to forfeit a smaller share of their income in federal taxes in 1999 than at any time in the last 20 to 30 years. These two patterns are reconciled by the fact that burdens have risen among high-income households and, more importantly, that the share of aggregate income going to higher-income households facing higher tax rates has risen over time.

We conclude that the combination of a short-term budget surplus, a strong economy, and a tax system that is imposing the lowest rates for most households in more than two decades provides a rare confluence of good fortune that should be used to address the nation's long-term fiscal problems, rather than being squandered on tax cuts financed by the on-budget surplus. Although we do not explicitly analyze the allocation of the off-budget surplus that is accruing in social security trust funds, the same line of reasoning as above suggests that tax cuts financed out of social security trust fund accumulations would be even less appropriate than cuts financed from the on-budget surplus.

Section I evaluates the projected surpluses over the next 10 years. Section II analyzes the long-term fiscal imbalance. Section III examines the effects of a large-scale tax cut. Section IV asks whether Americans are overtaxed and explores trends in aggregate and family tax burdens over time. Section V offers some concluding thoughts.

I. Surpluses over the next 10 years

A. Current projections

Table 1 shows the CBO's January 1999, baseline budget projections. Between 2000 and 2009, the unified budget is expected to accumulate $2.565 trillion in surpluses. The surplus is projected to double relative to GDP, from 1.4 percent in 2000 to 2.8 percent in 2009, and to average about 2.2 percent of GDP.

The off-budget surplus reflects the amount by which social security tax payments and interest earned by the social security trust fund on the Treasury bonds it holds exceeds social security benefit payments and administrative costs[2]. Off-budget surpluses are estimated at $1.777 billion, rising from $127 billion in 2000 to $217 billion by 2009. As a proportion of GDP, the off-budget surplus is relatively constant, rising from 1.5 percent in 2000 to 1.6 percent in later years.

The rest of the budget is projected to run small deficits in 1999 and 2000 and to begin running significant surpluses in 2002. The on-budget surplus gradually rises from about $50 billion in 2002 and 2003 to $164 billion by 2009. As a share of GDP, the on-budget surplus rises from -0.1 percent in 2000 to 1.2 percent in 2009.

If the surplus is maintained, debt held by the public is projected to shrink by two-thirds in nominal terms, and from 41 percent of GDP in 1999 to 8.9 percent in 2009. Relative to GDP, this would be lowest level of public debt since before World War I.

B. Recent Improvements

i. Magnitude

The turnaround in the budget forecasts has been nothing short of astounding. From 1981 to 1995, federal deficits averaged $193 billion per year, or 4.0 percent of GDP. Federal debt held by the public nearly tripled in real terms and nearly doubled relative to GDP. In 1995, the federal deficit stood at $164 billion and deficits stretched "as far as the eye can see."

Since then, the budget forecasts have improved dramatically. For example, Figure 1 shows that, in March 1995, CBO forecasted a deficit of $472 billion for 2005. By

[2]A very small amount of the off-budget surplus represents the operations of the Postal Service. These amounts are included in all of the "off-budget" numbers presented in the paper.

January 1999, the forecast (corrected for policy changes) had changed to a surplus of $259 billion.

The cumulative estimates, shown in Figure 2, demonstrated similar changes. In January 1998, the CBO estimated a 10-year surplus of $660 billion. By July 1998, this was revised to $1.55 trillion, and by January 1999, the figure was revised to $2.565 billion.

In his January 1998, State of the Union address, President Clinton proposed to use the surplus to "save social security first." At that point, the entire 10-year surplus resided in social security; the rest of the budget showed a substantial deficit over the 10-year horizon (Figure 3). It was not until the most recent forecast that there was a projected on-budget surplus. It is the emergence of the on-budget surplus that has energized the debate about how to use the surplus.

ii. Sources

The recent improvements in fiscal position can be attributed to a strong economy, the deficit reduction packages in 1990 and 1993, rising revenues, and a decline in spending as a proportion of GDP. These sources, of course, are interrelated.

The economy Between 1992 and 1998, the economy grew continuously as unemployment, interest rates, and inflation all fell. The improvement in the economy had many sources, including sound monetary policy and some fortuitous events (such as very low energy prices).

Deficit Reduction Packages Some credit should also be given to the deficit reduction packages enacted in 1990 and 1993. George Bush's willingness to abandon a poorly-conceived "no new taxes" pledge in 1990, and Bill Clinton's 1993 tax increases, passed without any Republican support, greatly improved the fiscal status. Each of those budget and tax agreements were projected to reduced deficits by about $500 billion in the first five years after their enactment. The tax acts also raised the top income tax rate from 28 percent to 39.6 percent. Thus, when the income of higher-income households grew dramatically in subsequent years, tax revenues rose because of the higher marginal tax rate on those income gains as well as the increase in income itself.

Spending cutbacks Between 1992 and 1998, spending fell by 2.9 percentage points of GDP, from 22.5 percent to 19.6 percent. Defense spending accounted for much of the decline, falling by 1.7 percent of GDP. In addition, domestic discretionary spending fell by 0.3 percentage points of GDP, entitlements and other mandatory spending fell by 0.5 percentage points, and net interest fell by 0.3 percentage points. An important component of the decline in entitlement spending was lower-than-expected outlays for federal health care, mainly Medicare and Medicaid.

Revenue Growth The 1992-98 period also saw robust revenue growth. Revenues grew by 2.8 percentage points relative to GDP, from 17.7 percent to 20.5 percent. Federal revenue growth outpaced GDP growth in every year from 1994 to 1998. Most of the revenue gain was due to individual income taxes. After averaging 8.0 percent of GDP from 1950 to 1990, income tax revenues rose from 7.7 percent of GDP in 1992 to 9.9 percent in 1998. In 1993-5, income tax revenues grew by an average of over 7 percent per year, while nominal GDP grew by less than 5.5 percent per year. In the next three years, income tax revenues grew by more than 11 percent per year, while nominal GDP grew by about 5 percent annually.

While the 1993 tax package raised revenues relative to GDP in 1994, growth of tax revenues relative to GDP since then has been due to four factors, according to the CBO (1999, pp. 48-9). First, capital gains realizations increased by 150 percent between 1993 and 1997. Most of this increase mirrors the growth in the stock market and occurred before the 1997 tax act reduced capital gains taxes. Taxes on capital gains realizations accounted for nearly a third of the growth of tax liabilities relative to GDP from 1993 to 1997.

Second, taxable components of GDP--including wages, interest, dividends, rent, and proprietors' income--rose relative to GDP. This accounted for about 10 percent or more of the increase. Third, other components of AGI that are not part of GDP also rose. In particular, a rise in retirement income, perhaps due in part to the stock market boom, accounted for about 15 percent of the increase.

Fourth, and most significantly, the effective income tax rate on income other than capital gains rose and accounted for about 40 percent of the increase in revenues relative to GDP growth. But there were no increases in statutory tax rates during this period, and the 1997 tax act actually reduced average tax rates for many taxpayers. Rather, the increase in effective tax rates occurred because, despite the income tax rate hikes on the top 2-3 percent of households in 1990 and 1993, higher-income households had proportional income gains that outpaced other groups.

C. Deconstructing the surplus

i. The underlying economic forecast

One possible concern in any budget projection is the broad economic forecast that underlies the fiscal estimates. On the whole, however, CBO's economic forecasts appear to be mid-range or conservative relative to other forecasts. For example, for 1999 and 2000, CBO forecasts real growth of 2.3 percent and 1.7 percent, respectively. The analogous Blue Chip consensus estimates are 2.4 percent and 2.3 percent, and the Blue

Chip "Low 10" estimates are 1.9 percent and 1.8 percent, respectively.[3]

ii. Projected spending

Federal outlays were 19.6 percent of GDP in 1998, their lowest level relative to GDP since 1974. The budget forecast projects that federal spending will grow by 3.2 percent annually in real terms, but will decline relative to the rest of economy, falling to 17.3 percent of GDP in 2009 (Table 2). In only one year since 1958 has federal spending been a smaller share of GDP.

Components of spending are projected to grow in very different patterns from 1998 to 2009. Net interest payments are estimated to fall by almost two-thirds in nominal terms and from 2.9 percent of GDP to 0.6 percent of GDP. The decline is due to the vastly lower levels of public debt that would occur if the surpluses are maintained.

Social security, Medicare, and Medicaid are projected to grow from 8.1 percent of GDP to 9.6 percent. Although these levels are still manageable, they foreshadow larger increases that will occur when the baby boomers begin to retire en masse.

A key assumption is that discretionary spending will fall from 6.6 percent of GDP to 5.0 percent. The spending caps are assumed to be enforced between 1999 and 2002, and discretionary spending is assumed to stay constant in real terms from 2002 to 2009.

These assumptions may be unrealistic. For example, to comply with the spending caps in the Deficit Control Act, discretionary outlays would have to decline in nominal terms in each of the next three years, from $575 billion in 1999 to $568 billion in 2002. This implies that even if all of the "emergency spending" and IMF funds that were provided last year are discontinued, other discretionary appropriations will have to decline in nominal terms in 2000 by about $13 billion (CBO 1999, p. 64).

Even if the 1999-2002 spending levels comply with the caps, holding discretionary spending constant in real terms from 2002 to 2009 may prove difficult. Table 3 shows trends in the level and composition of discretionary spending between 1980 and 2009. Since 1980, discretionary spending has fallen from 10.2 percent of GDP to 6.6 percent. About half of the decline has occurred in defense, which has fallen from 5 percent to 3.2 percent of GDP. Domestic discretionary spending has fallen by almost as

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[3]The CBO assumes real growth will average 2.3 percent per year from 1998 to 2009. This implies slower future GDP growth than in the last 25 years. The estimate assumes faster annual productivity growth than in the past--1.8 percent in the future, compared to 1.1 percent from 1973-98. Growth of employment, however, is projected to be significantly slower than in the past. The labor force and employment are projected to grow annually by about 1 percent per year, compared to about 1.4 percent between 1973 and 1998.

much, from 4.7 percent to 3.2 percent. International spending fell from 0.5 percent to 0.2 percent. Thus, relative to the size of the economy, discretionary spending has already sustained deep cuts over time.

However, virtually all of the reductions in real discretionary spending relative to GDP that have taken place since 1990 have occurred in defense spending (Table 3), where at least some downsizing was inevitable following the collapse of the Soviet Union. But large additional reductions there may prove difficult. If so, then a major portion of future cuts will have to come from domestic spending.

The implications of the budget's forecasted decline in discretionary spending relative to GDP would be startling. Suppose that all international spending were eliminated, and the rest of the cut were divided equally between domestic and defense spending, so that each was allocated 2.5 percent of GDP in 2009. For domestic spending, this would be the lowest percentage since 1962 (CBO 1999, p. 135). For defense, it would be the lowest percentage since before World War II (OMB 1999, tables 1.2 and 3.1).

Changing the discretionary spending trajectory can have huge effects on future budget outcomes. Table 4 reports the results of various changes in discretionary spending, accounting for the interest costs of the change as well as the change in discretionary outlays.[4] Holding discretionary spending at its current level of GDP would cost $1.4 trillion over the next 10 years. But even more modest changes in the spending trajectory would cut significantly into the surplus. For example, if discretionary spending were held constant in nominal terms from 1999 to 2002 and then held constant in real terms after that, the 10-year surplus would be reduced by $73 billion. If discretionary spending were held constant in real terms from 1999 to 2009, the 10-year on-budget surplus would be reduced by $609 billion. That is, more than three-quarters of the 10-year surplus is based on the assumption that real discretionary spending will fall.

iii. Trust fund accumulations

More than 50 percent of the projected on-budget surpluses are due to accumulations in federal trust funds for pensions and Medicare. Table 5 shows that from 2000 to 2009, these funds are expected to grow by $363 billion and $55 billion, respectively. Together, accumulations in these two trust funds account for 53 percent of the projected 10-year on-budget surplus.

Analysts on all sides recognize that it is inappropriate to use social security trust

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[4]To account for the added net interest costs of reductions in the surplus relative to baseline, we use the 3-month Treasury bill rate (CBO, 1999, p. 18), projected by CBO to be 4.5 percent for calendar years 1999-2009.

funds to finance tax cuts or non-social security spending programs. The reason is that government budget accounting seriously misrepresents the long-term costs of the social security. But social security is only the tip of the iceberg when it comes to misleading government accounting. Like the social security trust fund, government pension reserves and the Medicare trust fund represent funds that are owed to current workers when they retire. Thus, it would be appropriate to save the surpluses generated in the trust funds by using the revenues to reduce the debt, rather than cutting taxes or increasing spending. Indeed, for similar reasons, many states already separate their pension reserves from funds available for tax cuts and other spending.

iv. Will Medicare be allowed to go bankrupt?

Medicare's long-term financial problems are more dire than social security's. CBO projected last summer that the Medicare trust fund would be insolvent by 2012. A reasonable estimate is that the recent improvement in overall budget status pushed the date of insolvency back a few years. Nevertheless, the $800 billion on-budget surplus that is forecast for 2000-9 is predicated on the notion that nothing will be done to address Medicare's problems. Clearly, any diversion of general revenues to Medicare would reduce the amount available for tax cuts.

v. Projected revenues

Federal revenues were 20.5 percent of GDP in 1998, the highest level since 1944, when they were 20.9 percent. They are projected to rise slightly relative to GDP in 1999 and then to decline by about 0.5 percentage points. From 2003-9, revenues are projected to be 20.2 percent, a larger share than in any year from 1945 to 1997. Revenues from corporate income taxes, payroll taxes, and other taxes are each expected to decline by about 0.2 percentage points of GDP (Table 6).

Income tax revenues are forecast to grow at 4.3 percent per year, roughly the same as the 4.4 percent growth of GDP from 1998 to 2009. After the explosive income tax growth of the past five years, the revenue forecast may seem relatively benign. But the forecast may be less conservative than it appears, because it seems to assumes that most of the recent surge of revenue relative to GDP will be permanent.

Estimating the proportion of the revenue surge that is assumed to be permanent is difficult to do in a precise way. In Table 7, we provide some rough measures of this proportion. For example, most of the revenue surge occurred in the individual income tax, which rose from 7.9 percent of GDP in 1994 (after OBRA 1993 had taken effect) to a projected 9.8 percent in 1999, only to fall to 9.6 percent in 2003-7, before rising to 9.7 percent in 2009. Using the estimated low of 9.6 percent of GDP suggests that 85 percent of the rise in income tax revenues relative to GDP from 1994 to 1999 is implicitly assumed to be permanent. Using all federal revenues suggests that 76 percent of the surge is assumed to be permanent in the forecast. The table shows that, depending on the tax measure and year used, the forecast assumes that somewhere between 72 and 95 percent of the revenue surge is assumed to be permanent[5].

Whether this assumption is reasonable depends on whether the sources of the gain are considered likely to continue. As noted above, about one-third of the revenue surge is due to higher capital gains realizations, which are in turn due to the surging stock market in the last few years. If half of the surge in realized capital gains continues in the future (as gains accrued in recent years are gradually realized) and all of the other components of the surge continue to hold, then roughly 83 percent of the revenue surge will prove permanent. However, if less than half of the capital gains surge continues and if any of the remaining two-thirds of the surge proves temporary, the permanent component of the revenue surge could fall well below 80 percent.

Small changes in the proportion that is assumed permanent can have large changes in the 10-year budget estimates. If the implicit assumption overstates the actual share of the revenue surge that is permanent by 10 percentage points, then future revenues would be lower by about 0.2-0.3 percent of GDP. Including the costs of added debt service, this would reduce the surplus by $300-450 billion over the 2000-9 period.

vi. Uncertainty

There are three generic reasons why surplus projections are difficult. First, the surplus is a residual, the difference between revenues and outlays. Roughly speaking, the surpluses over the next 10 years are projected to be about 10 percent of revenues or of outlays. Thus, relatively small changes in the economy, or in revenues or spending relative to the economy, can have large impacts on the surplus.

Second, changes in government's fiscal position at one point tend to build on themselves over time. That is, short-run mis-estimates are typically amplified as the forecast horizon lengthens. For example, an increase in revenues reduces current deficits, but it also reduces interest costs, which reduces future debt and deficits.

Third, the economy is difficult to predict. CBO (1999, p. 85) reports the 10-year growth of real wages, salaries and corporate profits per member of the potential labor force, which is the labor force adjusted for cyclical variations in the economy. This figure was as high as 45 percent in the late 1960s, but then fell to negative 15 percent by 1982, and has since risen to over 10 percent. CBO (1999, p. 82) also reports that, in their

[5]These rough estimates should be qualified by two factors that work in offsetting directions. First, as real incomes grow, revenues should rise relative to GDP in a progressive tax system. Second, capital gains tax rates were cut in the 1997 act, which will likely reduce the long-term level of revenues relative to GDP.

5-year forecasts from 1988 to 1998, the first projection of the surplus in a particular year was off by an average (absolute value) of 13 percent of outlays. Over 10 years, the variability would likely be larger. With projected outlays in 2009 of $2,346 trillion, or 17.3 percent of GDP, 13 percent would be $300 billion, or 2.25 percent of GDP, enough to wipe out most of the surplus in that year.

The range of uncertainty created by these factors is huge relative to the precision of the cumulative surplus estimates. For example, if revenues are mis-estimated by 1 percent, the surplus would be about $270 billion different over 10 years. If revenues were off by 0.5 percentage points of GDP, the surplus would be about $750 billion different.[6] These hypothetical revenue changes, however, are only a tiny fraction of the large changes in real income per labor force member noted above.

In addition to these generic factors, there are a number of identifiable factors that create uncertainty about the surplus projections over the next 10 years. On the revenue side, these include whether the revenue surge will continue, how the stock market will evolve, and the growth in income among high-income households. On the spending side, the evolution of discretionary spending and of medical costs may have large effects on budget outcomes. External sources--for example, the international financial problems that have beset Asian countries and others--also increase uncertainty.

II. The long-term fiscal imbalance

As noted above, short-run budgetary outcomes can provide a highly misleading picture of the government's fiscal status. In this section, we examine long-run projections of the federal government's fiscal status.

A. Methodology

Our analysis relies on the most recent long-term budget forecasts produced by CBO. This forecast begins with the assumptions embodied in CBO's 10-year budget forecast. After the 10-year horizon, assumptions are shown in table 8. Social security and Medicare expenditures are assumed to follow the intermediate projections of the trustees, adjusted for differences between the economic forecasts of CBO and the Social Security Administration. Medicaid is projected using the same basic approach as that used for Medicare, incorporating a key — and perhaps overly optimistic — assumption that the growth rate of aggregate medical spending per enrollee slows gradually to match that of average wages by 2020. These assumptions imply that social security expenditures are projected to rise from about 4 percent of GDP in 1998 to 7 percent by

[6] These estimates include the increased debt service costs due to higher debt, but exclude higher debt service costs due to higher interest rates and any other fiscal penalty relating to the size of the economy.

2050. Medicare and Medicaid are projected to rise from about 3 percent of GDP in 1998 to 9 percent in 2050.

Discretionary spending, federal consumption of goods and services, and all other government programs, with the exception of net interest, are assumed to grow with GDP. Net interest falls and actually turns negative, as debt held by the public is projected to fall below zero by 2012. Twenty years later, though, debt is projected to become positive and grow rapidly thereafter. Tax revenues are a constant share of GDP, except for supplementary medical insurance premiums collected for Medicare, which grow relative to GDP.

These assumptions, as shown in table 8, result in government non-interest expenditures rising steadily from about 17 percent of GDP in 1998, to 19 percent in 2010, 21 percent in 2020, and 23 percent in 2030. During this period, net interest expenses are projected to fall and eventually turn negative, as the debt is paid down. Starting around 2030, however, the pressure created by the higher level of government non-interest expenditures is projected to create deficits that become larger over time.

Using these assumptions, we update calculations based on a methodology developed in Auerbach (1994) and applied there and in Auerbach (1997). The technique solves for the "fiscal gap"--the size of the permanent increase in taxes or reductions in non-interest expenditures (as a constant share of GDP) that would be required to satisfy the constraint that the current national debt equal the present value of future primary surpluses. The primary surplus is revenues minus all expenditures other than net interest. The same result would follow from assuming that the debt/GDP ratio eventually returns to its current level.

