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A SIX-PLANK PLATFORM TO SAVE THE ECONOMY FROM RECESSION

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INTRODUCTION

Many economists, political analysts, and media commentators are now telling Americans that the economy is heading for a recession. Although the current economic expansion is the longest in America's peacetime history, the economy has struggled with anemic growth of just over one percent in the past nine months. While politicians will try to blame everything and everyone from Saddam Hussein to the business cycle for the looming economic hard times, any recession that occurs should be stamped with the label, "Made in Washington, D.C."

The lesson that policy makers should have learned from the last two decades is that bad economic conditions are mainly the result of bad government policies. In the 1970s, high taxes, wasteful spending, inflation, and excessive regulation combined to produce stagflation. As a result of the weak economy, fewer jobs were created, many businesses went bankrupt, and families suffered. In the 1980s, by contrast, tax cuts, an improved monetary policy, and deregulation helped spark the current economic expansion and the greatest burst of job creation in American history.

Deadly Economic Mix. So far, the 1990s have resembled the 1970s with regard to government economic policy. In the current session of Congress, legislators have increased the minimum wage, enacted new regulations that enormously increase the costs of doing business, and appropriated huge increases in domestic spending. Still to come is the so-called Clean Air Act, a

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new bill to promote racial quotas, a massive child care entitlement program, and a record tax increase — a deadly mix even to a strong economy.

America's longest peacetime period of economic growth need not come to an end. The right combination of policies could restore and extend the expansion. To stave off recession and boost economic growth, George Bush and Congress should adopt a Six-Plank Platform.

Plank #1: Encourage more savings and investment by reducing the capital gains tax to 15 percent;

Plank #2: Increase incentives for working Americans by reducing the Social Security payroll tax burden;

Plank #3: Leave more financial resources in the productive sector of the economy by strictly limiting annual increases in federal spending to four percent;

Plank #4: Restore economic confidence immediately by announcing that tax increases are "off the table";

Plank #5: Strengthen American competitiveness by removing barriers to savings and investment in the tax code; and

Plank #6: Ease the regulatory burden on business and spur more job creation by eliminating those provisions of the Clean Air Act and the Civil Rights Act that retard economic growth.

STUMBLING TOWARD RECESSION

The economy indeed is weakening. The annual rate of growth was only 0.3 percent in the last quarter of 1989, 1.7 percent the first quarter of 1990, and an estimated 1.2 percent for second quarter of 1990. The Index of Leading Economic Indicators, used by forecasters to predict future economic performance, has risen only 0.7 percent since January. After flirting with the 3000 level in early June, the stock market has steadily declined, beginning even before the Persian Gulf crisis. Other economic indicators show similar sluggishness.

Despite the mounting evidence of impending recession, the Administration appears reluctant to support a comprehensive pro-growth agenda. Indeed, on fiscal policy issues, the Bush Administration has become part of the problem. Largely at the urging of Budget Director Richard Darman and Treasury Secretary Nicholas Brady, the White House is calling for a combination of high-tax austerity and an inflationary easy money policy on the part of the Federal Reserve Board. Eerily, this is the formula Jimmy Carter used to create the stagflation of the late 1970s.

DEFICIT HYSTERIA LEADING TO WRONG CONCLUSIONS

Notwithstanding the evidence of the past ten years, Brady in particular apparently believes the economy's performance is inextricably tied to the budget deficit. As a result, he and Darman are urging Bush to accept a tax increase even though there is no evidence or reason to believe Congress would use the money for deficit reduction.

Deficit spending is an important concern, but it is just one of many variables that influence economic growth. The deficit, moreover, is a symptom, not the disease. Federal spending is the problem. Regardless of whether it is financed by taxes or borrowing, federal spending consumes resources that could be better used by the productive sector of the economy. While it may shift the burden, replacing spending financed by borrowing with spending financed by taxes does not help the economy.

Nor is the deficit as much of a crisis as the Administration and some members of Congress suggest. Even under a worst-case scenario, it is unlikely that the deficit will be more than 3 percent of gross national product (GNP) this year and next. This is considerably below the 1983 deficit of 6.3 percent of GNP, the 1985 deficit of 5.4 percent of GNP, and the 1987 deficit of 3.4 percent of GNP. If a budget deficit equalling 3 percent of GNP threatens the economy today, the economy should have collapsed in those previous years when the deficit was a much larger share of GNP. Obviously, the deficit by itself does not determine the health of the economy.