CBO undertakes a similar calculation by measuring the size of the immediate and permanent revenue increase or spending cut that would be necessary to result in a debt-to-GDP ratio in 2070 equal to today's ratio. The cutoff at 2070 is arbitrary, however. Our estimates using a longer horizon will be larger than CBO's since, as shown in table 8, the budget is projected to be substantially in deficit during the years approaching 2070 (and those that follow). That is, the picture between now and 2070 understates the magnitude of the long-term problem.

B. Estimates

Table 9 reports various estimates of long-run fiscal gaps. Under the current budget projections, CBO estimates the fiscal gap is 0.6 percent of GDP. This compares to an estimate of 1.2 percent last August. The improvement is attributable primarily to two changes in long-term projections. First, the long-run GDP share of personal income taxes as a share of GDP has been adjusted upward, from 8.4 percent to 9.1 percent. Second, the growth rate of Medicare has been adjusted downward, leading to a reduction in the share of GDP absorbed by Medicare that rises over time, reaching .43 percent of GDP by 2030 and .80 percent of GDP by 2070. The long-term improvements mirror the short-term improvements in the forecast, indicating that the short-term improvements are, essentially, being assumed to be permanent.

Our estimate using the 2070 cutoff is a fiscal gap of 0.39 percent of GDP which is slightly lower than CBO's estimate. Using the permanent horizon, the estimate is 1.53 percent, assuming that social security and Medicare maintain their 2070 shares of GDP in subsequent years. Even this estimate is likely to understate the magnitude of the problem, because the same forces driving social security, Medicare, and Medicaid spending to rise as a share of GDP until 2070 will be present thereafter. Thus, the assumption of constant GDP shares is almost certainly too optimistic. For example, the 1998 Social Security Trustees' Report projects that the gap between OASDI benefits and payroll taxes will grow from 2.20 percent of GDP in 2070 to 2.26 percent GDP in 2075, the last year for which these projections are available.

It bears emphasis that all of these figures, and the underlying projections in table 8, presume that (a) current surpluses are used for debt reduction rather than on spending programs or tax cuts, and (b) the discretionary spending targets in the 10-year forecast are met.

Spending the on-budget surplus on tax cuts over the next 10 years would have severe effects on the long-term fiscal imbalance. CBO estimates that tax cuts would raise the fiscal gap to 2.2 percent.

Allowing all spending <u>except</u> Medicare, Medicaid, social security and net interest (essentially all discretionary spending) to remain constant as a share of GDP from 1999 on, rather than falling from 1999 to 2009 as projected in the budget forecast, would also have a large effect on the long-term fiscal imbalance. We forecast that the long-term fiscal gap through 2070 would rise from .39 percent of GDP to 2.12 percent of GDP, while the long-term gap would rise from 1.53 percent of GDP to 3.41 percent of GDP.

If the social security gap, as estimated in the most recent Trustees' Report, were somehow magically eliminated -- if revenue increases or benefit cuts were permanently put in place that closed the gap that Report identified -- the permanent fiscal gap would fall to .69 percent of GDP. That is, fixing social security would solve just over half the long-run problem. Indeed, fixing social security in this manner would *more* than take care of the gap through 2070, leaving that gap at -.45 percent of GDP. But, in a sense, these estimates overstate the extent to which social security imbalances are the source of the long-term fiscal imbalance. If social security were fixed <u>and</u> discretionary spending held constant as a share of GDP starting in 1999, the long-term budget gap would fall from 3.41 percent of GDP to 2.57 percent of GDP. Thus, "fixing" social security closes about one-fourth of the long-term gap associated with current policies, <u>before</u> account is taken of projected cuts in discretionary spending relative to GDP. The remaining gap is primarily attributable to the projected growth in Medicare and Medicaid. Over the period until 2070, the corresponding gap would fall from 2.12 percent of GDP to 1.28 percent of GDP, representing a reduction of about 40 percent of the fiscal gap.

Delaying the necessary adjustments will only make the situation worse. If the surplus is saved, but no adjustment is made until 2014, the permanent fiscal gap would be 1.89 percent, and the gap through 2070 would be 1.02 percent of GDP. Finally, the situation will be worse still if delay is coupled with a short-run tax cut. Assuming that the 10% income tax cut is adopted for fiscal years 2000-2009 and that no subsequent fiscal action is taken until 2010, the permanent gap in that year (needed to reverse the tax cut and close the remaining gap) would be 2.54 percent of GDP. That is, enacting the proposed tax cut and waiting ten years to act again would raise the long-run gap by about 1 percent of GDP. For the 2070 horizon, the gap would rise from 0.39 to 1.68 percent of GDP, a larger increase because the shorter horizon allows fewer years to recover from delay.

A few cautionary notes about fiscal gaps are warranted. First, fiscal gap estimates are subject to large amounts of uncertainty. Nevertheless, it remains clear that the government faces a long-term financing problem. There is virtually unanimous agreement, for example, that social security and Medicare face long-term deficits.

Second, the estimated fiscal gaps are intended only to indicate the magnitude of the long-term budgetary imbalance. They are not a statement about the expected effects of policy.

Thus, the long-term fiscal situation provides no justification for a large-scale tax cut. The key point is that the emerging federal surpluses do not represent surpluses in an economic sense. Rather, they are largely an artifact of the peculiarities of federal government accounting. Specifically, the government keeps its books on a cash-flow basis. As a result, the official measure of the government deficit is a flawed and somewhat arbitrary measure of the burdens that fiscal policy places on future generations. Even though the government has more money coming in than going out over the next 10 years, this should not be confused with having an economic surplus.

III. Across-the-board tax cuts

Rep. Kasich (R-OH) and others members of Congress have introduced in H.R. 3 a proposal for an across-the-board 10 percent cut in regular income taxes. The tax cut would be effective January 1, 2000. A similar bill has been introduced in the Senate.

A. Revenue Effects

The Joint Committee on Taxation has estimated that the bill would reduce tax revenues by $776 billion over the next 10 years. This is significantly less than 10 percent of income tax revenues over the period, which would be $1,079 billion. The reason why a 10 percent rate cut does not cut revenues by 10 percent is that the reduction only applies to regular income taxes, not to the alternative minimum tax or capital gains. The tax cut will in all likelihood push more people onto the AMT, since it reduces conventional tax liability, but not AMT liabilities.[7]

The tax revenue loss, however, is not the total cost to the government, since reduced revenues in each year would raise the national debt and hence raise net interest payments. In table 10, we calculate the added interest costs and estimate that the total revenue costs over the 10-year period would be about $984 billion[8]. This figure exceeds the total projected 10-year, on-budget surplus by about $200 billion. That is, the proposed 10 percent across-the-board income tax rate cut would implicitly use about $200 billion of revenues from the social security trust fund over the next 10 years.

Figure 4 plots the implied cost of the tax bill and the projected on-budget surpluses on a year-by-year basis through 2009. The figure shows that from 2000 to 2006, the estimated costs of the tax cut exceed the projected on-budget surplus.

B. Distributional effects

Table 11 provides Joint Committee on Taxation estimates of the distributional impact in 2001 of the proposed tax cut. We explore a variety of measures of the distributional impact, all of which suggest that the tax cut would imply disproportionately large benefits to higher-income households. These effects are presumably much less progressive than allowing the surplus to be used to lessen the needed restructuring of Medicare and social security.

i. Distribution of tax burdens and tax cuts by income class

About 70 percent of tax filers are projected to income below $50,000 in 2001 and, under current law, they would be expected to pay about 22 percent of all federal taxes. The top 1.8 percent of taxpayers, with income above $200,000, will pay 25 percent of all federal taxes; the top 15 percent of taxpayers have income above $100,000 and will pay about 60 percent of all federal taxes.

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[7]About 177,000 households are projected to see an increase in tax liabilities due to the 10 percent rate cut because of interactions between the AMT and personal credits (Democratic Staff, Committee on Ways and Means 1999).

[8]The Democratic staff, Committee on Ways and Means (1999) has generated an estimate of $988 billion.

The 10 percent income tax rate cut would provide benefits to the highest income taxpayers in excess of the proportion of federal taxes they pay. The top 1.8 percent would receive 31 percent of the cut, and the top 15 percent would receive two-thirds of the reduction. The bottom 70 percent would receive only 16.6 percent of the tax cut.

ii. Percent changes in tax payments and in after-tax income

The percentage change in federal taxes would also be largest for the highest income groups. Federal taxes would fall by over 6 percent for taxpayers with income over $200,000, by 3-4 percent for households with income between $10,000 and $50,000, and by only 0.5 percent for households with income below $10,000.

Several factors that determine the pattern of tax cuts by income class. First, tax burdens do not fall by anywhere near 10 percent, for the simple reason that income taxes constitute less than half of federal revenues. For the vast majority of households, combined employer and employee payroll taxes are larger than income tax payments. Second, tax burdens fall by a greater percentage for high-income households, because income taxes are a larger share of their total tax burden. According to the CBO (1998), payroll taxes exceed income taxes for 74 percent of all households, including about 80 percent of households in the third and fourth income quintiles, and over 90 percent in the bottom two income quintiles. Third, as shown in the table, about one-third of all taxfilers, including over 90 percent of those with income below $10,000, and 64 percent of those with income between $10,000 and $20,000 would receive no tax cut at all. These taxpayers, although they currently pay no income tax, may well have to pay payroll taxes and excise taxes. Fourth, the proportional cut in income tax liabilities is greater than 10 percent for some low- or middle- income households. For example, consider a household that currently owes $1,000 in taxes before credits, receives a $500 credit, and thus pays $500 in taxes. If rates were cut by 10 percent, the household would owe $900 before credits, or $400 after credits are applied. Thus, the 10 percent income tax rate cut would reduce the household's net tax payment by 20 percent, from $500 to $400.

Because of differences in pre-existing tax levels across income classes, the percentage change in after-tax income can provide additional information. The table shows the uniform result that the higher the income group, the larger is the percentage increase in income after federal taxes.

iii. Tax cut in dollars

Because income levels and tax payments vary extensively across the population, examination of the actual tax cuts received by income class can provide useful information in addition to the percentage changes noted above. The top 1.8 percent of taxpayers, those with incomes over $200,000, would receive an average tax cut of $9,221. For the 6.1 percent of households with income between $100,000 and $200,000, the tax cut would average $1,855. In contrast, for the bottom 70 percent of taxpayers, with income below $50,000, the average tax cut would be $128. The bottom 50 percent of households would receive almost nothing. The 33 percent of households with income between $10,000 and $30,000 would receive an average of $77 per year. For the 15 percent of households with income below $10,000, the average tax cut is $1.

C. Economic Impact

Tax cut advocates claim that an across-the-board tax cuts would have beneficial economic effects by boosting consumption spending, personal saving and labor supply. These effects may not be that large, however, and may not be desirable, either. For example, with the economy running at full employment, low inflation, and low unemployment, the traditional rationale for a government-induced increase in personal consumption spending is lacking.

Moreover, the effects on saving and labor supply are likely to be small, since both the change in the after-tax return to those activities, and the underlying behavioral elasticities are small. For example, a household that pays 15 percent on the margin in federal income taxes plus 15.3 percent in combined employee and employer payroll taxes faces an effective marginal rate of about 28.2 percent (=.303/1.0765). Cutting the income tax rate by 10 percent would reduce the effective marginal tax rate to 27.7 percent (= (.303-.025)/1.0765). This would raise the after-tax return to saving or working by about 1.94 percent (=(1-.277)/(1.282) -1). With a saving elasticity of 0.4, which could well be too high, this would imply an increase in personal saving of less than 1 percent. Estimated labor supply elasticities for men, who account for the vast majority of hours of labor supplied in the U.S. economy, are typically close to zero. For married women, an elasticity closer to 1 is more reasonable, but even an elasticity this high would imply only a 2 percent increase in labor supply.

For a taxpayer in the 28 percent income tax bracket, the estimated increase in after-tax returns to saving and labor supply is about 4.3 percent. Again, the implied effect on saving and labor supply is small. For taxpayers in the 39.6 percent bracket, who presumably do not face payroll taxes at the margin, the increase is 6.5 percent. Even this increase in the after-tax rate of return, coupled with a 0.4 saving elasticity, would generate only a 3 percent increase in saving. Thus, for example, if the overall personal saving rate were 5 percent and it were all due to the less than 1 percent of taxpayers in the top bracket, the tax cut would generate an increase in personal saving to 5.15 percent. An increase this large would have a tiny impact on growth, but the actual increase would likely be much less, since not all saving is done by the top 0.5 percent of taxpayers and since the personal saving rate is currently less than 5 percent.

Another problem is that, since cutting the surplus has the same economic impact as raising a deficit, large-scale tax cuts could reduce financial markets' confidence that budgetary discipline is being maintained, which in turn would raise interest rates. This would increase the impact of the cut on saving via higher rates, but the higher rates would indicate reduced investor confidence in the future, which can hardly be considered to be a positive economic feedback, and which would likely result in reduced investment and economic growth.

D. Tax cuts and the budget rules

Large-scale tax cuts would require a waiver of the budget rules, which currently require that tax cuts be offset by other tax increases or mandatory spending cuts. Though imperfect, and sometimes avoided, the budget rules have helped to constrain spending and especially to minimize fiscally irresponsible tax cuts. The budget rules were put in place in 1990 in part to avoid tax reductions that increased future deficits. But reducing the surplus has exactly the same economic effects as raising the deficit--lower national saving, higher government debt and interest costs, and increased financial burdens placed on future generations--so there is little justification for removing the rules, especially when the "surplus" is an artifact of arcane and internally inconsistent accounting procedures.[9]

IV. Are Americans Overtaxed?

It is often claimed that Americans are overtaxed and therefore deserve a tax break. Note that this claim is not particularly related to whether a surplus exists. Moreover, the assertion is subjective to a large extent. One's views on whether Americans are overtaxed depend in part on how one values government spending. Nevertheless, there are some relevant facts to consider.

A. Aggregate Tax Revenues

I. Historical Comparisons

From 1950 to 1995, federal revenues fluctuated between 17 percent and 19 percent of GDP (Figure 5). There was a general decline in the importance of the corporate income tax and excise taxes with a commensurate increase in payroll taxes. Individual income taxes averaged 8.25 percent of GDP, and ranged from 7.6 percent to 9.4 percent.

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[9]There is some discussion that a way may be found around the budget rules without explicitly repealing them, such as the emergency spending that was done last year. It should be clear that these procedures violate the spending caps de facto even if not de jure.

Starting in recent years, though, overall tax revenues and income tax revenues have increased. Total revenues were 17.7 percent of GDP in 1992, rising to 20.5 percent of GDP in 1998. Other than one year during World War II, federal taxes claim a higher share of GDP today than any time in U.S. history.

The rising share of taxes in the economy is the natural result of the tax increases in 1990 and 1993, the long economic expansion of the 1990s, the rise in capital gains realizations, rapid income growth among high-income households, and other factors, as noted above.

ii. Cross-country Comparisons

Relative to other countries, U.S. tax burdens are fairly low. Of the 29 OECD countries in 1996, the United States had the 25th lowest ratio of taxes to GDP. Japan's ratio was 0.1 percentage point of GDP lower than the U.S. ratio, and only Mexico, Turkey, and Korea had lower ratios (OECD 1998).

B. Tax burdens for typical households

Perhaps surprisingly, however, the increase in the tax share of GDP is not associated with rising tax burdens for most families. There are many measures of how large the tax burden is for typical families. They vary according to the year, the taxes included, assumptions about who bears the burden of particular taxes, the components of income included, and the income level examined. By and large, however, the estimates suggest that most families at fixed points in the income distribution have been paying less in federal taxes over time.

i. Treasury estimates

Using a long-standing methodology, the Department of the Treasury (1998) estimates income and payroll tax burdens for families of four with all income from wages, and with income at different points of the distribution of income for families of four (Table 12 and Figures 6 and 7). For four-person families with the median income of $55,000 for four-person families, the income tax burden in 1999 is projected to be 7.5 percent, the lowest level since 1966. For families with half-median income, the 1999 income tax burden is projected to be -1.2 percent. This is the lowest level since 1955, when the estimates begin. These figures show that median and low-income households are decidedly not paying more in income taxes. Much of these reductions are due to the child credits passed in 1997, but even without those credits, average income tax burdens are well below their peaks in the 1980s.

For families with double the median income, the income tax burden in 1999 is projected to be 14.1 percent of income, the lowest income tax burden since 1972. This family, however, would be firmly ensconced in the top 10 percent of the income distribution. Thus, for families in a very broad range of the income distribution, federal income taxes are lower in 1999 than in the last 20-30 years or more.

The last three columns of Table 11 show the combined burden of federal income and employer and employee payroll (social security and Medicare) taxes. These rates are higher, of course, since they include payroll taxes. However, despite the secular rise in payroll taxes, these rates are remarkably low compared to their historical counterparts. For median income families, the 1999 tax rate will be lower than any since 1978, while for half-median income families, the 1999 tax rate will be lower than any since 1968. For families with double the median income, the 1999 tax rate is the lowest since 1990 and is approximately the same as it has been since 1980.[10]

One caveat for the Treasury estimates is that, in the data for 1997-9, the income levels associated with each typical family are adjusted only for inflation. Real income growth is assumed to be zero. This implies that the 1999 tax burdens are understated, since real income growth has in fact been positive. Nevertheless, other estimates of tax burdens give results and time patterns very similar to Treasury's.

ii. Congressional Budget Office estimates

Estimates by the Congressional Budget Office (reported in CBO 1998 and Committee on Ways and Means 1991, 1993) of total effective federal taxes as a percentage of adjusted family income are presented in Table 13 and Figures 8 and 9. Tax rates for the bottom three quintiles will be lower in 1999 than in any measured year in the table, dating back to 1977. Average tax rates in the fourth quintile have held fairly constant over the last twenty years.

Only in the top quintile has there been an increase in federal tax burdens. That increase is concentrated among the wealthiest households, and is only an increase when measured from the vantage point of the 1980s. Essentially average tax rates for the top quintile and subgroups in 1999 are very closely to their 1977 values. Moreover, as Table 14 shows, despite the recent increase in tax rates, growth of after-tax income was higher for households in the top income groups than in other households. Table 15 shows that before-tax income grew even faster for the top income groups. In a progressive tax system, average tax burdens should rise as real income rises. Thus, the combination of constant average tax burden for the highest-income households from the 1970s to the 1990s, plus huge increases in real income in these groups, implies that the tax schedule

[10]These estimates include employer and employee payroll taxes in the numerator but do not include the employer portion of payroll taxes in income in the denominator. Adding employer payroll taxes to the denominator reduces the tax rate but does not affect the trends. The characterization of current versus earlier tax rates remains almost exactly as noted in the text.

facing these households has been reduced significantly over time.

Thus, the CBO data provide a clear reconciliation of the seemingly contradictory trends that most families are paying less in taxes, but aggregate tax burdens are rising. The reconciliation is that average tax rates grew for the top income groups and their income grew much faster than the rest of the population as well.

Note also that the CBO may overstate the degree of tax burden increase among high-income households. This is because the adjusted family income measure is based on cash income, and hence realized capital gains. In the past few years, accrued gains have far exceeded realized gains (Gale and Sabelhaus 1999), so that a broader measure of income that included accrued gains and excluded realizations would presumably show even higher income growth at the top end, and therefore a smaller increase in the average tax rate.

iii. Joint Committee on Taxation estimates

Table 16 shows estimates of federal tax burdens by income class generated by the Joint Committee on Taxation, for 2001. The overall average federal tax burden is just over 22 percent, and for households in the 50th to 60th percentile, the burden is 19.4 percent. These figures are slightly below CBO's, which estimated that for the 40th to 60th percentile the average tax burden is 19.8 percent in 1999, because the JCT uses a broader definition of income.[11]

iv. Tax Foundation estimates

The Tax Foundation (1998) publishes estimates of the burden of all taxes--federal, state and local. They apply the taxes to two different families: a family with the median income of all one-earner families, and a family with the median income of all two-earner families. Their estimates are shown in table 17 for selected years since 1955. For 1997, the median one-earner family pays an estimated 35.6 percent of income in taxes, while the median two-earner family pays an estimated 38.2 percent of income in taxes. These estimates have increased only slightly over time, and are within one percentage point of the average tax burdens in 1985 and 1995.

These estimates are much higher than the estimates by Treasury and CBO, and several issues arise in interpretation. First, the estimates do not apply to the median family or household. Rather, the estimates are based on median income among families

[11] The JCT definition more closely resembles an economic measure of income, and includes AGI, tax-exempt interest, employer contributions for life and health insurance, employer share of FICA tax, worker's compensation, nontaxable social security benefits, the insurance value of medicare benefits, alternative minimum tax preference items, the excluded income of U.S. citizens living abroad.

with one or two earners. Thus, the tax rates do not apply to retirees, students, or the unemployed. The median income among two-earner families, for example, is at the 67th percentile of all families (Lav 1998). Since taxes tend to rise with income, one reason the Tax Foundation finds a higher tax rate is that it examines families that are at higher places in the income distribution.

Second, several factors lead to overstatements of the tax rate. The study omits a number of deductions like child credits. It does not consider the use of flexible spending accounts. Pension contributions and health insurance are not considered as part of income. The study assumes that the typical household pays estate taxes, even though only 1.5 percent of people do. The study counts corporate taxes, but does not count corporate income; it counts property taxes but does not count the imputed income from housing. For all of these reasons, the study overstates taxes, understates income, and is not a reliable guide to tax policy choices.

Third, the Tax Foundation estimates include state and local taxes as well as federal burdens. This difference, however, cannot explain why the Tax Foundation estimates differ so significantly from the others. The average federal tax rate for families in the middle quintile is just under 19 percent in 1999, according to CBO. Lav (1998), using the CBO's figures, suggests that a reasonable estimate is that all federal, state, and local taxes account for about 26 to 30 percent of income for families in the middle fifth of the income distribution. This figure is still significantly lower than the Tax Foundation estimate. Using the JCT estimates of federal tax burdens would generate an even lower overall tax burden estimate.

v. Additional comments

Several other facts suggest that the tax burden on American households is not as crushing as tax cut advocates sometimes claim. First, because of personal exemptions, standard deductions, the earned income credit, and the child credit, a family of four will not owe any net income tax in 1999 until it earns around $28,000. A significant portion of families fall into this income group. Second, approximately 75 percent of more of tax-paying units are in either the zero or the 15 percent marginal tax bracket (Burman, Gale and Weiner 1998).

Third, to the extent that taxes impose burdens on low- and middle-income families, it is the payroll tax and not the income tax that is the source of the problem. Payroll taxes account for about two-fifths of the 26-30 percent of income that a typical family is estimated to pay in all federal, state, and local taxes, and about 55 percent of its payments of federal taxes (CBO, 1998, table A-3). Since payroll taxes are associated with future social security benefits, all of the burden measures reported above overstate the true costs of taxation for most households.

Fourth, the estimates do not include the burdens imposed by state and local taxes. But evidence shows that incorporating these taxes would not affect the basic conclusions above.

C. The moral dimension

Some tax cut advocates have argued that tax revenues "belong" to the American people and so any excess funds should be returned to them. This view is correct as far as it goes, but does not go far enough. The problem is that the future liabilities of government also "belong" to the American people. The question in each case is, which American people, current or future. It would be irresponsible for taxpayers, or government, simply to ignore the impending retirement of the baby boomers and the obligations that the elected representatives of America's people have made.

V. Conclusion

The emerging federal surpluses are no minor achievement, but are only a first step toward long-run fiscal sustainability. The short-term surpluses are an accounting illusion, and the long-term forecast shows a significant fiscal deficit.

These may seem like unfair criticisms; that is, it may seem like the goalposts have been moved back, now that we have reached a balanced budget in the short term. In a way, they have, but there is a good reason why. U.S. fiscal policy and the economy have benefitted from a demographic holiday during the last 15-20 years. Although we can generate budget surpluses while the baby boomers are in their peak taxpaying years, our fiscal problems will be massive if they cannot be resolved by the time the boomers retire and start receiving benefits. Tax cuts not only do not solve this problem, they make it worse.

The fiscal 1999 federal budget provides a rare opportunity to address the nation's long-term fiscal problems from the vantage point of a short-term surplus, a strong economy, and the lowest tax burdens for most families in decades. Under these circumstances, focusing on long-term problems now, while they are still manageable, is an offer we cannot afford to refuse.

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Table 1

CBO Baseline Budget Projections

Fiscal Year	Actual 1998	Projected 1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total 2000-2009
Billions of dollars													
Surplus													
On-Budget	-29	-19	-7	6	55	48	63	72	113	130	143	164	787
Off-Budget	99	127	138	145	153	161	171	183	193	204	212	217	1,777
Unified	70	107	131	151	209	209	234	256	306	333	355	381	2,565
Debt Held by the Public	3,720	3,630	3,515	3,378	3,183	2,989	2,770	2,529	2,237	1,917	1,574	1,206	
Percent of GDP													
Surplus													
On-Budget	-0.3	-0.2	-0.1	0.1	0.8	0.5	0.6	0.6	1.0	1.0	1.1	1.2	0.66
Off-Budget	1.2	1.4	1.5	1.5	1.5	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.57
Unified	0.8	1.2	1.4	1.6	2.1	2.0	2.2	2.3	2.6	2.7	2.7	2.8	2.24
Debt Held by the Public	44.3	41.4	38.6	35.6	32.1	28.9	25.6	22.3	18.9	15.5	12.2	8.9	

Source: CBO, January 1999, The Economic and Budget Outlook: Fiscal Years 2000-2009, Summary Table 3

Table 2

Actual and Projected Budget Expenditures, 1998-2009

	Actual	Projected										
Fiscal Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Nominal Spending (billions of dollars)												
Social Security	376	387	404	423	443	464	487	511	538	566	596	631
Medicare	211	220	232	248	258	282	304	336	347	383	413	444
Medicaid	101	108	117	126	136	147	160	174	190	207	225	245
Net Interest	243	231	218	207	195	183	170	156	140	123	104	85
Discretionary	554	575	574	573	568	583	598	614	630	646	663	680
All Other	166	186	194	202	206	222	232	241	241	241	254	261
Total	1,651	1,707	1,739	1,779	1,806	1,881	1,951	2,032	2,086	2,166	2,255	2,346
Real Spending (billions of 1998 dollars)												
Social Security	376	379	385	393	401	410	419	429	440	451	463	478
Medicare	211	215	221	231	234	249	262	282	284	305	321	336
Medicaid	101	106	112	117	123	130	138	146	155	165	175	185
Net Interest	243	226	208	192	177	162	146	131	114	98	81	64
Discretionary	554	563	547	533	515	515	515	515	515	515	515	515
All Other	166	182	185	188	187	196	200	202	197	192	197	198
Total	1,651	1,670	1,658	1,654	1,636	1,661	1,679	1,704	1,705	1,726	1,751	1,776
Percent of GDP												
Social Security	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.5	4.5	4.5	4.6	4.6
Medicare	2.5	2.5	2.5	2.6	2.6	2.7	2.8	2.9	2.9	3.1	3.2	3.2
Medicaid	1.2	1.2	1.3	1.3	1.4	1.4	1.5	1.5	1.6	1.7	1.7	1.8
Net Interest	2.9	2.6	2.4	2.2	2.0	1.8	1.6	1.4	1.2	1.0	0.8	0.6
Discretionary	6.6	6.6	6.3	6.0	5.7	5.6	5.5	5.4	5.3	5.2	5.1	5.0
All Other	2.0	2.2	2.2	2.3	2.2	2.3	2.3	2.3	2.2	2.1	2.1	2.1
Total	19.6	19.5	19.1	18.8	18.2	18.2	18.0	17.9	17.6	17.5	17.4	17.3

Source: CBO, January 1999, Economic and Budget Outlook: Fiscal Years 2000-2009, Tables 4-1 and 4-4, p. 62, 70

Table 3

Discretionary Outlays, 1980-2009

Fiscal Year	Total: Billions of 1998 dollars	Total: Percent of GDP	National Defense: Billions of 1998 dollars	National Defense: Percent of GDP	International: Billions of 1998 dollars	International: Percent of GDP	Domestic: Billions of 1998 dollars	Domestic: Percent of GDP
1980	546	10.2	266	5.0	25	0.5	255	4.7
1981	552	10.1	283	5.2	24	0.4	244	4.5
1982	551	10.1	314	5.8	22	0.4	215	4.0
1983	578	10.3	344	6.1	22	0.4	212	3.8
1984	595	9.9	358	6.0	26	0.4	212	3.5
1985	630	10.1	384	6.2	26	0.4	220	3.5
1986	652	10.0	407	6.3	26	0.4	218	3.4
1987	637	9.6	406	6.1	22	0.3	210	3.2
1988	640	9.4	401	5.9	22	0.3	217	3.2
1989	643	9.1	400	5.7	22	0.3	221	3.1
1990	624	8.8	374	5.3	24	0.3	226	3.2
1991	638	9.1	383	5.5	24	0.3	232	3.3
1992	621	8.7	352	4.9	22	0.3	247	3.5
1993	610	8.3	330	4.5	24	0.3	255	3.5
1994	598	7.9	311	4.1	23	0.3	264	3.5
1995	583	7.6	293	3.8	22	0.3	269	3.5
1996	555	7.1	276	3.5	19	0.2	259	3.3
1997	557	6.9	276	3.4	20	0.2	261	3.2
1998	554	6.6	270	3.2	18	0.2	266	3.2
1999	563	6.6	—	—	—	—	—	—
2000	547	6.3	—	—	—	—	—	—
2001	533	6.0	—	—	—	—	—	—
2002	515	5.7	—	—	—	—	—	—
2003	515	5.6	—	—	—	—	—	—
2004	515	5.5	—	—	—	—	—	—
2005	515	5.4	—	—	—	—	—	—
2006	515	5.3	—	—	—	—	—	—
2007	515	5.2	—	—	—	—	—	—
2008	515	5.1	—	—	—	—	—	—
2009	515	5.0	—	—	—	—	—	—

Note: 1980-1997 is deflated using Calender Year CPI-U from the 1999 Economic Report of the President, Table B-60, p. 395
1998-2009 is deflated using the Fiscal Year CPI-U estimates from CBO, January 1999, Economic and Budget Outlook, Table 1-5, p. 19

Source: CBO, January 1999, The Economic and Budget Outlook: Fiscal Years 2000-2009, Tables 4-1, F-10 and F-11, p. 62, 134-135

Table 4

10-Year Costs of Changes in Discretionary Spending

Policy 1999-2002	Policy 2002-2009	DS as % of GDP 2009	Cost Relative to Baseline (in billions of dollars)
Nominal DS Declines	Real DS Constant	4.97	---
Nominal DS Constant	Real DS Constant	5.03	73
Real DS Constant	Real DS Constant	5.43	609
Maintain % of GDP	Maintain % of GDP	6.50	1,410

*Includes added debt service costs to higher outstanding public debt

Table 5

Medicare and Retirement Trust Funds in the On-Budget Surplus, 1998-2009 (billions of dollars)

Fiscal Year	Actual 1998	Projected 1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total 2000-2009
Medicare													
Hospital Insurance (Part A)	2	8	9	8	14	12	10	5	8	1	-3	-9	55
Retirement													
Military Retirement	8	7	7	7	8	8	9	9	9	10	11	11	89
Civilian Retirement	29	30	30	30	30	28	28	27	26	26	25	24	274
Subtotal	37	37	37	37	38	36	37	36	35	36	36	35	363
Total	39	45	46	45	52	48	47	41	43	37	33	26	418

Source: CBO, January 1999, Economic and Budget Outlook: Fiscal Years 2000-2009, Table 2-4, p. 43

Table 6

Actual and Projected Tax Revenues, 1998-2009

	Actual	Projected										
Fiscal Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Revenues (billions of dollars)												
Individual Income Tax	829	863	893	919	958	990	1,035	1,085	1,138	1,195	1,258	1,323
Corporate Income Tax	189	193	188	191	202	214	226	238	250	259	267	273
Social Insurance	572	610	640	666	691	717	746	783	816	852	885	923
All Other	132	148	148	154	164	170	177	182	188	194	200	208
Total	1,721	1,815	1,870	1,930	2,015	2,091	2,184	2,288	2,393	2,500	2,611	2,727
Revenues (% of GDP)												
Individual Income Tax	9.9	9.9	9.8	9.7	9.7	9.6	9.6	9.6	9.6	9.6	9.7	9.8
Corporate Income Tax	2.2	2.2	2.1	2.0	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.0
Social Insurance	6.8	7.0	7.0	7.0	7.0	6.9	6.9	6.9	6.9	6.9	6.8	6.8
All Other	1.6	1.7	1.6	1.6	1.7	1.6	1.6	1.6	1.6	1.6	1.5	1.5
Total	20.5	20.7	20.6	20.4	20.3	20.2	20.2	20.2	20.2	20.2	20.2	20.2

Source: CBO, January 1999, The Economic and Budget Outlook: Fiscal Years 2000-2009, Summary Table 3

Table 7

How Much of the Revenue Surge Relative to GDP Is Assumed to be Permanent?

	Revenues as a Percent of GDP				Implied Share that is permanent using	
Tax	1994	1999	Projected Low 2000-2009	2009	Projected Low 2000-2009	2009
Individual Income	7.9%	9.8%	9.6%	9.7%	89%	95%
Individual and Corporate Income	10.0%	11.9%	11.6%	11.7%	83%	86%
All Federal	18.4%	20.5%	20.0%	19.9%	76%	72%

(1) Calculated as (Column (3) - Column (1)) / (Column (2) - Column (1))

(2) Calculated as (Column (4) - Column (1)) / (Column (2) - Column (1))

Table 8

Projections of Federal Receipts and Expenditures, 1998-2060

Calender Year	1998	2010	2020	2030	2040	2050	2060
NIPA Receipts	22	21	21	21	21	21	21
NIPA Expenditures							
Federal consumption expenditures	5	4	4	4	4	4	4
Federal transfers, grants, and subsidies							
Social Security	4	5	6	6	6	7	7
Medicare	2	3	5	6	6	6	7
Medicaid	1	2	2	3	3	3	3
Other	5	4	4	4	4	4	4
Net Interest	3	a	-1	a	1	4	11
Total	21	18	20	22	24	27	35
NIPA Deficit (-) or Surplus	1	3	1	-1	-3	-6	-14
Debt Held by the Public	44	5	-12	-7	16	53	129

a. Less than 0.5 percent.

Note: the base scenario assumes that rising deficits affect interest rates and economic growth.

Source: CBO, January 1999, Economic and Budget Outlook: Fiscal Years 2000-2009, Table 2-5, p. 43

Table 9

Estimates of the Long-Term Fiscal Imbalance

Source	Use of 10-year Surplus	Other Details	Fiscal Gap (% of GDP) Horizon 2070	Permanent
CBO (1999)	Debt Reduction	—	0.60	—
CBO (1999)	Tax Cuts	—	2.20	—
Authors	Debt Reduction	—	0.39	1.53
Authors	Debt Reduction	Discretionary Spending Constant, at 1999 level, as a % of GDP	2.12	3.41
Authors	Debt Reduction	Gap in non-Social Security portion of Budget	-0.45	0.69
Authors	Debt Reduction	DS / GDP constant, 1998-2009 Gap in non-Social Security portion of Budget	1.28	2.57
Authors	Debt Reduction	Delay Adjustment until 2014	1.02	1.89
Authors	Tax Cuts	10% Tax Cut; JCT estimate through 2009, then constant share of GDP Delay adjustment until 2010	1.68	2.54

Table 10

On-Budget Surplus and the Costs of a 10 percent Tax Rate Cut (in billions of dollars)

Fiscal Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total
On-Budget Surplus (1)	-7	6	55	48	63	72	113	130	143	164	787
10% Tax Cut											
Revenue Costs (2)	-58	-70	-76	-77	-79	-80	-82	-83	-84	-86	-776
Interest Costs (3)	-3	-6	-10	-13	-18	-22	-27	-32	-37	-42	-209
Total Costs (3)	-61	-76	-86	-90	-97	-102	-109	-115	-121	-128	-984

(1) CBO, January 1999, The Economic and Budget Outlook: Fiscal Years 2000-2009, Summary Table 3

(2) Joint Committee on Taxation

(3) Author's Calculations

Table 11

Distributional Effects of a 10% cut in Income Tax Rates

(Effects in 2001)

Income Group	Proportion of Households	Proportion of Federal Taxes Paid (Current Law)	Proportion of Tax Cut Received	Percent Change in Federal Taxes	Percent with No Cut in Federal Taxes	Percent Increase in After Tax Income	Average Tax Cut (Dollars)
< 10,000	15.5	0.4	0.0	-0.5	92.5	0.0	1
10,000-20,000	18.7	2.1	1.2	-2.8	64.3	0.3	35
20,000-30,000	14.7	5.2	3.5	-3.3	30.9	0.6	130
30,000-40,000	11.5	6.7	5.2	-3.8	14.4	0.9	244
40,000-50,000	9.4	7.7	6.7	-4.2	7.9	1.0	383
50,000-75,000	14.6	17.8	16.6	-4.5	3.3	1.3	614
75,000-100,000	7.6	14.8	14.1	-4.6	4.1	1.4	994
100,000-200,000	6.1	20.3	21.0	-5.0	4.8	1.8	1,855
200,000+	1.8	25.0	31.5	-6.1	16.8	2.5	9,221
	100.0	100.0	100.0	-4.8	34.4	1.4	537

Source: Joint Committee on Taxation estimates as reported in Democratic Staff of House Ways and Means Committee (1999).

Table 12
Average Tax Rates – Department of the Treasury

	Average Income Tax Rate			Average Income plus Employee and Employer Payroll Tax Rate		
Year	One Half Median Income	Median Income	Twice Median Income	One Half Median Income	Median Income	Twice Median Income
1955	0.0	5.6	10.8	3.9	8.9	12.4
1956	0.0	6.4	11.2	3.9	9.4	12.7
1957	0.0	6.7	11.4	4.4	9.9	13.0
1958	0.0	7.0	11.6	4.4	10.1	13.1
1959	0.0	7.5	11.9	4.9	11.2	13.8
1960	0.2	7.8	12.1	6.0	12.1	14.2
1961	0.5	7.9	12.2	6.3	12.1	14.3
1962	1.2	8.9	12.4	7.2	12.5	14.5
1963	2.0	8.7	12.9	8.9	13.2	15.1
1964	2.1	7.6	11.7	9.0	11.9	13.8
1965	2.2	7.1	11.1	9.1	11.3	13.2
1966	2.7	7.5	11.5	10.7	13.7	14.6
1967	3.3	8.0	11.9	11.6	14.0	14.9
1968	4.0	9.2	13.4	12.3	15.6	16.6
1969	4.6	9.9	14.2	13.5	16.4	17.5
1970	4.7	9.4	13.5	13.6	15.5	16.5
1971	4.7	9.3	13.5	14.4	15.4	16.5
1972	4.4	9.1	13.5	14.0	15.8	16.9
1973	4.9	9.5	14.1	15.7	17.8	18.2
1974	4.2	9.0	14.4	15.0	18.4	19.0
1975	4.1	9.6	14.9	14.9	19.0	19.6
1976	4.7	9.9	15.5	15.5	19.2	20.2
1977	3.6	10.4	16.4	14.5	19.7	21.0
1978	4.7	11.1	17.4	15.9	20.5	22.0
1979	5.1	10.8	17.2	16.4	21.8	22.7
1980	6.0	11.4	18.3	17.2	22.3	24.0
1981	6.8	11.8	19.1	18.9	23.5	25.7
1982	6.5	11.1	18.0	18.7	22.9	24.9
1983	6.5	10.4	16.8	18.7	22.3	24.0
1984	6.5	10.3	16.6	18.7	22.2	23.8
1985	6.6	10.3	16.8	19.2	22.8	24.3
1986	6.6	10.5	17.0	19.5	23.1	24.6
1987	5.2	8.9	15.8	18.2	21.7	23.3
1988	5.2	9.3	15.2	18.8	22.6	22.9
1989	5.3	9.4	15.3	18.9	22.7	23.1
1990	5.1	9.3	15.1	19.0	22.9	23.5
1991	5.0	9.3	15.0	18.9	22.9	24.3
1992	4.6	9.2	14.8	18.4	22.7	24.2
1993	4.4	9.2	14.7	18.3	22.7	24.2
1994	3.4	9.2	14.8	17.3	22.7	24.4
1995	3.5	9.3	15.0	17.5	22.8	24.3
1996	2.9	9.3	15.1	16.9	22.9	24.3
1997 E	2.7	9.3	15.1	16.7	22.8	24.4
1998 E,P	-0.5	7.8	14.3	13.7	21.5	23.8
1999 E,P	-1.2	7.5	14.1	13.1	21.1	23.7

E: Estimate from 1996 median income adjusted for price level changes.
P: Projected based on laws enacted as of January 1998; includes Child Tax Credit for 2 dependents

Source: Department of the Treasury (1998)

Table 13 (1)

Average Tax Rates -- Congressional Budget Office

All families (by income group)	1977	1980	1985	1988	1989	1990	1995 (2)	1999 (2) P
Lowest quintile	9.2	8.1	10.4	9.3	8.9	8.9	6.0	4.6
Second quintile	15.5	15.6	15.9	15.9	15.7	15.8	14.6	13.7
Middle quintile	19.5	19.8	19.2	19.8	19.4	19.5	19.7	18.9
Fourth quintile	21.9	22.9	21.7	22.4	22.0	22.1	22.5	22.2
Highest quintile	27.2	27.6	24.1	26.0	25.5	25.5	29.6	29.1
Overall	22.8	23.3	21.8	22.9	22.5	22.6	24.7	24.2
81-90 percent	24.0	25.3	23.5	24.6	24.2	24.4	25.3	25.2
91-95 percent	25.4	26.5	24.3	26.0	25.6	25.6	27.1	27.2
96-99 percent	27.1	28.1	24.3	26.5	26.2	26.1	29.4	29.0
Top 1 percent	35.4	31.9	24.5	26.9	26.2	26.3	36.5	34.4
Top 10 percent	28.9	28.7	24.4	26.5	26.0	26.0	31.3	30.6
Top 5 percent	30.6	29.7	24.4	26.7	26.2	26.2	33.0	31.8

(1) The average tax rate is defined as the ratio of total federal effective taxes divided by adjusted family income.