TOO MUCH GOVERNMENT EQUALS RECESSION

It is not just a coincidence that the economy's slide is occurring as policy makers are increasing government intervention in the economy. If government takes an ever greater amount of resources out of the productive sector of the economy and adds numerous additional costs and regulations, economic growth inevitably is reduced. Consumers will have less after-tax income to spend. Because they may fear unemployment, many consumers are reluctant to make big-ticket purchases like houses, automobiles, and major appliances. Companies postpone investments in new plant and equipment. Reduced consumer spending may force businesses to lay off employees, and it is almost certain that few new jobs will be created.

Just as unwise economic policies produced recession and stagflation in the late 1970s and early 1980s, the recent enactment of unsound policies and the consideration of additional anti-growth policies has increased the possibility of a recession in the near future.

INFLATION IS NOT THE ANSWER TO RECESSION

Treasury Secretary Brady apparently believes rekindling the inflationary policies of the late 1970s is the best way to save the economy from recession. He seems to forget that Carter's high tax and inflation recipe in the late 1970s produced 18 percent inflation, 21 percent interest rates, record drops in inflation-adjusted family incomes, and recession.

Brady has been especially active in urging the Federal Reserve Board to lower the value of the dollar, apparently in the belief that inflation will reduce interest rates. Lower interest rates would help the economy, but the only way to lower interest rates permanently is for the Federal Reserve Board to eliminate inflation entirely so that lenders no longer feel a need to add an "inflation premium" to the interest rate they charge borrowers. Devaluing the dollar, as Brady is demanding, would push interest rates higher in the medium and long term by sparking a resurgence of inflation.

The Administration's pro-inflation policy could not come at a worse time. After hovering around 4 percent for a number of years, inflation has jumped to nearly 6 percent. Mainly due to fears of higher inflation, interest rates on 30-year bonds have climbed about one-half of a percentage point in the past two months alone. If the Federal Reserve Board succumbs to White House pressure and adopts an easy money policy, interest rates will rise dramatically, choking off economic growth and opportunity. If there is a recession, truth in labelling would require that it be called the "Brady Recession."

A PRO-GROWTH AGENDA FOR AMERICA'S FUTURE

What does affect the health of an economy is the overall level of government spending and the full extent and nature of government intervention. Understanding this, the recent slowdown in the economy is no mystery. The good news is that this understanding also means that a recession need not occur. With the right policies, robust economic growth can be restored. Or, if a recession already exists, the right policies can end it quickly. These policies comprise a Six-Plank Platform for Economic Growth.

Plank #1: Cut the Capital Gains Tax.

Senator Robert Kasten of Wisconsin and Representative Mickey Edwards of Oklahoma, both Republicans, have introduced legislation to reduce the capital gains tax to 15 percent for all assets. Their legislation also would index this rate for inflation, protecting savers and investors from paying taxes on purely nominal gains. According to Allen Sinai, Chief Economist for the Boston Company, reducing the capital gains tax to this level would raise GNP by 0.4 percent annually through 1995, add 2.5 million new jobs, and generate an additional $30 billion to $40 billion of new tax revenues over the next five years. Business investment would increase by 1.3 percent annually if the capi-

tal gains tax were reduced, and the after-tax cost of capital for American firms would fall by more than 4 percent per year.

Plank #2: Reduce the Social Security Payroll Tax.

Several legislators have introduced legislation to reduce the burden of Social Security taxes. The two most promising bills have been introduced in the Senate by Daniel Patrick Moynihan, the New York Democrat, and by Wisconsin's Kasten. The federal government now collects over $50 billion more in Social Security taxes annually than is being paid out in benefits. This surplus is being spent on other government programs. Rather than using Social Security taxes to pay for other programs, the tax should be reduced. Perhaps more than any other tax, the payroll tax is a direct levy on jobs. According to Fiscal Associates, Inc., a Washington-based consulting firm specializing in the economic effects of tax policy, cutting the Social Security payroll tax by 2.2 percentage points would spur GNP growth by an additional 0.3 percent by 1993, and create 500,000 new jobs. By the end of the decade, Fiscal Associates project that real economic growth would be 0.6 percent higher annually and the economy would create a total of 900,000 more jobs.