(2) Estimates for 1995 & 1999 assume that all corporate taxes are borne by capital income holders. Estimates in earlier years are based on the assumption that corporate taxes are split equally between capital and labor.

P: Projected

Source: 1995-1999, Congressional Budget Office (1998); 1977-1988, Committee on Ways and Means (1993)

Table 14

Average Real After-Tax Income Growth by Income Group

All families (by income group)	1977	1980	1985	1988	1995	1999	1977-99	1985-99	1995-99
Lowest quintile	10,116	9,621	8,756	8,822	8,317	8,732	-14%	-0%	5%
Second quintile	22,489	21,126	20,004	20,387	18,818	19,982	-11%	-0%	6%
Middle quintile	33,091	31,458	30,948	30,887	29,315	31,377	-5%	1%	7%
Fourth quintile	43,541	42,061	43,307	44,766	42,141	45,035	3%	4%	7%
Highest quintile	75,673	76,908	90,804	97,911	92,615	102,427	35%	13%	11%
Overall	36,854	36,046	38,540	40,277	37,726	41,027	11%	6%	9%
81-90 percent	53,558	52,354	56,829	58,397	57,079	61,432	15%	8%	8%
91-95 percent	67,877	67,591	75,219	76,919	74,485	80,679	19%	7%	8%
96-99 percent	96,731	96,290	113,724	120,778	115,323	129,970	34%	14%	13%
Top 1 percent	250,671	285,763	414,397	502,833	463,634	515,392	106%	24%	11%
Top 10 percent	97,673	100,897	124,484	137,444	126,529	142,835	46%	15%	13%
Top 5 percent	127,529	134,317	173,848	197,949	179,222	205,825	61%	18%	15%

Source: 1995-1999, Congressional Budget Office (1998); 1977-1988, Committee on Ways and Means (1991)

Note: All incomes are in 1999 dollars.

Table 15

Average Real Pre-Tax Income Growth by Income Group

All families (by income group)	1977	1980	1985	1988	1995	1999	1977-99	1985-99	1995-99
Lowest quintile	11,156	10,469	9,763	9,726	8,847	9,153	-18%	-6%	3%
Second quintile	26,595	25,018	23,745	24,230	22,035	23,154	-13%	-2%	5%
Middle quintile	41,090	39,236	38,276	38,502	36,507	38,689	-6%	1%	6%
Fourth quintile	55,698	54,573	55,307	57,661	54,376	57,885	4%	5%	6%
Highest quintile	103,922	106,022	119,710	132,224	131,555	144,466	39%	21%	10%
Overall	47,711	46,970	49,252	52,229	50,101	54,125	13%	10%	8%
81-90 percent	70,471	70,086	74,287	77,449	76,412	82,128	17%	11%	7%
91-95 percent	90,988	91,960	99,364	103,945	102,174	110,823	22%	12%	8%
96-99 percent	132,691	133,922	150,230	164,324	163,348	183,056	38%	22%	12%
Top 1 percent	388,036	419,623	548,870	687,870	730,131	785,659	102%	43%	8%
Top 10 percent	137,374	141,511	164,661	186,999	184,177	205,815	50%	25%	12%
Top 5 percent	183,760	191,062	229,958	270,053	267,495	301,796	64%	31%	13%

Source: 1995-1999, Congressional Budget Office (1998); 1977-1988, Committee on Ways and Means (1991)

Note: All incomes are in 1999 dollars.

Table 16

Federal Tax Burdens by Income Class -- Joint Committee on Taxation

2001 data, except where noted

Income Group	Proportion of Households	Effective Federal Tax Rate	Average Federal Taxes Paid*
< 10,000	15.5	6.8	256
10,000-20,000	18.7	8.0	1,183
20,000-30,000	14.7	15.4	3,805
30,000-40,000	11.5	17.8	6,184
40,000-50,000	9.4	19.4	8,816
50,000-75,000	14.6	21.5	13,130
75,000-100,000	7.6	24.1	20,693
100,000-200,000	6.1	26.3	31,307
200,000+	1.8	29.1	146,320
	100.0	22.2	25,744

Source: Joint Committee on Taxation

* 1999 Data

Table 17

Average Tax Rate – Tax Foundation

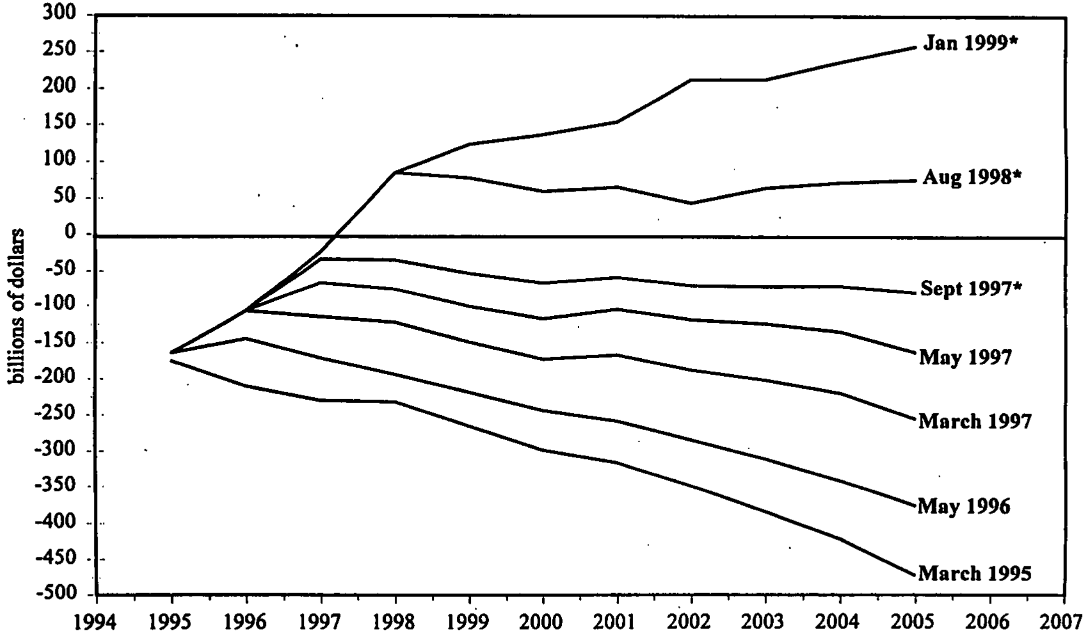
All Federal, State, and Local Taxes

Year	Median One-Earner Family	Median Two-Earner Family
1955	26.7	27.9
1965	28.8	28.5
1975	34.2	36.2
1985	34.8	37.5
1995	35.4	32.6
1997	35.6	38.2

Source: "Family Tax Burdens 20 Years Later, Revisited", Tax Foundation, February 5, 1998

Figure 1

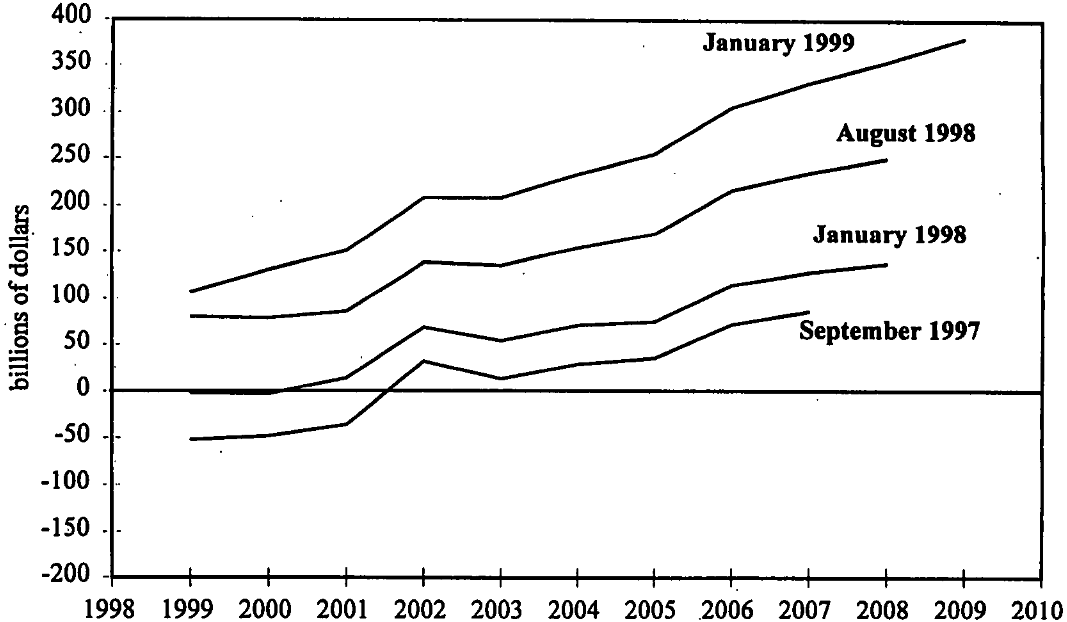
Projections of Baseline Deficit / Surplus



*Excluding the effects of the 1997 Reconciliation Acts.
SOURCE: Estimates by Robert Reischauer, based on CBO figures.

Figure 2

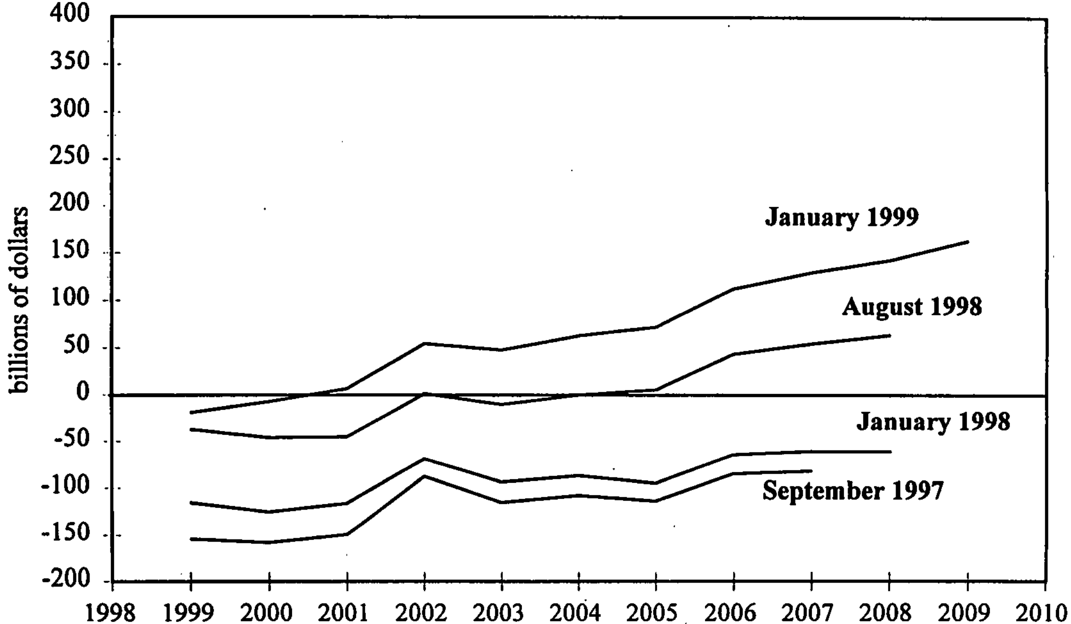
Unified Budget Deficit / Surplus Projections, 1999-2009



Source: Congressional Budget Office

Figure 3

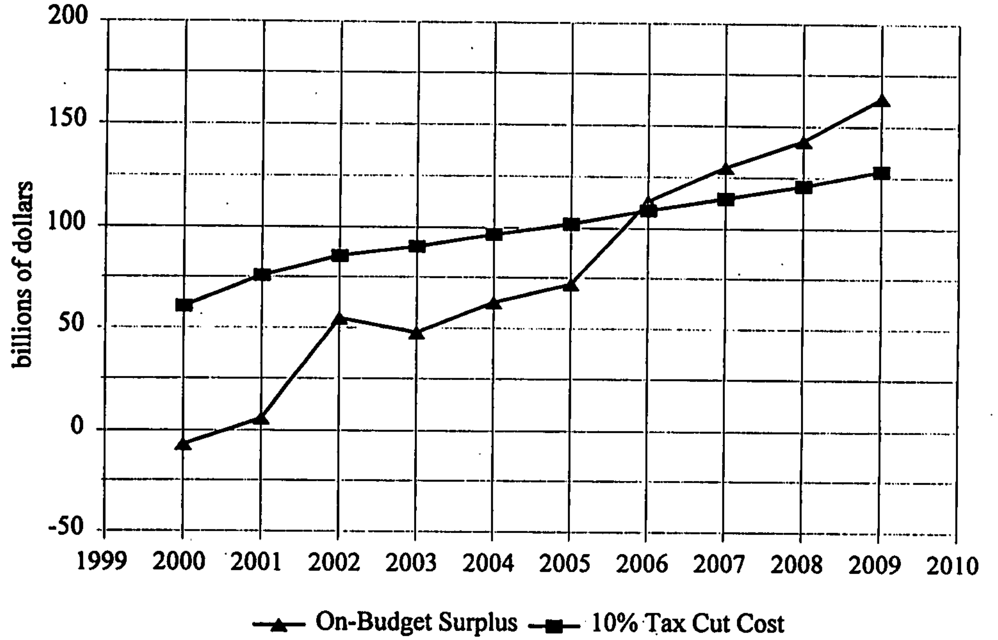
On-Budget Deficit / Surplus Projections, 1999-2009



Source: Congressional Budget Office

Figure 4

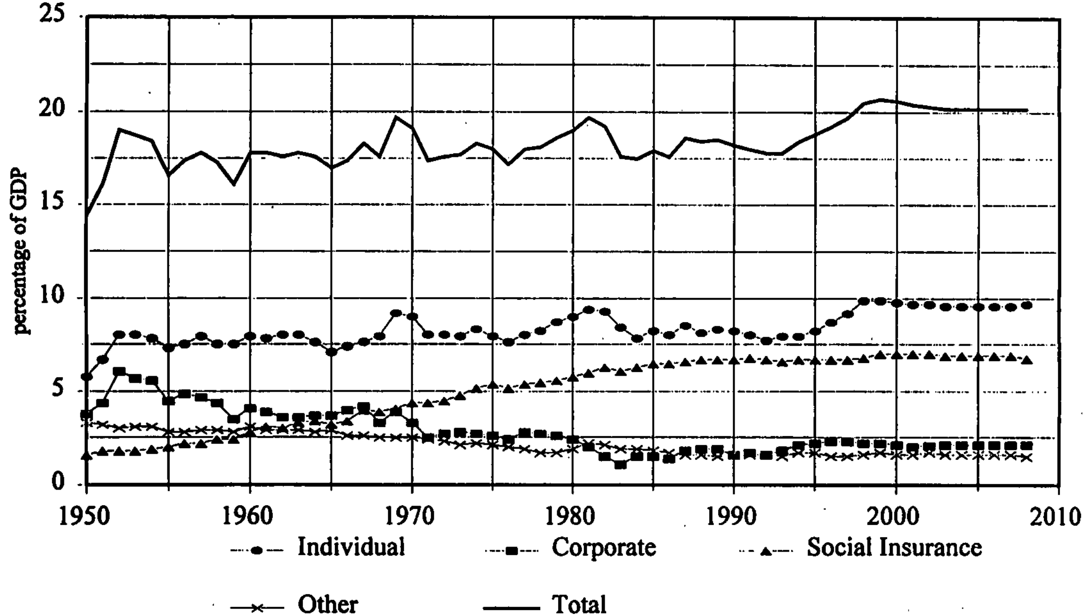
Comparison of On-Budget Surplus and Cost of a 10% Tax Cut



Source: Author's calculations and Joint Committee on Taxation

Figure 5

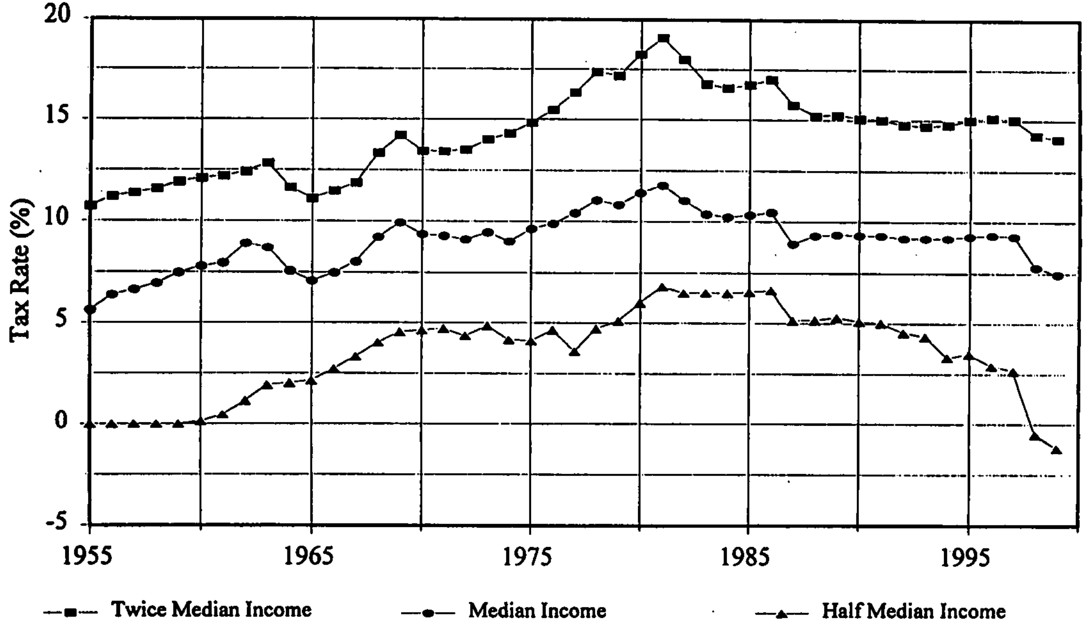
Tax Receipts (as percentage of GDP)



Source: 1950-1998: Budget for Fiscal Year 1999, Historical Tables, Table 2.3, p. 31-32
1999-2009: Congressional Budget Office, 1999, (Summary Table 3)