Plank #3: Cap Government Spending Growth.

While deficit spending by itself will not throw the economy into recession, ever-increasing federal spending consumes too much of the nation's resources. After increasing by nearly 10 percent annually the first half of the 1980s, spending growth slowed to about 4 percent annually after the enactment of Gramm-Rudman-Hollings Deficit Reduction Act in 1985. This modest achievement of fiscal responsibility, however, has seemingly evaporated. For the first nine months of the 1990 fiscal year, federal spending has been more than 10 percent higher than it was in the same period last year. This spending jump is the cause of the current deficit problem. The best way to solve the problem thus is to limit the future growth of federal spending. The Office of Management and Budget estimates federal tax collections will rise by nearly $400 billion over the next five years under current law. Limiting the growth of spending to 4 percent would allow a significant amount of those new tax revenues to be used for deficit reduction.[1]

Plank #4: Take All Tax Increases "Off the Table."

With the economy already teetering, a tax increase would push it off the edge. The budget summit, supposedly initiated to restore economic confidence actually is undermining the economy by raising the specter of higher taxes. Like a Sword of Damocles hanging over the economy's head, the threat of tax increases is eroding business confidence and throwing financial markets into uncertainty. A strong announcement by the President and other

1 See Scott A. Hodge, "Rx for the Federal Deficit: The Four Percent Solution," Heritage Foundation *Backgrounder* No. 787, September 4, 1990.

political leaders that tax increases are unacceptable would send the positive message to consumers and businesses that Washington is not going to deprive them of any more of their earnings.

Plank #5: Remove Tax Barriers to Savings and Investment.

Reducing the capital gains tax will increase savings and investment. So will expansion of the once very popular Individual Retirement Accounts (IRAs). All working Americans should be allowed to contribute up to $2,000 per year for themselves and $2,000 for their spouse into an IRA; their taxable incomes would be reduced by the amount of these contributions. The maximum contribution that is allowed should be increased annually at the rate of inflation. To increase IRA flexibility, Americans should be allowed to borrow against their IRAs to buy homes for themselves or their children.

Also prompting more investment will be elimination of the tax code's bias against spending on new plant and equipment. Properly defined, taxable profits should be the difference between total costs and total revenues. One of the costs for businesses is new investment. Under the current tax code, however, a business cannot subtract the full cost of investments greater than $10,000 from total revenues to determine yearly profits. Representative Nancy Johnson, the Connecticut Republican, has proposed legislation to raise the amount of investment that can be deducted from a business's tax liability annually from $10,000 to $250,000. By lowering the cost of investment, Johnson's legislation would spur business expansion and job creation.

Plank #6: Drop Consideration of Costly Regulatory Legislation.

Congress and the Administration already have added a heavy regulatory burden to the economy in the past two years. This will be increased greatly by the pending Clean Air Act and the Civil Rights Act. Both would impose heavy costs on the economy. The Clean Air Act makes no effort to balance costs and benefits and relies on centralized government dictates rather than market incentives to improve air quality. The Civil Rights Act, rather than promote equality, would force businesses to adopt racial quotas under the threat of costly litigation. The President should announce unambiguously that both bills will be vetoed if they reach his desk.

BUDGET IMPACT OF A PRO-GROWTH PACKAGE

The main goal of an anti-recession, pro-growth tax cut package is economic growth, not deficit reduction. Nonetheless, the revenue loss from reducing payroll tax rates will be offset by already projected increases in tax revenues, new monies generated by the capital gains tax cut, and the budgetary savings realized by capping spending growth at 4 percent.

Most important, this pro-growth package would prevent or cut short the biggest budget-buster of all: a recession. Even a mild recession could push the deficit above $300 billion.

The Office of Management and Budget estimates tax collections over the next five years, under current law, as follows (in $ trillions):

Fiscal Year	1990	1991	1992	1993	1994	1995
Revenues	1.044	1.122	1.195	1.279	1.363	1.441

Cutting the capital gains tax rate to 15 percent would increase tax revenues by $30 billion to $40 billion over five years according to Allen Sinai's thorough estimates. Assuming the legislation would generate $35 billion, spread evenly over five years, federal tax collections would be (in $ trillions):

Fiscal Year	1990	1991	1992	1993	1994	1995
Revenues	1.044	1.129	1.202	1.286	1.370	1.448

According to the Congressional Budget Office's static revenue estimates, both the Moynihan and Kasten Social Security payroll tax cuts would reduce revenues. Some of the revenue loss doubtless would be offset by higher economic growth, as predicted by Fiscal Associates, Inc. Assuming, however, no offset, the impact on future tax collections from both the Moynihan and Kasten legislation are (in $ billions):

Fiscal Year	1991	1992	1993	1994	1995
Moynihan	-6.6	-16.7	-28.1	-40.9	-55.3
Kasten	-9.2	-23.2	-39.1	-45.8	-48.8

If the Moynihan legislation passes, actual tax collections over the next five years, including the reduction in the capital gains tax, would be (in $ trillions):

Fiscal Year	1990	1991	1992	1993	1994	1995
Revenues	1.044	1.122	1.185	1.258	1.329	1.393

The Office of Management and Budget estimates total fiscal 1990 spending, excluding the one-time expense of purchasing insolvent Savings and Loans, will be $1.2077 trillion. A complete spending freeze at this level combined with Social Security and capital gains tax cuts would produce a budget surplus of $50 billion by 1993. A complete spending freeze, however, probably is politically impossible. The more modest approach would be to cap federal spending at four percent annual growth. While this Four Percent Solution would not balance the budget until sometime between 1995 and 2000, the deficit would certainly cease to exist as an economic problem in just a few years.

Pro-Growth Four Percent Solution
($ billion)

Fiscal Year	1990	1991	1992	1993	1994	1995
Revenues $	1044	1122	1185	1258	1329	1393
Spending	1208	1256	1306	1358	1413	1469
Deficit	164	134	121	100	84	76

To accomodate the "Four Percent Solution," the Gramm-Rudman-Hollings targets would be charged to reflect the projections above. Policy makers already have agreed to revise current deficit targets. Changing them to reflect a package that could save the economy from recession as well as put the country on a path to a balanced budget would be the soundest approach.

The budget figures also would have to be changed to accomodate legislation expanding IRAs and increasing the amount of investment expenditures that businesses can expense deduct from their income for tax purposes. The magnitude of the change would depend on the extent of the final legislation. Policy makers could choose to offset the revenue loss by reducing how fast federal spending could increase, thus balancing the budget on the same schedule. Alternatively, they could simply adjust the new Gramm-Rudman-Hollings targets by the appropriate amount and reach a balanced budget one or two years later.

CONCLUSION

With the American economy possibly heading for recession, lawmakers must set aside traditional special-interest politics. The record economic growth that began in 1982 is no accident. It is the result of tax cuts, stabilized monetary policy, and reduced government intervention in the economy. It is also no accident that the economy is softening as policy makers retreat from the market-oriented policies that characterized the 1980s.

The way to stop a recession or to reduce its severity is to return to policies that promote economic growth. America needs tax cuts, not tax increases. Rather than return to the fiscal policies of the 1970s, federal spending growth must be limited to 4 percent. Instead of punishing new investment, the tax code should reward expenditures on new plant and equipment. Similarly, the anti-savings bias in the tax code should be eliminated. Expensive new regulations need to be shelved in favor of legislation that strengthens American competitiveness.

People, Not Numbers. The stakes are enormous. The economy is not numbers, it is people. When growth falters, people lose their jobs. When the economy slows, entrepreneurs see their businesses fail. When the stock market falls, millions of people's pensions lose value. More than any other group, it is the poor who suffer most. The record job creation of the 1980s disproportionately benefitted women, minorities, and the poor. They would be the ones who bear the brunt of a recession.

For that reason, if no other, policy makers must put aside their traditional differences and enact a bi-partisan Six-Plank Economic Growth Package.

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