Figure 6

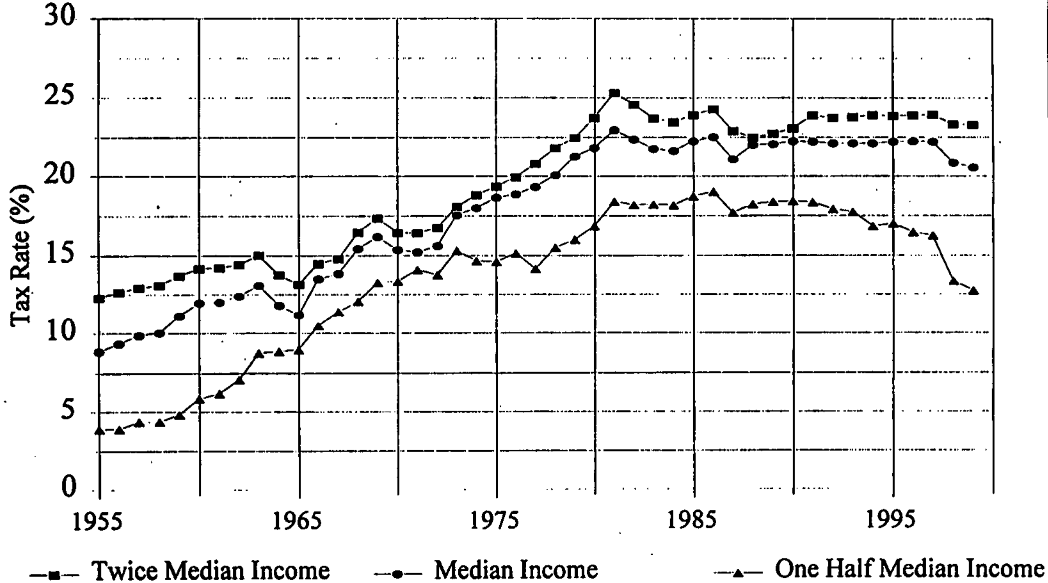
Average Federal Income Tax Rate*



* Family of four with all income
Source: Department of the Treasury

Figure 7

Average Federal Income plus Payroll Tax Rate*

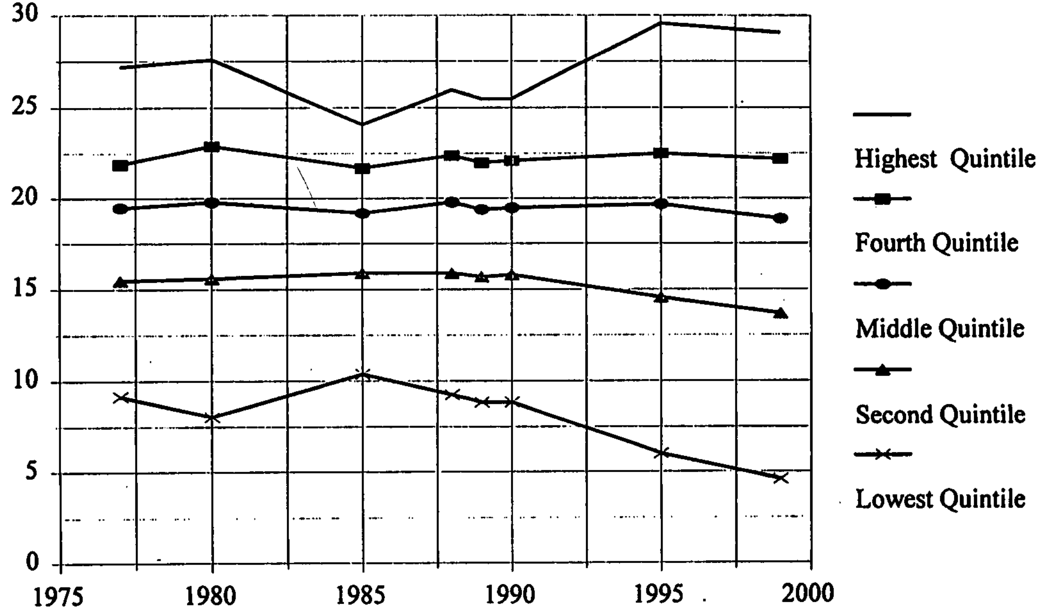


* Family of four with all income from wages.

Source: Department of the Treasury

Figure 8

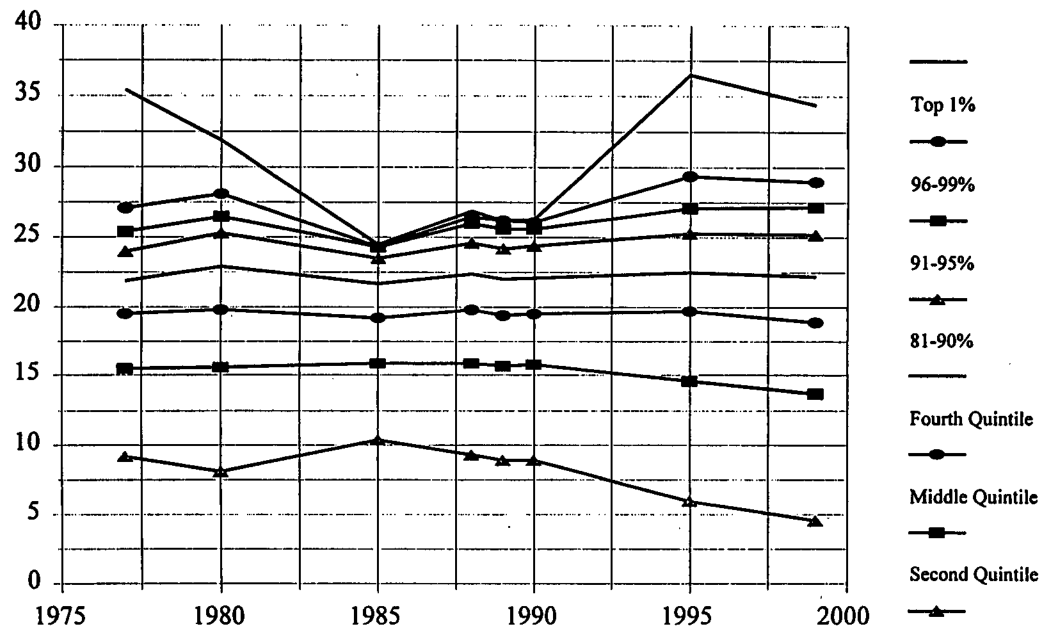
Average Federal Tax Burdens by Income Quintile, 1977-1999



Source: Congressional Budget Office (1998) and Committee on Ways and Means (1993)

Figure 9

Average Federal Tax Burdens by Income Percentile, 1977-1999



Source: Congressional Budget Office (1998) and Committee on Ways and Means (1993)

Economic Growth Through Tax Cuts: What's the Best Approach?

Statement of John G. Wilkins, Principal
National Economic Consulting
PricewaterhouseCoopers L.L.P.
before the
Joint Economic Committee
United States Congress
March 4, 1999

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Statement of John G. Wilkins, Principal
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Mr. Chairman and Members of the Committee:

I am co-director of PricewaterhouseCoopers' National Economic Consulting practice. In 1989 I was U.S. Treasury acting Assistant Secretary (Tax Policy). I am former senior advisor to the Assistant Secretary, Director of the Office of Tax Analysis, and Director of the Treasury Department's Revenue Estimating Division. I am also past Vice Chairman of the Organization for Economic Cooperation and Development's (OECD) Committee on Fiscal Affairs.

It is a pleasure to be here today to give my views on economic growth through tax cuts. My statement reflects my own views and does not necessarily represent those of PricewaterhouseCoopers (PwC) or its clients.

Introduction

On February 1, 1999, President Clinton submitted to the Congress his budget for fiscal year 2000. That budget included:

- Providing over 50 proposed tax reliefs, at a cost of $28.1 billion over the next 6 years (1999-2004);
- Extending six tax provisions that will otherwise expire, at a cost of $4.6 billion,
- Introducing new tax and fee increases from tobacco legislation ($34.5 billion) and nearly 90 other measures ($43.9 billion).

Taken together, these revenue proposals yield net Federal tax and fee increases of $45.8 billion between now and September 30, 2004, and add about 1/10 of a percentage point to the already record high ratio of government receipts to gross domestic product (GDP).

An unparalleled strong peacetime economy has kept taxes at record levels. Only once since 1929 have taxes claimed a larger percentage of GDP -- and that was in 1944, when taxes were increased to pay for the war effort. The same economic growth that has helped boost tax revenues has produced the first unified budget surplus since 1969, when a small surplus was recorded thanks to the temporary surcharge levied to help pay for the Vietnam conflict.

Given this unusual situation -- historically high taxes and an economy strong enough to yield unexpectedly large budget surpluses -- tax cuts are quite naturally being considered. There appears to be a political consensus that most of the unified budget surplus -- 62 percent as recommended by the President -- be devoted to shoring up the social security trust fund. There is no consensus, however, about how to deal with the remaining 38 percent of the projected surplus. Some advocate across-the-board tax cuts. Others recommend more selective, targeted tax cuts. Still others would apply these funds to retire a portion of the debt. And, finally, there are undoubtedly some who would spend this surplus on new or expanded government programs.

The President has proposed that most of the remaining surplus be devoted to help the long term solvency of the medicare trust fund (15 percent of the unified surplus) and to pay for establishing universal savings accounts with a government matching share (11 percent of the unified surplus), with the remainder going to military spending and other discretionary spending programs. A significant number agree with the need to aid the medicare program, narrowing the debate to how to deal with something less than one-fourth of the unified surplus.

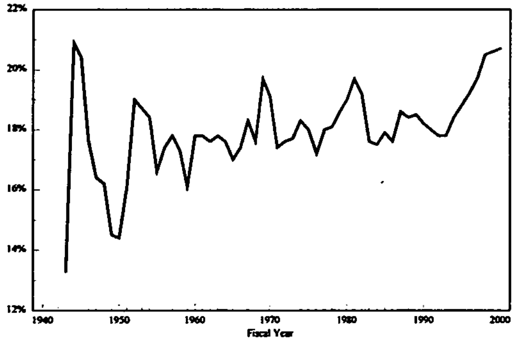
In my statement today, I will discuss the potential benefits of general tax reductions as well as more targeted reductions. The data analysis underlying conclusions presented here has been generated by PricewaterhouseCoopers' proprietary dynamic economic model. This model produces dynamic revenue estimates that not only take account of taxpayer behavior but also take account of the impact of tax changes on macroeconomic variables, such as real growth, interest rates, corporate profits, and labor force participation. For a full description of the PricewaterhouseCoopers (formerly Coopers & Lybrand) model, see *Joint Committee on Taxation Tax Modeling Project and 1997 Symposium Papers*, November 20, 1997.

Historical Perspective

In evaluating the case for tax cuts -- either general or targeted -- it is useful to consider our tax structure in an historical context. Are we taxing ourselves more or less than we have in the past? Is the economy ready for a tax reduction?

Tax Rates at an All-time High. Effective tax rates as measured by the ratio of taxes to GDP are expected to be 20.6 percent this year and are projected to rise to 20.7 percent in 2000, a peacetime high. Only during one year of World War II when special levies were enacted to help pay for the war effort were taxes higher -- 20.9 percent of GDP in 1944. (See figure A.)

Figure A
Federal Government Receipts
as a Percentage of GDP, 1943-2000



Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2000.*

As Federal government revenues have reached peak levels, the composition of receipts has changed. Since 1990, the importance of income taxes (both individual and corporate) has grown. At the beginning of this decade, income taxes accounted for 54.3 percent of total Federal receipts; this year they will account for 58.2 percent. Broad measures of tax rates on both individual and corporate incomes show that they have grown in importance not only because the economy has grown but also because their effective rates have been allowed to creep upward. This distinction is important because while it is appropriate to expect tax revenues to grow in proportion to the growth in the tax base generated by a strong economy, it is dangerous to allow effective tax rates to increase too much. The latter will eventually lead to tax avoidance and evasion schemes that undermine our self-assessment system.

The calculations appearing in Table 1 show that the individual income tax as a percent of taxable personal income has risen from 11.6 percent in 1990 to 14.0 percent in 1998. Similarly, the overall effective rate of corporate income tax on corporate profits has risen from 25.2 percent in 1990 to 26.2 percent in 1998. Historically, whenever these rates have risen too fast and too high, there has been a tax reduction to lower them.

Table 1
Federal Effective Individual and Corporate Tax Rates, 1990-1998

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Individual Income Tax as a Percent of Taxable Personal Income	11.6	11.4	11.1	11.5	11.6	11.9	12.4	13.2	14.0
Corporate Income Tax as a Percent of Corporate Profits Before Tax	25.2	26.2	24.7	25.3	26.2	24.7	25.3	24.8	26.2

Sources: *National Income and Product Accounts*; *Budget of the United States Government, Fiscal Year 2000.*

Interestingly, when individual income taxes are coupled with Federal payroll taxes, it is clear that workers are not shouldering a larger share of Federal taxes today than they were in the recent past. In 1990, the combined share of individual income tax, social security and Federal worker retirement revenues accounted for 82.0 percent of the total tax pie. Today, that percent is nearly the same, estimated to be 81.8 percent of all Federal revenues.

Considering *only* the effective tax rate on overall federal revenues to GDP and the tax rates for individual income taxes on taxable personal income and corporate income tax on corporate profits, a tax cut would appear appropriate. A reduction on the order of $200 billion a year over the 2000-2004 period would lower the tax to GDP ratio from 20.3 percent (on average) to the historical average of 18.2 percent that applied for the two-decade period, 1970 through 1989.

A reduction of $137 billion a year over the five-year forecast period in the individual income tax would bring that tax's rate down to the 1970-1989 norm of 11.8 percent of taxable personal income; and a reduction of $108 billion each year of the forecast period would bring the individual tax rate in line with the 1990-1998 average of 12.2 percent.

For corporations, the 1998 effective tax rate on profits before tax is slightly lower than it was during the 1970-1989 period; however, a modest tax reduction of $2-1/2 billion each year would be required to reestablish the 1990-1998 effective tax rate.

Economic Performance. The economy is very strong, continuing an expansion begun eight years ago. The current expansion has now set a post-war record.

Growth. The economy has experienced real growth of about 4 percent (fourth quarter over fourth quarter) for the past three years. In the last quarter of 1998, the economy grew at a phenomenal 5.6 percent real rate.

Employment. The eight-year economic expansion has now set a post-war record. At 4-1/2 percent for last year, the unemployment rate is the lowest it has been since 1969.

Employment, with more than 132 million civilian workers at the end of 1998, is the highest it has ever been.

Prices. Inflation, as measured by the annual increase in consumer prices, is the lowest it has been since the mid 1960s. A cautionary note: much of the slow growth in price levels must be attributed to the unusual drop in oil prices and to the sharp decline in the price of imports due to the economic crises in Asia and in other trading partners.

Productivity. Gains in productivity were about 2.2 percent for all employment in 1998, strong but well lower than 1996 (2.7 percent), 1992 (3.4 percent), and 1986 (2.6 percent). Indeed, although the last three years have been good years for labor productivity, there is no discernible upward trend over a longer period of years. Productivity growth is fragile but extremely important to sustaining a strong economy.

Based on the status of the economy, *by itself*, there appears no reason for large tax cuts, which traditionally are designed to stimulate a sluggish economy. Indeed, some have observed that with employment as high as it is and with very few looking for jobs, a large tax cut could simply encourage more consumption than the economy could handle, placing pressure on prices and interest rates, and further hurting the trade deficit by encouraging still more imports.

Dynamic Revenue Estimating and Tax Reductions

Although all economists recognize that tax law changes, especially large cuts or increases, have an impact on the macroeconomy, both the Joint Committee on Taxation (JCT) and the Treasury Department's Office of Tax Analysis (OTA) do not take this impact into account when producing official revenue estimates for the tax writing committees of Congress and the Administration, respectively. There are probably sound reasons for ignoring the macroeconomic impact when the tax law changes are not huge. The imprecision of many macroeconomic models and the sheer volume of work involved when a multitude of tax provisions are being considered are two obvious ones. To their credit, both staffs attempt to take account of changes in taxpayer behavior when tax law changes are proposed. This is nowhere more evident than in the case of capital gains tax revenue estimates, which depend so much on unlocking assumptions.

Both the Office of Management and Budget and the Congressional Budget Office publish periodic forecasts that are intended to be consistent with Administration proposed policies. These sporadic releases are not, however, good substitutes for dynamic revenue estimates that take into account not only the static revenue change and the revenue change attributable to taxpayer behavior, but also macroeconomic-related revenue changes induced by tax law. Examples of the latter, which, by convention, are ignored by the JCT and the OTA, include tax revenues from induced (or retarded) economic growth, changes in interest rates, international trade, and consumption, as well as changes in wages, corporate profits, and other taxable sources of income.

The PricewaterhouseCoopers dynamic economic model was developed several years ago to respond to questions regarding the true revenue loss or increase associated with fundamental tax reforms and other significant tax proposals. The model incorporates the types of large samples of individual and corporate income tax returns used by the JCT and the OTA in their work, but also introduces a macroeconomic model that forecasts changes in the economy based on alternative sets of tax laws. PwC is currently helping the Russian ministry of finance construct a similar model, which makes it entirely possible that Russia may adopt dynamic revenue scoring before the United States does.

As reported in *The New York Times, The Wall Street Journal, The Washington Post, The Washington Times*, and elsewhere, the PwC model has been used to evaluate the Dole-Kemp tax cut proposed during the 1996 presidential election campaign, the Armey flat tax, the Nunn-Domenici plan, and the Schaffer-Tauzin national retail sales tax, among other proposals for fundamental tax reform. The PwC model has also been used to evaluate the impact of targeted provisions such as the research and experimentation tax credit, commonly called the R&D credit.

Some results of this model for both across-the-board tax cuts and for the R&D credit appear below.

Across-The-Board Tax Rate Cuts

Several members of the 106th Congress have suggested across-the-board individual income tax rate reductions of 10 percent or more. The Grams-Roth-Kasich version of such a plan (S.3 and H.R.3) would apply a 10 percent rate reduction to regular individual income tax rates, but to neither the ceiling rate on capital gains nor the alternative minimum tax. This tax plan has been estimated by the JCT to cause Federal revenues to decline $360.4 billion over a five-year forecast period, 2000-2004. The OMB has projected individual income tax revenues for that same period to be $4,766.7 billion under current law. Those two figures imply an overall individual income tax reduction during the five-year period of approximately 7.6 percent.

Based on earlier analysis completed with the PwC model, I would estimate a potential overall revenue offset to this tax cut primarily as a result of: (1) the willingness of wage earners and entrepreneurs to forego portions of tax-preferred fringe benefits and deferred compensation in favor of currently taxed compensation; (2) the willingness of workers to work more hours; and (3) the willingness of marginal workers who may not even be counted in the labor force to seek jobs. Although Federal Reserve Board Chairman Greenspan last week warned the Senate Committee on Banking, Housing and Urban Affairs that "the number of people willing to work" and not working is at its lowest percentage on record, the labor response assumed in the PwC model does not contradict his comment. This is because Chairman Greenspan's measure of those willing to work does not include potential second earners in a household and others who would seek a job *only if* tax rates were lowered.

For the macroeconomy as a whole, these behavior effects would lead to:

- a very modest increase in GDP of about 1/10 of 1 percent;
- a marginal increase in productivity of less than 1 percent over the period;
- a personal consumption increase of nearly 1 percent; and
- increases in investment, personal income, and corporate profits.

Targeted Pro-Growth Tax Cuts

Although there appears to be general agreement to set aside the major portion of the unified budget surplus to retire debt in order to help the social security trust fund, there appears to be a less-than-united voice in favor of across-the-board tax cuts. This suggests that targeted cuts, such as those proposed by the bills being developed by Rep. Nancy Johnson (R-CT) and Sen. Charles Grassley (R-IA) may be the more likely result. This approach would also be consistent with President Clinton's budget recommendations for targeting tax relief, although his would be paid for with other revenue-raising measures. The Johnson-Grassley plan calls for roughly $100 billion of tax relief over the five-year budget period, 2000-2004.

Whenever a list of targeted tax reductions is drawn up, it is important to rank potential measures according to how great a salutary impact they will have on the economy. Also important as a selection criterion, however, is the complexity that targeted tax provisions may add to an already overly-complex income tax structure.

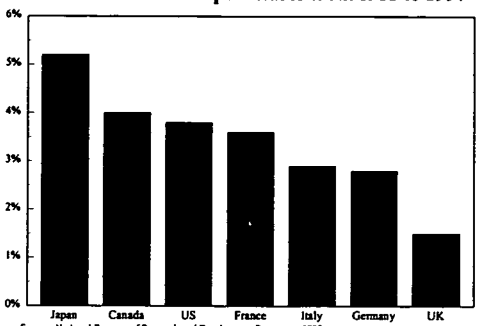
A corporate income tax rate reduction would be high on a list of pro-growth tax cuts, and may be the best broad-based general provision. Any international tax provision designed to remove some complexity and to help U.S. multinational enterprises compete overseas would also rank very high. However, a permanent R&D tax credit would top the list of targeted provisions. This has been recognized by nearly 100 members of the House and 22 members of the Senate who support legislation to make the credit permanent. Notably, the permanent R&D tax credit is also a major element in the Johnson-Grassley plan.

R&D Tax Credit

Making the R&D credit permanent does not add complexity because a temporary credit has been in the tax code for almost two decades. First enacted in 1981, the credit has been extended a total of nine times, with the most recent extension scheduled to expire June 30, 1999. Unneeded complexity results from suspending it and reinstating it, as was done in 1996, and from the uncertainty for businesses embarking on multi-year R&D projects.

Since 1981, when the R&D credit was first enacted, the United States has experienced a 3.8 percent annual rate of increase in real nondefense R&D spending. As shown by Figure B, by contrast, both Japan and Canada have significantly higher rates of R&D spending growth, with growth rates of 5.2 percent (estimated) and 4.0 percent, respectively. Of the remaining G-7 members, France's R&D spending grew 3.6 percent a year while Italy, Germany, and the U.K. grew at 2.9 percent, 2.8 percent, and 1.5 percent, respectively. The U.K., Germany, Japan, and Canada all provide government incentives for private investment in R&D.

Figure B
Annual Average Percentage Change in Nondefense R&D Expenditures from 1981 to 1997



Source: *National Patterns of Research and Development Resources: 1998*
Note: For Japan, France and Italy the percentage change was calculated from 1981 to 1995; in Germany and the United Kingdom the percentage change is over the period 1981 to 1996. For each country, these are the most recent figures available.

In 1995, the last year for which fully comparable data are readily available, the United States devoted 2.05 percent of its GDP to nondefense R&D, while Japan, at 2.73 percent, and Germany, at 2.22 percent, each spent considerably more relative to their GDPs. France devoted 2.04 percent of GDP to R&D, nearly identical to the United States. In order to keep R&D in the United States and not drive it offshore, it is necessary to maintain incentives that encourage more private sector R&D spending.

Policy Rationale. Economists argue that tax policies should generally not be designed to promote particular activities because the market will better allocate resources to their best use. In the case of R&D, however, the market will not allocate optimal resources to R&D spending because many segments of the economy other than the innovator making the R&D investment will benefit from the R&D spending. The benefits from R&D spending may be short-lived to the innovator but they are very long-lived to the economy as a whole because subsequent research builds upon prior research carried out by those who will never enjoy the full benefits of their R&D activities. These so-called "spillover" benefits to society far outweigh the direct benefits to the original innovator. Consequently, profit motives alone are insufficient to generate the level of R&D that the economy as a whole should demand. Put another way, an entrepreneur or corporation will never take into consideration the benefits that others will enjoy when making R&D spending decisions. Given the uncertain payoff from R&D spending, this means that many risky or marginal projects will never be started even though the expected value of benefits for the economy as a whole is far greater than the costs. In its study of this phenomenon, the President's Council of Economic Advisers observed in their 1995 annual report that the spillover benefits from R&D resulted in a social rate of return about twice the estimated private rate of return, estimated to run 20 to 30 percent.

The scenario described here is exactly the kind of market failure situation for which the government should interfere with the private market for the good of society as a whole.

Stimulated R&D Spending. The R&D credit is designed intentionally to stimulate additional private sector R&D spending; and it does a good job. Most researchers conclude that for every tax dollar given up for the credit, there is a dollar or more of increased private sector R&D spending. In fact, some have found a $2 benefit in terms of additional R&D spending for each $1 of foregone tax revenue.

Productivity Gains. As the babyboom generation reaches retirement age and the workforce continues to shrink relative to the retired population, the only way that we will achieve continued economic growth is through productivity gains. A PwC study of the R&D credit found that over a 13-year period a permanent R&D credit would induce companies to spend an additional $41 billion more on R&D at 1998 prices. This, in turn, would cause the *annual* productive capacity of the economy to grow $13 billion by the last year. Increases in productivity from R&D spending work much like increases from fixed investment but the payoff is much greater and comes sooner.

Rate of Return. The PwC study of a permanent R&D credit found a remarkable 31 percent annual rate of return from the credit. This is more than twice the typical rate of return from investments in plant or equipment because, unlike plant and equipment investments, the return from R&D has roughly a 2 for 1 spillover benefit for the rest of the economy.

Economic Benefits. Through productivity increases, a permanent R&D credit will stimulate additional growth in the economy. The PwC study found that an additional $58 billion of new goods and services would be added to the economy over a 13-year period at 1998 prices. That increased GDP would be attributed to the following.

• Personal consumption	$33 billion	57 percent
• Residential construction	3 billion	5 percent
• Business investment	12 billion	21 percent
• Net exports	10 billion	17 percent
	$58 billion	100 percent

Incomes. Personal income would be about $11 billion higher annually at the end of a 13-year period, largely as a result of increased wages due to enhanced productivity. The increase in after-tax income for families would be the equivalent of a $5 billion tax cut over 5 years, a $25 billion tax cut over 10 years, and a $47 billion tax cut over 13 years.

Prices. Price reductions of manufactured goods would save consumers nearly $5 billion by the 13th year. Lower prices from productivity gains resulting from increased R&D spending would be particularly great in pharmaceuticals, motor vehicles, chemicals and plastics, and computers and communication equipment.

Trade. Lower prices of domestically produced goods would cause exports of manufactured goods to increase some $5 billion at 1998 levels and imports to drop some $3 billion.

Induced Tax Revenues. Because of the unusually high 31-percent return on R&D investments, the credit actually pays for itself in the long run. On a year-by-year basis, the PwC model shows that 18 percent of the static revenue loss would be recouped by increased taxes from induced economic growth during the first five years of a permanent credit. Thirty-nine percent would be recouped during years six through ten. And 76 percent would be recouped during years eleven through thirteen. In the thirteenth year alone, 81 percent of the current year credit cost would be recouped by reflow tax revenues. Over a longer period, the credit would easily pay for itself.

The ability of the credit to pay for itself can also be demonstrated by example. Consider the following situation.

Step 1.	$1 of credit generates $1 (conservative estimate) of R&D spending.
Step 2.	A 31 percent return produces 31 cents of new productive capacity.
Step 3.	80 percent of that capacity, or 24.8 cents, actually gets into GDP.
Step 4.	The federal government's average marginal tax rate is estimated to be 110 percent of the average rate on GDP, or 22.3 percent during the budget forecast period.
Step 5.	This produces annual new tax revenues of 5.5 cents each year.
Step 6.	Discounted at the government's 2.8 percent real borrowing rate, this is equal to $1.97 of tax revenue in present value terms -- more than enough to offset the initial $1 cost of the credit.

Note: The $1.97 of present value benefits shown in this example is greater than the amount appearing in the study cited above because the government's borrowing rate has declined and the overall effective tax rate on GDP has risen since that study was completed.

Conclusion

We have reached a unique period in our history. At no time in memory have we had a unified budget surplus ready to be returned to the taxpayers responsible for creating it *and*, at the same time, had such a strong economy that a tax cut may not be good medicine. This confluence of conditions creates an unusual opportunity for Congress to enact pro-growth tax measures that may take several years to fully mature and pay dividends. Although the economy may not require immediate attention, we need to make investments that will keep it strong well into the 21st century. Put another way, we need an insurance policy that will kick in two, or three, or even four years down the road when the economic engine may begin to slow down.

This calls for targeted tax measures that will increase innovation and capital investment. Investment in capital will yield the growth in labor productivity that Chairman Greenspan has stated is necessary to continue the recent strong growth in spending "without a pickup in inflation." The R&D tax credit meets the criteria for productivity growth perhaps better than any other measure. Although a permanent R&D credit would immediately create new jobs in the R&D sector, the real benefit down the road is the increase in productivity in all sectors of the economy, including especially those that do no R&D spending.

Similar to all capital investments, the additional R&D spending induced by the credit typically requires a number of years before the full impact on productivity is achieved. Only then will there be a marked increase in real economic growth, taxable personal income and corporate profits.

The R&D credit clearly remains one of the best investment the government can make because it has been proven to more than pay for itself in terms of higher tax revenues generated by increased productivity.

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Counselor

Prepared Statement
of
James C. Miller III
before the
Joint Economic Committee
of the
United States Congress
March 4, 1999

Since serving as Director of the Office of Management and Budget during most of President Reagan's second term, I have been associated with Citizens for a Sound Economy (CSE), a research, education, and advocacy organization with a quarter-million members and supporters.[1] On their behalf as well as mine, I thank you for holding this hearing.[2]

Elected officials have a responsibility to ponder the effects of government policies on the economic welfare of the citizenry. The government does many things that improve economic welfare — protecting the nation's security, identifying and enforcing property rights, establishing and maintaining a reliable currency, and the like. It also does other things, often with good intentions, which diminish economic welfare — wasteful spending, unnecessary regulation, excessive redistribution, and the like. Of particular relevance here is the proportion of the total economy consumed by or accounted for by government. Too little government will stunt yearly production, but too much government will stunt production as well.

Please look at the figure. As the relative size of government (ratio of economic output commanded by government to total output, expressed as a percent) increases,

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[1]Neither CSE nor CSE Foundation receive any money from the Federal government.

[2]I also want to thank Tyrus Cobb, Patrick Fleenor, Scott Moody, and Jerrie Stewart for help in preparing this statement.

total output of goods and services at first rises and then falls. At a stage of anarchy, output is low, but as property rights are secured, as contracts are enforced, and as rights to persons are protected, economic output expands; however, as government (in both relative and absolute terms) grows further, it reduces total output through suffocating regulations, tax policies that blunt incentives, other confiscatory measures, and outright waste. Also, the relative size of government can't increase forever without so penalizing total output that the absolute size of government falls.

In keeping with the available evidence (more on that below), the figure implies that total output tends to peak when government commands approximately 20 percent of that output. By definition (with government at this point a growing fraction of the total), output consumed by the private sector peaks at a lower level of government. And, in keeping with current theory and some limited evidence, resources devoted to government tend to peak at around 45-50 percent of output.

Using U.S. data for the period 1949 to 1989, Gerald Scully found that the growth-maximizing tax rate for the U.S. government would have been 22 percent instead of the observed 35 percent. If this tax rate had prevailed over the period, the rate of economic growth would have been 5.6 percent instead of 3.5 percent; total wealth created would have been \$76.4 trillion instead of \$29.9 trillion; and tax revenue would have been \$17.5 trillion instead of \$13.8 trillion.[3] Scully's conclusions are in accord with similar research based on U.S. data by Peter Grossman, Edgar Peden, and Richard Vedder and Lowell Gallaway.[4]

In a study published last year by your committee, James Gwartney, Robert Lawson, and Randall Halcombe draw similar conclusions, but based their work on the experience of OECD member countries.[5] According to the authors, if the size of U.S.

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[3]Gerald W. Scully, "The 'Growth Tax' in the United States," Public Choice, 1995, pp. 71-80. He found similar results for New Zealand: "Taxation and Economic Growth in New Zealand," Public Policy Review, 1996, pp 1-9.

[4]Peter J. Grossman, "The Optimal Size of Government," Public Choice, 1987, pp. 193-200; Edgar A. Peden, "Productivity in the United States and Its Relationship to Government Activity: An Analysis of 57 Years, 1929-1986," Public Choice, 1991, pp. 153-73; Richard Vedder and Lowell Gallaway, "The Impact of the Welfare State on the American Economy," Joint Economic Committee of the U.S. Congress, December 1995; and Vedder and Gallaway, "Government Size and Economic Growth," Joint Economic Committee of the U.S. Congress, December 1998.

[5]See James Gwartney, Robert Lawson, and Randall Holcombe, "The Size and Functions of Government and Economic Growth," Joint Economic Committee of the U.S. Congress, April 1998.

government (relative to GDP) had remained the same as in 1960, real GDP in 1998 would have been 20 percent greater. Also, if non-defense expenditures had remained at the same level (relative to GDP) in 1960 and defense expenditures had continued to decrease (relative to GDP), real output would have been 40 percent greater in 1996.[6]

The federal government acquires command over resources in one of four ways. First, it can tax and spend, the usual way. Second, it can borrow and spend. Third, it can "print money," or simply inflate. And fourth, it can conscript resources through regulation. At present, the federal government is running a surplus, not a deficit, and inflation is very low. But, the annual cost of federal (not to mention state and local) regulation is quite high, with estimates by Thomas Hopkins and others now reaching toward three-quarters of a trillion dollars.[7]

The degree of freedom government allows the private sector matters a great deal. For example, in a study published by the Heritage Foundation and the Wall Street Journal, Bryan Johnson, Kim Holmes, and Melanie Kirkpatrick found a strong *positive* relationship between the degree of economic freedom in a country and that country's rate of economic growth. For example, they found that long-run average annual per-capita economic growth was 2.88 percent for countries whose economies are "free," 0.97 percent for those whose economies are "mostly free," -0.32 percent for those whose economies are "mostly unfree," and -1.44 percent for those whose economies are "repressed."[8] They also found a positive relationship between the

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[6]Ibid., pp. 15-6. Richard Rahn, Harrison Fox, and Lynn Fox analyzed a variety of developed countries and concluded from this international comparison that the growth-maximizing size of government is much lower -- on the order of 10 percent of GDP. (See Richard W. Rahn, Harrison W. Fox, and Lynn H. Fox, "Economic Growth and the Optimal Size of Central Government," Rockville, MD, Citizens for Budget Reform, April 13, 1997.) A few other scholars found contrary results, concluding that the optimal size of government might well be larger. (See, for example, Rati Ram, "Government Size and Economic Growth: A New Framework and Some Evidence from Coss-Section and Time-Series Data," American Economic Review, March 1986, pp. 191-203.)

[7]Thomas D. Hopkins, "Regulatory Costs in Profile," Center for the Study of American Business, Washington University in St. Louis, August 1996. Similar results were found by John F. Morrall. (See U.S. Office of Management and Budget, Report to Congress on the Costs and Benefits of Federal Regulation, 1997.)

[8]Bryan T. Johnson, Kim R. Holmes, and Melanie Kirkpatrick, 1999 Index of Economic Freedom, (Washington: Heritage Foundation, 1999), p. 10. A study by Gwartney and Lawson came to similar conclusions. See James Gwartney and Robert Lawson, Economic Freedom of the World 1997 Annual Report, Vancouver, B.C.,

degree of economic freedom a country gives to its private sector and the wealth of its citizens.[9] Gerald Scully, mentioned earlier, found that in societies with free and open political systems the standard of living (per capita income) rises (on average) 2.53 percent per year vs. 1.41 percent for those that don't. In those societies that have a basic rule of law, the standard of living rises 2.75 percent per year vs. 1.23 percent for those that don't. In societies that recognize property rights, the standard of living rises 2.76 percent per year vs. 1.10 percent for those that don't. And finally, in those societies that have all three attributes, the standard of living rises on average 2.73 percent vs. 0.91 percent for those lacking these attributes.[10] Herbert Grubel found that among OECD countries greater economic freedom leads to lower unemployment, higher life expectancy at birth, higher adult literacy, and lower poverty; he also found that redistribution of income had a negative effective on per-capita income.[11]

Suffice it to say that federal tax (as well as regulatory) policies have a significant effect on the economy, and that the preponderance of the evidence is that taxes are far too high, in the sense of imposing a significant brake on economic growth. So, the first lesson is that the federal government should tax less. How should it do that? Should it simply reduce taxes across the board? Reduce certain taxes and not others? Some combination?

I will be more than happy to respond to your questions on this, but let me say with all due respect that the time has long since passed when we can cobble together a package to revise the current tax code and make any sense out of the result. Rather, we must scrap the current tax code and start all over.

What would a suitable replacement tax code look like? Let me suggest a few principles.

First, the purpose of the tax code should be to raise the money the government needs to operate — no more, no less;

Fraser Institute, 1997.

[9] Ibid., p. xxix.

[10] Gerald W. Scully, "The Institutional Framework and Economic Development," Journal of Political Economy, 1988, pp. 653-62. Also, see Scully's Constitutional Environments and Economic Growth (Princeton: Princeton University Press, 1992) and Zane A. Spindles, "Liberty and Development: A Further Empirical Analysis," Public Choice, 1991, pp. 197-210.

[11] Herbert G. Grubel, "Economic Freedom and Human Welfare: Some Empirical Findings," CATO Journal, Fall 1998, pp. 287-304.

Second, the tax code should minimize collection costs — actually, the sum of the collection costs experienced by the private and public sectors;

Third, the code should minimize the microeconomic "distortion costs" associated with tax avoidance;

Fourth, the code should minimize macroeconomic "growth costs" — for example, should not penalize saving and investment;

Fifth, the code should be capable of being well understood by taxpayers;

Sixth, the code should be considered fair, both horizontally and vertically; and

Seventh, the code should make plain to voters the true costs of government.

No tax proposal to my knowledge meets all of these requirements in every particular, so it would appear that some tradeoffs would be required. But truly, either of the widely-discussed flat tax proposals on income or consumption would rank near perfection when compared with the hodge-podge of provisions incorporated in the present Internal Revenue Code.

Finally, let me say a few words about how we get from here to there. My point is that language and predicate matter, and they matter a lot. Whoever determines the way a tax proposal is discussed often determines the outcome. When kids play football at the local vacant lot, the owner of the football usually has more to say about the rules of engagement than anyone else. I've heard Congressman John Dingell say that given the choice between establishing the goals of a regulatory law and establishing the process through which the regulations will be promulgated, he'll choose the latter every time. He who brings to the table the agenda for a meeting has an inordinate effect on the outcome. And who can be opposed to a "fair deal," to a "great society," to "anti-discrimination laws," to a "new frontier," and to a "progressive tax?" My point is that the side of the argument that determines the language used to describe a proposal and addresses the arguments on their own turf has a substantial advantage. And so far in this debate, the side opposing tax relief has had such an advantage. Let me illustrate.

Within the Washington Beltway and among the commentators, the immediate response to any proposal for a tax cut is, "What will it cost?" This is government-centric language. The predicate embodied in both the Declaration of Independence and the U.S. Constitution are the opposite: "We the People" (and the States) grant the federal government certain limited powers. It's our money, not the federal government's. To the government a tax cut may be a "cost," but to the people it's a benefit. As Amity Shlaes has argued we should view tax revenue as what government takes from us, not what government rightfully owns.[12]

The debate over the redistributional consequences of a tax cut are subject to the same capture of language and perspective. It is customary to characterize a tax cut as "rewarding" certain groups or income classes and not rewarding others as much if at all. That kind of rhetoric is very effective in defeating almost any tax-cut proposal. Why? Because it's the rich who pay the vast majority of the taxes on income. According to the Tax Foundation, the top 1 percent of taxpayers pay nearly a third of all federal income taxes collected, and the top 10 percent pay nearly two-thirds.[13] If you rob a rich Peter to pay a poor Paul, get caught, and have to make restitution, then all the "benefits" go to Peter, who is rich. But Peter never should have been robbed in the first place.

It's often pointed out that federal tax revenue as a proportion of GDP is "only" 20 percent or so, and that this figure is smaller than in many other developed countries. Yet, federal tax revenue as a proportion of GDP is higher today than at any time since World War II. More importantly, let's go back to the perspective outlined in the Declaration and the Constitution: why should we be giving the government more in tax revenue almost each and every year? Why can't we keep the extra money we earn? Does the government really need so much more? Isn't the Cold War over, enabling some reduction from pre-war levels? (In my judgement, of course, defense spending has been cut to dangerous levels.) And with the economy in such good shape, you'd think there would be far less need for spending on the safety net.

Yet, as shown in Table 1, since 1980 the overall tax burden per capita has risen 177 percent in nominal terms, and 48 percent in real terms. Moreover, the argument that U.S. tax revenue as a percent of GDP is lower than in many developed countries is of little solace. As Table 2 shows, the contribution made by American citizens to their government on average exceeds the per-capita payments by citizens in every other member of the OECD, save tiny Luxembourg.

The facts and evidence are clear. The government is too large. The tax code is an abomination. Taxpayers bear far too heavy a burden.

We owe it to our progeny to fix this mess.

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[12]See Amity Shlaes, "The Greedy Hand," Wall Street Journal, February 25, 1999, p. A18 — an article based on her new book, The Greedy Hand: How Taxes Drive Americans Crazy and What to Do About It (New York: Random House, 1999).

[13]See Patrick Fleenor, "Top Five Percent of Taxpayers Pay over Half of Total Federal Individual Income Taxes," Tax Foundation, November 1998.

Economic Output vs. Relative Size of Government

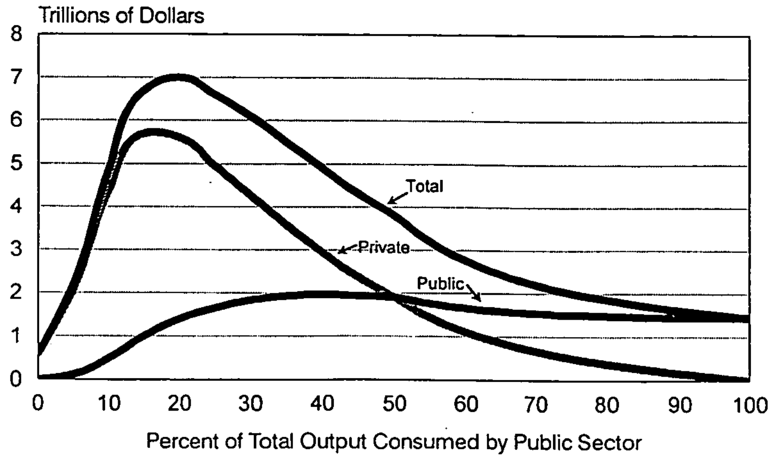

Table 1: U.S. Tax Receipts Per Capita

Calendar Year	In Nominal Dollars Total	Federal	State/Local	In Real Dollars (1998) Total	Federal	State/Local
1980	3,682	2,479	1,595	6,885	4,635	2,983
1981	4,150	2,830	1,703	7,092	4,836	2,911
1982	4,194	2,790	1,765	6,742	4,486	2,865
1983	4,400	2,874	1,897	6,784	4,431	2,981
1984	4,853	3,167	2,086	7,211	4,706	3,186
1985	5,210	3,410	2,222	7,485	4,898	3,192
1986	5,468	3,540	2,376	7,655	4,956	3,327
1987	5,900	3,869	2,455	8,013	5,255	3,335
1988	6,206	4,079	2,582	8,132	5,344	3,384
1989	6,653	4,373	2,759	8,365	5,498	3,469
1990	6,921	4,529	2,922	8,342	5,459	3,522
1991	7,059	4,557	3,110	8,183	5,283	3,605
1992	7,336	4,700	3,311	8,275	5,302	3,735
1993	7,696	4,947	3,470	8,459	5,437	3,814
1994	8,163	5,282	3,647	8,762	5,670	3,915
1995	8,548	5,558	3,797	8,969	5,831	3,984
1996	9,092	5,976	3,941	9,364	6,155	4,060
1997	9,674	6,426	4,089	9,782	6,498	4,134
1998e	10,213	6,857	4,208	10,213	6,857	4,208

Note: Federal plus state/local figures do not add to total figures because state/local figures include transfers from the federal government.

Source: Scott Moody, Facts and Figures on Government Finance, 33rd Edition (Washington: Tax Foundation, forthcoming).

Table 2: Tax Revenue Per Capita, OECD Countries, 1996

Country	GDP Per Capita (at Purchasing Power Parities)	Tax Revenue As Percentage of GDP	Tax Revenue Per Capita
Luxembourg	32,416	44.7	10,081
United States	27,821	28.5	8,652
Switzerland	25,402	34.7	7,900
Norway	24,364	41.1	7,577
Iceland	23,242	32.3	7,228
Japan	23,235	28.4	7,226
Denmark	22,418	52.2	6,972
Belgium	21,856	46.0	6,797
Canada	21,529	36.8	6,696
Austria	21,395	44.0	6,654
Germany	21,200	38.1	6,593
Netherlands	20,905	43.3	6,501
France	20,533	45.7	6,386
Australia	20,376	31.1	6,337
Italy	19,974	43.2	6,212
Sweden	19,258	52.0	5,989
Ireland	18,988	33.7	5,905
Finland	18,871	48.2	5,869
United Kingdom	18,636	38.0	5,796
New Zealand	17,473	35.8	5,434
Spain	14,954	33.7	4,651
Korea	13,580	23.2	4,223
Portugal	13,100	34.9	4,074
Greece	12,743	40.6	3,963
Mexico	7,776	16.3	2,418
Turkey	6,114	25.4	1,901
Poland	N/A	42.1	N/A
Hungary	N/A	40.3	N/A
Czech Republic	N/A	40.5	N/A

Source: Organization for Economic Cooperation and Development.

TESTIMONY ON TAXATION BEFORE THE JOINT ECONOMIC COMMITTEE

BY WAYNE D. ANGELL

MARCH 4, 1999

I am delighted to have the opportunity to testify before the Joint Economic Committee on the subject of tax policy. The good news at the present time is that the United States economy is currently shielded from economic problems abroad by an extraordinary combination of near perfect monetary policy and a "New Era" economy that generates rising profits and a soaring equity market. The bad news is that, in my opinion, without an increase in our national savings rate, the growing reliance of the U.S. economy on foreign capital could prove to be a significant problem down the road.

The performance of an economy is very dependent on the incentives to work, save, and invest. When some of these productive activities are taxed more heavily than are others people will alter their behavior so as to minimize their tax bill, thus diminishing the performance and efficiency of the U.S economy.

Tax rates are critical

Tax *rates* play a critical role in determining incentives. The current tax system heavily penalizes saving versus consumption, and it should not come as a surprise that savings rates in the U.S. are low. With low domestic savings rates, the U.S. is forced to rely more heavily on the willingness of foreigners to finance our capital spending.

In effect, high tax rates on saving and low tax rates on consumer spending is a public tax policy choice guaranteed to lead to a balance of trade deficit and an inflow of capital from abroad. This inflow obligates the U.S. to future interest, dividend, and profit payments that further increases the external indebtedness of the nation.

As the U.S. increasingly comes to rely on foreign capital, there would be a tendency for interest rates to rise here relative to abroad. Such a situation can already be seen in sovereign credit markets. The yield on 10-year U.S. government bonds, at around 5.4%, is higher than Germany's 4.1% or Japan's 1.9%. Eventually such an international disparity in interest rates would tend to choke off capital spending in the high interest rate country leading to an economic slowdown.

Changes in tax rates and the growth rate of government spending in the 1980s and 1990s

In recent years, most of the numerous changes to the tax system have had a detrimental impact on economic incentives. Fortunately, the negative impact of these tax changes has been more than offset by the beneficial decline in the rate of inflation from 4 percent to 1 percent, the reduction in the capital gains tax rate to 20%, the reduction in the ratio of government spending to GDP, and significant steps toward freer trade, all of which have made our economy more efficient.

Unfortunately, the tax rate changes of the 1990s did not increase national saving. Increasing marginal income tax rates of high-income/high-saving households simply transferred the savings from the household to government sector. We persist in following the mistaken notion that we can rely on high marginal tax rate increases as a means of increasing tax receipts without any adverse effect on the saving rate. Without a huge inflow of foreign saving, interest rates in the U.S. would necessarily have to rise until the after-tax, after-inflation rate of return on saving motivated more savings or choked off capital spending. It seems very appropriate that we consider ways to improve our tax system while we are still in the lee of the currency devaluation storm that has sent world savings to our capital market.

Accounting for the recent economic performance of the United States

First, real government spending as a proportion of real GDP has declined from 20.7 percent in 1990 to 17.1 percent in the fourth quarter of 1998. This reduction in the use of real productive resources by government has freed up scarce resources and has been the sole source of the increase in the national savings rate from 14.5 to 17.5 percent in the 1990s.

Second, the impact of higher tax rates on personal incomes has been offset by a much larger reduction in the inflation-adjusted tax rate on capital gains. The decline in the inflation-adjusted capital gains tax rate has come about from a reduction in the statutory tax rate from 28% to 20% and a fall in inflation expectations in recent years from about 4% to about 1%. As a consequence, I estimate that the effective tax rate on real capital gains has fallen from around 56% in the early 1990s to around 27% at the present time.

The decline in the capital gains tax rate has unleashed an investment boom that has raised the share of nonresidential fixed investment in real GDP to a post-war record high of 12.7% last year from an average share of 9.2% in the early 1990s. In addition, rapid technological innovations in computers and the internet have raised the rate of return on capital, further boosting investment spending. Thus, despite the increase in top income tax rates in 1993, economic growth has averaged 4.0% per year over the last three years as the growth in real business equipment spending has averaged a 20-year high 14.0%.

Third, NAFTA and other trade initiatives have acted as a tax rate cut stimulating international trade growth 50 percent faster than the growth of domestic output in the last eight years. Exports have grown as a percent of GDP from 9.4 percent in 1990 to 13.2 percent in 1998.

Finally, the decline in the inflation rate to near negligible proportions has added to the efficiency of the economy in addition to cutting the effective capital gains tax rate. Price stability is interpreted by corporate CEOs as their businesses not having pricing power and that has been a major driving force in the use of capital goods to achieve sustainable increases in labor productivity and economic growth. Additionally, the price mechanism allocates resources more efficiently as stable prices make it easier to identify a change in relative prices between goods and services. When inflation is higher, a relative price change might be mistaken as a move in the general price level.

Under-saving and balance of trade problem

The boom in capital spending has outstripped the increase in national savings generated by the lower growth rate of real government spending, in turn boosting the U.S. trade deficit. Meanwhile, the decline in inflation expectations has raised U.S. equity price/earnings ratios and increased household wealth, consumer spending, and imports, since the major motive for individuals to save is to increase their economic wealth and the rise in wealth from equity ownership has probably lowered the propensity to save.

In addition, an economy entering the ninth year of expansion with no recession in sight has reduced the precautionary need for savings by households and corporations. The motive to save for a rainy day is lessened if the likelihood of rain is diminished.

In the 1970s our economy was mired in an economic stagnation brought about by high statutory marginal tax rates made even worse by the effect of double digit inflation on the real capital gains tax rate. Now we are plagued by a tax system that accentuates both our under-saving and our balance of trade problems.

The income tax system is the problem

Our income tax system burdens U.S. exports with a high portion of the full cost of government. This burden includes some of the social security and medicare payroll taxes, the proportion of our individual income tax on wages and salaries that is passed backward to the employer, and the proportion of our corporate income tax that corporations include in the prices of the products they sell. Then foreign governments add part of their cost of government directly on to our exports through a value added tax.

On the other hand, imports arrive on our shores priced after the value added tax abroad has been rebated. Unlike countries with value added tax systems, the United States does not add-on our cost of government to the price of imported goods, thus potentially putting U.S. goods for sale in the U.S. at a disadvantage versus foreign goods.

Our income tax system not only taxes value added, but effectively double taxes income earned from production that is not consumed through the yearly taxation of compound interest. Our choice to tax corporate income passed on to individuals by both the corporate and personal income tax effectively curtails the incentive to save. The following table shows in detail the combined penalty tax rates applied to corporate income passed through to individuals by dividends (at 45 to 61 percent) and by corporate stock buy-backs (at 45 to 48 percent) compared to interest payments, which are taxed at between 15% and 40%.

Corporate	Individual Income Tax Rates					Cap gain	average
35.0%	40.4%	39.6%	36.0%	28.0%	15.0%	20.0%	31.8%
Interest	40.4%	39.6%	36.0%	28.0%	15.0%	15.0%	31.8%
Dividends	61.3%	60.7%	58.4%	53.2%	44.8%		55.7%
Cap gains	48.0%	48.0%	48.0%	48.0%	44.8%		47.4%

Rather than meddling with the current complex tax code, why not reform the tax system?

Would providing for a 75 percent exclusion of dividends from individual taxation, a further reduction in the capital gains tax rates from 20 to 10 percent and from 15 to 7.5 percent make much difference? Yes, it would make an enormous difference to reform the tax on equity income passthroughs to individuals so that corporate debt versus common stock issue advantage was leveled. Corporations would no longer have a tax motive to issue debt. Corporate balance sheets would be strengthened and the corporate default risk to the economy would be lessened. Such a change would make an enormous difference in the efficiency of corporate finance and economic growth, and it would somewhat improve the national savings rate.

Would a 10 percent across-the-board reduction in marginal tax rates on individual income, the alternative minimum tax rate, and on corporate income tax make a difference? Yes, such a reduction in marginal tax rates would undoubtedly further brighten our growth prospects by continuing the acceleration of capital formation and labor productivity. I believe that the national savings rate would rise as a result, but not necessarily rise faster than capital spending. Our national under-saving problem would not be solved.

Even after these changes in the existing tax system, we would still have a very complex tax system that would continue to exact high compliance costs on our government, corporations, and individuals. And we would have a tax system that would continue to be susceptible to the same income redistribution attempts that has taken our tax code in the wrong direction during the 1990s. But, most importantly, these changes would not solve our interrelated twin problems of under-saving and the persistent balance of trade deficit.

We need to replace our income based tax system with a national retail sales tax

I favor the proposal of Americans For Fair Taxation to adopt a national retail sales tax in place of all taxes based on income (the regressive social security payroll tax, the personal income tax, the corporate income tax, and the inheritance tax). For the record, I enter my article *"Tax Americana: The 23 Percent Solution,"* (February 2, 1998). Only by turning to a tax system that considers the amount of benefit that an individual or family take from the economy rather than the amount of capital and labor they contribute, as the tax base can we make the necessary reforms to the tax system.

For our society it is time to recognize a basic postulate of economics: *when an activity is taxed more heavily people will choose to do less of it.* It is time to stop taxing people for what they put into the economy (working, organizing production, saving, and investing). It is time to start taxing people based on what they take out (consuming and using resources). A sales tax recognizes that the amount of saving determines who is rich and who is poor. The farmer or businesswoman who works long hours, and saves a high proportion of income in order to buy enough machinery, office or land to succeed during tough times are the real contributors to our economic well being. Their consumer spending is often modest, yet they frequently die with million dollar estates. Should they be taxed on their income or on their consumption? Yet their heirs may expend very little effort on work and lots of effort on spending. Which activity should we discourage through taxation?

The proposed national retail sales tax is fair. It proposes a monthly rebate of 23 percent of the amount of consumer spending that takes each individual and family to the top of the poverty line. At that level of income and spending federal taxes paid would net out after rebate at zero. Corporate spending on final goods that provide enjoyment to corporate executives and other workers would be taxed at 23 percent with no rebate. New houses and some business final capital spending would be taxed at 23 percent.

The transition to the proposed national retail sales tax would require the Fed to monitor whether the growth slowdown from increased savings effects were running ahead or behind of the growth stimulus from rapid improvement in net exports. The FOMC would likely need to lower the funds rate toward a 2 to 2.5 percent range. My preference would be for the FOMC to monitor price level indicators, such as the price of gold, as more reliable than economic growth indicators as to how rapidly to lower interest rates. I would also prefer that the FOMC maintain a slight bias toward restraint on the price level in order that the embedded income type taxes in costs should come out of prices rather than the 23 percent sales tax being added on to current costs.

My recommendation is that the Joint Economic Committee seriously considers this proposal along with other proposals brought before you. No other proposal has the potential boost economic growth in the U.S. while reducing the dependency on overseas savings.

THE GLOBAL SPECTATOR

ECONOMICS DEPT

February 2, 1998

Tax Americana: The 23 Percent Solution

By Wayne Angell

BEAR STEARNS

Our tax code continues to become more complex even as political leaders in both parties espouse tax simplification. This complexity breeds problems with enforcement, as was abundantly documented in Senate hearings last fall in which Americans from all walks of life vented their frustration with and distrust of the Internal Revenue Service. Is it any wonder that taxpayers are fed up with a system that assesses more than 34 million civil penalties a year -- one for nearly every four households?

The income tax, a creature of the 20th century, has proven to be a deeply flawed system that punishes savings and rewards those who can successfully "game" the system by exploiting its complexities to avoid paying taxes. The question is no longer whether to alter our tax system but how to alter it. Fortunately, a national debate over serious tax reform is beginning, with a variety of proposals being put forward.

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To be politically viable and economically credible, any tax reform plan must be simple and fair. After analyzing the various proposals put forward, I strongly believe the best approach is a federal sales tax that completely replaces all federal income taxes and payroll taxes -- leaving the American worker with his or her full paycheck every payday.

This proposal, which its proponents call the Fair Tax, will abolish the payroll tax, by far the most regressive feature of our current system. It will abolish the IRS, all individual tax forms and audits, and eliminate 90 percent of the $225 billion in compliance that Americans now pay. Instead, the federal government would

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raise revenue by establishing a national sales tax of 23 percent on all new goods and services at the point of final purchase. There would also be a universal monthly rebate equal to taxes paid on the purchase of necessities.

The Fair Tax is the result of two years and more that $1 million worth of economic research conducted by leading economists such as Dale Jorgenson of MIT, Joseph Kahn at Stanford University and Gilbert Metcalf at Tufts University. Their research addresses some of the questions that will be raised by such a bold idea.

The 23 percent figure was chosen because it would raise roughly the same amount of money that all our federal taxes raise today -- ensuring that government services would be funded at the same levels as they are today.

That rate may seem high at first blush. But remember, all the taxes that artificially inflate the prices of goods and services -- primarily, the corporate income tax and payroll taxes -- will be removed because the current tax code will be scrapped. The economists' research shows that prices paid under the Fair Tax will be no higher -- and may actually be lower -- than the prices paid for goods and services today, even with the Fair Tax included. This means that a mom who goes to the supermarket to buy a six-pack of soda would end up paying about the same amount in total price as she does today -- only she would have her full paycheck to spend.

Economists say that because the Fair Tax repeals all payroll taxes and provides a rebate, it would be as progressive as the current graduated income tax. In 1997, under present law, a family of four with an income of just $16,050 pays a minimum of 7.7 percent of its income in federal taxes. Under the Fair Tax, the family would get a rebate determined by the government's poverty level multiplied by a tax rate that would cover the taxes paid on necessities. The family would effectively pay no federal taxes at all.

Today, families earning $32,100 pay 14.5 percent of their federal income and payroll taxes, but because of the rebate under the Fair Tax, they would pay only 11.5 percent if they spent all of their income, less than 11.5 percent if they saved some of their income.

Well-to-do families might pay more or less than they do now, depending on their behavior. Households that take advantage of loopholes and deductions to pay little tax today and who spend a large portion of their income would most likely pay more under the Fair Tax system. A wealthy family that does not game the current system, spends frugally and invests most of its money would pay less.

Then there are the larger economic benefits. Once Americans are free to keep every dollar they earn, they will be able to save more and businesses will be able to invest more. Capital formation, the real source of job creation and innovation, will be facilitated.

According to Lawrence Kotlikoff, an economist at Boston University, the Fair Tax will raise the economy's capital stock (the value of equipment and buildings) by 42 percent, its labor supply by 4 percent, its output by 12 percent and real wages by 8 percent. Additionally, U.S. producers will no longer be penalized at the expense of foreign competition. Right now, all the various federal taxes increase the total cost of products by an estimated 20 percent to 30 percent. U.S. producers will know that the same 23 percent tax rate charged on their sales will also be charged on their competitor's imported products.

Finally, the Fair Tax will lower compliance costs by an estimated 95 percent, holding prices down.

The Fair Tax plan involves three specific actions necessary for serious, meaningful, tax reform: (1) passage of legislation that repeals the income tax, all payroll taxes, the estate and gift tax, capital gains taxes, self-employment taxes and the corporate tax; (2) passage of legislation that installs a single rate national sales tax; (3) adoption of a constitutional amendment that would repeal the 16th Amendment and make the taxation of income unlawful.

These are big steps, but the radical simplicity of the Fair Tax makes them worth taking. Every taxpayer will be subject to the same sales tax rate with no exceptions and no exclusions; but those least able to share in the cost of government will carry no federal tax burden at all. While there is general agreement that the current system must go, we must be sure to replace it with a just tax system that will give America the competitive edge in the 21st century and beyond. The Fair Tax will do just that.

Tax Cuts at the State Level: Lessons for Washington?

March 1999

Joint Economic Committee Staff Report
Office of the Chairman, Senator Connie Mack

This staff report expresses the views of the author only. These views do not necessarily reflect those of the Joint Economic Committee, its Chairman, Vice Chairman, or any of its Members.

Tax Cuts at the State Level: Lessons for Washington?

As the President and Congress consider options for the fiscal 2000 budget, they face the unusual situation of deciding what to do with large and growing budget surpluses. Federal legislators may wish to follow the lead of state legislators who have been handing back a portion of surplus state funds to taxpayers each year since 1994. The states have delivered a net tax cut of over $22 billion during the past five years (1994-1998), and many are considering further cuts in 1999.

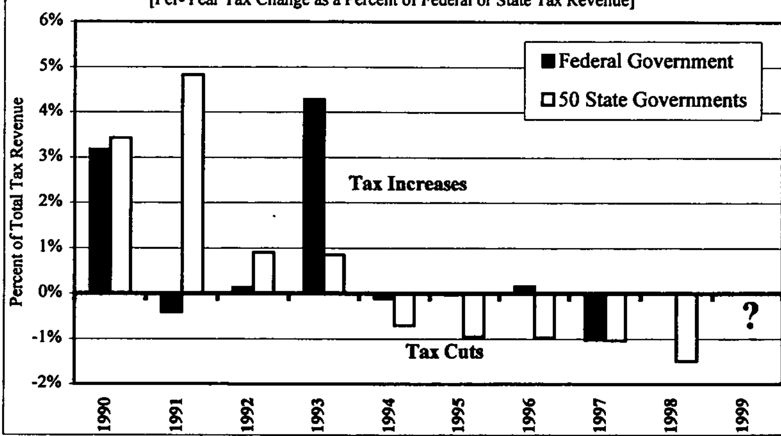
Both federal and state budgets have benefited from strong economic growth as tax revenues have risen along with growth in personal income, consumption, and business profits. Federal revenues have grown particularly quickly because the largest federal revenue source – the income tax – tends to grow faster during economic expansions than the largest state revenue source – the sales tax. As such, it is striking that states have provided larger tax cuts recently than the federal government, despite receiving a smaller revenue windfall from economic growth.

Five Years of Tax Cuts at the State Level

During the early 1990s, the federal government and many state governments raised tax rates in an attempt to close large budget gaps. But since 1994, state governments have reversed course and enacted net tax cuts five years in a row (1994-98), according to figures from the National Association of State Budget Officers.[1] See Figure 1.

Figure 1: Revenue Effects of Enacted Tax Changes

[Per-Year Tax Change as a Percent of Federal or State Tax Revenue]



Note: State figures are first-year revenue changes as a percent of total state tax revenue; federal figures are the average per-year revenue change during the first five years, as a percent of federal tax revenue.
Sources: CBO and NASBO.

In order to compare federal and state tax changes, tax increases and cuts in Figure 1 are scaled to the size of total federal or state tax revenues, respectively. Note that these are changes in tax revenue due only to legislated changes in tax law, not changes in tax revenue due to economic growth or other factors.[2]

The 1998 state tax cut (effective for fiscal 1999) totaled over $7 billion, or 1.5 percent of total state tax revenue. If the federal government were to enact a tax cut of a similar relative size (1.5 percent of federal tax revenue) it would total about $25 billion per year, or about $125 billion over five years.

Congress did enact a significant tax cut package in 1997 which included the $500 per-child tax credit. The 1997 tax cut was estimated by the Joint Committee on Taxation to reduce taxes by an average of $16 billion per year during 1998-2002.[3] The tax cut represented about one percent of annual federal tax revenues. In contrast, the states have cut taxes by about one percent of total state revenue - every year during the past four years, and yet they are still running large budget surpluses.

States Consider Further Tax Cuts in 1999

More tax cuts may be on the way for state taxpayers in 1999. The Center for the Study of the States noted in a recent report that states will likely continue the "pattern of widespread tax cutting" in 1999.[4] While substantial budget surpluses in many states are being kept in "rainy day" funds, many states think that there is room for both a prudent build-up of state surpluses and the return of a portion of excess revenues to taxpayers.

The National Conference of State Legislatures (NCSL) notes that tax cuts are being considered in over 30 states this year.[5] One state fiscal expert estimates that state tax cuts being considered this year have a combined value of at least $5 billion.[6] Such cuts would come on top of last year's tax cuts in 36 states amounting to over $7 billion per-year of net tax relief.[7]

State tax cuts in recent years have been primarily aimed at reducing personal income taxes. Personal income tax cuts have come in a variety of forms including increasing deductions and personal exemptions, and lowering tax rates. For example, the average top state personal income tax rate has fallen slightly from 6.2 percent in 1993 to 5.9 percent in 1999.[8]

Here are some of the largest state tax cuts currently being proposed by Governors across the country:

Colorado: In his State of the State address, freshman Governor Bill Owens proposed reducing the individual income tax rate from 5.0 percent to 4.75 percent, exempting a portion of investment income from the income tax, and other tax reductions to save Colorado taxpayers $575 million.

Florida: Governor Jeb Bush has introduced a $1.2 billion tax cut package for the Florida legislature to consider in 1999. His proposals include a $480 million reduction in property taxes, a $376 million one-time rebate to utility customers, a $182 million cut in unemployment insurance premiums, and a $178 million tax cut for investment income.

Massachusetts: Governor Paul Cellucci will try this year to pass an individual income tax cut that will drop the tax rate from 5.95 percent to 5.0 percent. This reduction would come on top of substantial prior year cuts including last year's record $1 billion tax reduction.

Michigan: Governor John Engler has introduced a plan to reduce the state's individual income tax rate from 4.4 percent to 3.9 percent phased in over five years, eventually saving Michigan taxpayers about $1 billion per year. The tax cut would be the largest reduction to date under Governor Engler.

Minnesota: Governor Jesse Ventura has proposed a $1.1 billion sales tax cut under which the average family would receive a $775 sales tax rebate in 1999. He has also proposed a $1.6 billion phased-in income tax reduction which includes elimination of the marriage penalty and cutting the bottom individual income tax rate.

New Jersey: Governor Christine Todd Whitman has proposed that state money be used to reduce local property taxes over the next five years. When fully phased-in, the tax reduction for New Jersey property owners will be about $1 billion per year. Whitman has gained a tax-cutting reputation by cutting individual income taxes 30 percent during her first few years in office.

Pennsylvania: Governor Tom Ridge has proposed the largest tax cut ever by a Pennsylvania Governor. His budget plan calls for $273 million of reductions, including cuts to the business stock and franchise tax, and the corporate income tax. There is support in the state legislature to provide cuts to the personal income tax as well.

Texas: In his 1999 State of the State speech, Governor George W. Bush has proposed the largest tax cut in state history. The plan would cut property taxes by $2 billion, sales taxes by $330 million, and various business taxes by $307 million.

Wisconsin: Governor Tommy Thompson has proposed cutting state personal income taxes 10 percent over five years and providing state taxpayers with property tax relief. The income tax cut would increase the standard deduction and personal exemptions, and adjust personal income tax rates.

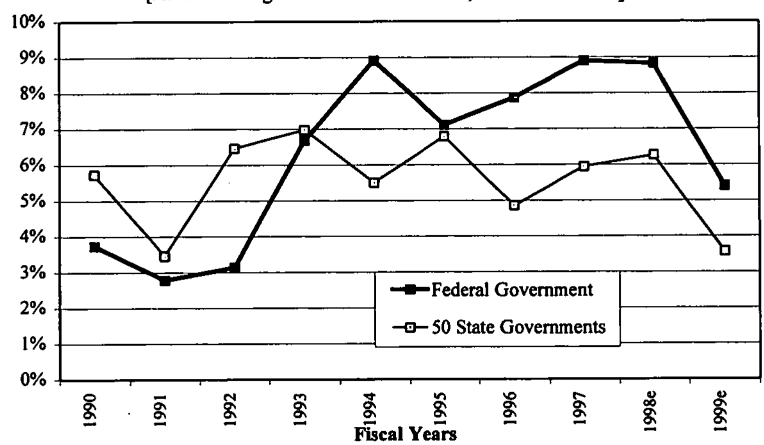
Federal Tax Revenue Growth Outpaces the States During the 1990s

Widespread state tax cuts have been facilitated by the strong economic growth experienced by most states during the late 1990s. Economic growth tends to push up taxpayers' incomes, thus boosting income tax collections. Higher incomes also increase consumption spending, thus filling state government coffers with higher sales and excise tax revenues.

Strong economic growth has resulted in high federal tax revenue growth as well. In fact, federal tax revenue growth has exceeded state tax revenue growth every year since 1994, as shown in Figure 2. Federal tax revenues have grown at an annual average rate of 7.8 percent during fiscal 1994-1999, compared to 5.5 percent for the 50 state governments considered together.[9]

Figure 2: Growth in Federal and State Tax Revenue

[Annual Change in Total Tax Revenue; Nominal Dollars]



Note: the state growth rate for 1999 is estimated based on NASBO projections.
Source: JEC calculations based on data from the CBO, NASBO, and the U.S. Bureau of Census.

Considering the large windfall of tax revenue that has swelled the federal budget in recent years, it is striking that larger federal tax cuts have not been enacted. State governments have received a smaller revenue windfall from strong economic growth, but have managed to provide relatively larger tax cuts than the federal government since 1994.

Income and Sales Tax Growth

The divergence in tax revenue growth rates between the federal and state governments is partly explained by the relatively larger tax cuts enacted at the state level, as discussed above.[10] The differing revenue growth rates are also attributed to the different mix of tax sources that fund the federal and state governments. Put simply, the largest federal revenue source – income taxes – have grown much faster since 1994 than the largest state government revenue source – sales taxes.

Table 1 compares the federal and state governments with respect to the relative reliance on various tax sources. Personal and corporate income taxes represent 59 percent of federal tax revenues, but 40 percent of state tax revenues. Sales taxes provide 49 percent of state tax revenues, but just 4 percent of federal tax revenues.

Table 1: Sources of Federal and State Tax Revenue, 1997

Tax Source	Federal	State
Income Taxes	59%	40%
Sales and Excise Taxes	4%	49%
Payroll Taxes (OASDI and HI)	34%	0%
Other	3%	12%
Total	100%	100%

Source: OMB and the Bureau of Census.

Sales and excise taxes tend to grow at about the same rate as growth in economic output, whereas income taxes tend to grow faster than economic output during expansions. For example, federal income taxes grew at an average annual 9 percent rate between 1994 and 1999, compared to federal excise taxes which grew at 6 percent.[11] [12]

One important implication of this tendency is that governments which rely heavily on a progressive income tax system will tend to grow larger over time, relative to the size of the economy. As a consequence, recent economic growth has contributed to pushing federal revenues up to 20.7 percent of GDP in fiscal 1999, the highest level since World War II.

The tendency for federal tax revenues to run ahead of underlying economic growth suggests that a budgetary mechanism to return excess revenues to taxpayers should be considered at the federal level. Two dozen state governments have either statutory or constitutional tax and/or expenditure limitations (TELs) that could be examined as models to solve this federal budgetary problem.

Is It Time For a Federal Tax or Expenditure Limitation?

There has been continued interest in recent years in creating new mechanisms to ensure fiscal discipline in federal budget-making. For example, there have been a number of recent drives to enact a federal Balanced Budget Amendment (BBA), most recently an unsuccessful Senate vote in 1997. Implementation of a federal BBA would follow the practice of 48 state governments which currently operate under either statutory or constitutional requirements to balance their budgets.[13]

With the federal budget now in balance and tax revenues growing quickly, the focus could shift instead towards limiting the overall size or growth of the federal government through a tax or expenditure limitation (TEL). After all, it is the overall level of government expenditures which indicates the total resources being drained from the private sector, regardless of whether or not the resources come from taxation or borrowing.

Currently, over two dozen state governments operate under some form of TEL. Table 2 shows that TELs come under a variety of forms.

Table 2: States With Revenue or Expenditure Limitations

Revenue Limits	Florida, Massachusetts, Michigan, and Missouri
Expenditure Limits	Alaska, Arizona, California, Connecticut, Hawaii, Idaho, Montana, Nevada, New Jersey, North Carolina, Oregon, South Carolina, Tennessee, Texas, Utah, and Washington
Revenue and Expenditure Limits	Colorado and Louisiana
Appropriations Limited to Revenue Projections	Delaware, Iowa, Mississippi, Oklahoma, and Rhode Island

Source: National Conference of State Legislatures.

Four states have revenue-based TELs which limit annual increases in state revenue to personal income, population growth, inflation, or some combination of these factors. Sixteen states have expenditure-based TELs which are similarly linked to growth in either personal income or other factors. Two states have both revenue and expenditure-based TELs. Five states have TELs which link appropriations to prior state projections of revenue.

In addition to employing various methods for measuring budget limits, the states with TELs have a variety of different mechanisms which come into play once a limit is reached.[14] In a number of states, including Connecticut, Rhode Island, and Washington, all or part of surplus revenues are directed into rainy day funds or used to pay down state debt. But in many states, excess revenues above TEL limits are fully or partially refunded to taxpayers. These states include California, Colorado, Florida, Hawaii, Louisiana, Massachusetts, Michigan, Missouri, Oregon, and South Carolina.

Colorado provides an interesting case study showing how the booming economy in the 1990s can trigger refunds to taxpayers. Under the 1992 Taxpayers Bill of Rights Amendment (TABOR), growth in state expenditures is limited to the growth in state population plus inflation. In years with excess revenues above the amount required to fund expenditures under the limit, refunds must be made to state taxpayers.

Limits under TABOR required that the state government return $139 million to taxpayers in 1997 and $563 million in 1998. The refunds are claimed when filing state income taxes and are based loosely on taxpayers' federal adjusted gross income. This year, taxpayers can expect another tax cut under TABOR. Governor Owens has proposed a $575 million cut which includes a lowering of the income tax rate from 5.0 percent to 4.75 percent. Barry Poulson, an economics professor at the University of Colorado has called TABOR one of the most stringent budget limits in the country and recently noted that, "I think TABOR is the only reason Colorado has not gone on a spending binge."[15]

Despite successful TELs in a number of states such as Colorado, TEL's in many states have not been particularly effective.[16] The NCSL notes that because of the mixed effectiveness of these traditional TELs, a movement towards requiring supermajority votes to raise state taxes has gained steam.[17] Fourteen states now require supermajority votes in both state chambers for tax rate increases - half of these states implemented the supermajority requirement during the 1990s.

Supermajority vote requirements may be either three-fifths, two-thirds, or three-quarters, as summarized in Table 3. In 10 of the 14 states, the supermajority requirement applies to all tax increases. The exceptions are Arkansas (which excludes sales and alcohol taxes), Florida (applies only to the corporate income tax), Michigan (applies only to the state property tax), and South Dakota (applies only to sales and income taxes). Governors in New Jersey, New York, and Pennsylvania have proposed adding their states to the list of jurisdictions that require supermajority votes to raise taxes.

Table 3: States Which Require Supermajorities for Tax Increases

Supermajority Vote Required	States
Three-Fifths	Delaware, Florida, Mississippi, and Oregon
Two-Thirds	Arizona, California, Colorado, Louisiana, Nevada, South Dakota, and Washington
Three-Quarters	Arkansas, Michigan, and Oklahoma

Source: National Conference of State Legislatures.

At the federal level, there has been substantial interest in recent years in enacting some type of supermajority requirement for tax increases. Last year, Representative Joe Barton proposed a Tax Limitation Constitutional Amendment which would have required a two-thirds supermajority vote in both the House and the Senate to raise taxes. House Speaker Hastert has been a strong supporter of a supermajority requirement and plans for a vote on such an amendment early in 1999.

Federal Tax Cut Options for 1999

As many states offer one-time taxpayer refunds and various permanent tax cuts in 1999, federal policymakers have the chance to make up for lost time. Unfortunately, the Administration has not provided a good starting point for tax cuts with its fiscal 2000 budget. Although the budget does include a variety of very narrowly targeted tax breaks, such as a new long-term care credit, it includes a greater amount of tax increases. On net, the budget would raise taxes $89 billion over the next ten years, according to the Joint Committee on Taxation.[18]

Americans might wonder why taxes need to be increased at a time when tax revenue growth is already strong due to the growing economy. The unexpected strong tax revenue growth has been the primary factor creating the large and growing federal budget surpluses. In effect, taxpayers have "overpaid" on their contributions to support federal spending. The Congressional Budget Office currently projects that the baseline fiscal 2000 unified budget surplus will grow to $131 billion, from $107 billion in fiscal 1999.

Congressional leaders have proposed a variety of tax cut plans in order to return some of the budget surpluses to individuals.

Some of the proposals being considered are the following:

- **Ten-Percent Across-the-Board Tax Cut**: A ten-percent across-the-board reduction in statutory personal income tax rates would be a straightforward method of reducing income taxes for most federal taxpayers. The proposal would return about $80 billion per year to taxpayers, or $776 billion during the first ten years, according to the Joint Committee on Taxation.[19]

- **Alternative Across-the-Board Tax Cut**: As an alternative to the ten-percent tax cut, other plans have been proposed to provide broad-based income tax cuts. One idea is to substantially raise the income threshold for the 28-percent tax bracket. This approach would reduce taxes for most federal taxpayers, but would not have the advantage of reducing top marginal tax rates which have important growth effects on the economy.

- **Targeted Tax Cuts**: A number of proposals have been introduced to fix a number of widely-recognized problems with the individual income tax. These include:

- Eliminate the "marriage penalty" which results in married taxpayers in some circumstances paying more tax than two single taxpayers with the same combined income as the married couple;
- Provide an exclusion for interest income of $200 and dividend income of $400 in order to encourage greater savings;
- Expand the income limit on the current estate tax exemption in order to reduce the burden of the "death tax;"
- Index the alternative minimum tax (AMT) for inflation to avoid increasing numbers of middle-income taxpayers being hit by this complicated tax;
- Further reduce the capital gains tax rate to encourage greater savings and investment.

Conclusion

With the disappearance of budget deficits from current federal projections, federal policymakers are now considering various tax cut options. State governments are also enjoying large budget surpluses, and a majority of them are considering additional tax cuts this year after five years in a row of net tax cuts for state taxpayers.

A growing number of state governments operate under budget constraints that make tax increases more difficult, and tax cuts more likely, for state taxpayers. If federal budget surpluses persist for a number of years as currently forecasted, federal legislators should consider some of the budget rules now in place at the state level such as balanced budget requirements, tax and expenditure limitations, and supermajority voting requirements for tax increases.

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[1] *The Fiscal Survey of the States*, National Association of State Budget Officers (NASBO), December 1998.
[2] Note also that federal and state figures are projections of revenue effects before changes in tax law go into effect, since government estimators generally do not revise prior projections of tax law changes.
[3] *Projecting Federal Tax Revenues and the Effect of Changes in Tax Law*, Congressional Budget Office, December 1998. CBO generally utilizes Joint Committee on Taxation estimates for revenue effects of changes in tax law.
[4] *State Revenue Report*, Center for the Study of the States, December 1998.
[5] National Conference of State Legislatures (NCSL) analyst quoted in the *Investors Business Daily*, February 22, 1999.
[6] "Thinking About Principles This Legislative Season," David Brunori, *State Tax Notes*, February 1999.

[7] NCSL estimates that 36 states cut taxes in fiscal 1998. A separate survey by NASBO estimates that 32 states provided net tax cuts in fiscal 1998. Both surveys estimate that the net state tax cut was about $7 billion.
[8] Author's calculation of the average top statutory personal income tax rate across the 43 states and D.C. that have personal income taxes, based on data from the Federation of Tax Administrators.
[9] Growth in state tax revenues 1990-98 are based on Bureau of Census figures. Growth in state tax revenues for 1999 is based on NASBO estimates for fiscal 1999 general fund revenues.
[10] The larger state tax cuts may also have a small positive effect on federal revenues as a result of positive growth effects.
[11] See *State Revenue Report*, December 1998, from the Center for the Study of the States for a discussion regarding why income taxes have tended to grow faster than sales taxes in recent years.
[12] See *The Fiscal Letter*, NCSL, Autumn 1997, for a discussion of tax revenue growth rates.
[13] *The Book of the States*, The Council of State Governments, 1998-1999 Edition.
[14] *State Tax and Expenditure Limits*, NCSL, 1998.
[15] "States Divvy Up Surplus Money," *Investors Business Daily*, February 22, 1999.
[16] See *Taming Leviathan: Are Tax and Spending Limits the Answer*, Cato Institute, 1994. Also see *State Tax and Expenditure Limits*, NCSL, 1996.
[17] *State Tax and Expenditure Limits*, NCSL, 1996.
[18] As reported by *Tax Notes*, March 1, 1999.
[19] As reported by the Bureau of National Affairs *Daily Tax Report*, February 22, 1999. The estimate may be higher or lower depending on whether changes to the Alternative Minimum Tax are included in the tax package.

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