Executive Memorandum

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# A PROVEN FORMULA TO RESTORE ECONOMIC GROWTH

America's largest-ever tax increase, enacted last year, was supposed to reduce the budget deficit and strengthen the economy. Instead, it is proving an economic disaster. America's longest peacetime period of economic growth has screeched to a halt, throwing the economy into a recession for the first time since 1979-1982. National output, according to the National Center for Policy Analysis, will fall by nearly $600 billion and American workers will see more than 500,000 jobs vanish. Meanwhile, the fiscal 1991 deficit, estimated to total only $100 billion last January, is now projected to climb to between $300 billion and $400 billion because of slower growth and record increases in federal spending.

This recession, like most others, is the result of high taxes, excessive government spending, erratic monetary policy, and burdensome regulation. The way to end the recession is to reverse the mistakes that caused it. This is what the "Economic Growth and Jobs Creation Act of 1991" (S. 381; House version to be introduced February 19) could do. Crafted by Senator Malcolm Wallop of Wyoming and Representative Tom DeLay of Texas, both Republicans, and Representative Robin Tallon, the South Carolina Democrat, this legislation would spur growth by reducing the tax burden on workers, on employers, on savers, and on investors. The bill contains four key elements:

**1) Roll Back the Social Security Payroll Tax.** This would roll back Social Security payroll tax rates from their current record high of 12.4 percent to 10.6 percent. The immediate effect: putting more money into the pocket of every working American and lowering operating costs for businesses. Allowing individuals and businesses to keep more of the money they earn would fuel the economy. According to research produced last year by the Institute for Policy Innovation, a Texas-based think tank, a 2.2 percentage point reduction in the Social Security tax would create nearly one million additional jobs over a ten year period. Since Social Security is running a huge surplus, reducing the tax would not endanger the system or reduce benefits. Trimming the Social Security surplus, meanwhile, would prevent Congress from spending the surplus on other programs.

**2)Cut the Capital Gains Tax.** This would cut the maximum tax on capital gains from the current 28 percent to 15 percent. The effect, according to Allen Sinai, Chief Economist of the Boston Company: creating 2.5 million jobs over five years, reducing the federal deficit by $30 billion-$40 billion in the same period, and increasing the gross national product by 2.8 percent, adjusted for inflation, over the five-year time span. Lowering the capital gains tax also would help lower the cost of the S&L deposit insurance bailout. A lower tax rate would boost the value of assets by increasing the expected value of future after-tax proceeds; if the federal government can sell the assets of failed thrifts at higher prices, the bailout's net cost to the taxpayer will drop. Capital gains tax reduction, by increasing the value of financial assets, would also strengthen commercial banks and insurance companies, many of which are in precarious condition.

Under current law, the capital gains tax is not indexed for inflation. Those who sell assets thus pay taxes on purely inflationary gains, meaning the tax rate on real income can be much higher

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than 28 percent. The Wallop/DeLay-Tallon bill would eliminate this additional disincentive to invest by allowing indexing. A lower capital gains tax would strengthen U.S. international competitiveness. Many of America's trading partners, such as Germany and Taiwan, do not tax long-term capital gains at all, while Japan taxes capital gains income at a maximum of only five percent.

**3) Eliminate the Tax Penalty Against Investment.** This would promote vastly increased investment by allowing businesses, after a phase-in period, to subtract from their gross revenues the money they spend on new machinery, factories, and other investments, just as they do the money spent on salaries, office supplies, and advertising. The business' taxable profits thus would be determined by subtracting all expenses from revenues. This system is known as "full expensing." That profit then would be subject to income taxes. Expensing would lower the cost of capital for American companies, enabling them to better compete with German and Japanese firms.

Under current tax law, money spent on investments cannot be subtracted fully from total revenues each year. Instead, depending on the type of investment, this cost must be spread out over several years, a practice known as depreciation. This greatly increases the cost of investment in today's dollars. By initially creating the equivalent of expensing by changing depreciation schedules to account for inflation and other costs, followed by full expensing after five years, the Wallop/DeLay-Tallon bill would increase investment and make America more competitive.

**4) Increase Savings Incentives.** This would allow almost all Americans to reduce the tax burden on retirement income by saving money through Individual Retirement Accounts (IRAs). The very popular IRAs that were available before the 1986 Tax Reform Act allowed taxpayers to deduct the amount of their IRA deposit from the amount of income subject to taxation. The advantage of this was evident to everyone, and produced a considerable amount of new savings; the problem is that taxes must be paid on this amount and all interest earnings when the taxpayer retires and withdraws his money from the IRA. Many taxpayers have found themselves in a higher tax bracket at retirement then they were when they originally deposited the money in their IRAs.

The IRA proposed by Wallop/DeLay-Tallon would eliminate the taxation of interest income or principal when it is withdrawn upon retirement. Even though the money deposited into this type of IRA no longer would be tax deductible, the elimination of taxation at the "back end" would make this type of IRA a better deal for most Americans.

The Wallop/DeLay-Tallon bill is a good start for policy makers interested in restoring prosperity and creating jobs. But tax reduction is only part of the medicine for America's ailing economy. Prescribed too must be the reduction of government regulation, binding limits on federal spending, and budget process reforms that encourage fiscal responsibility. By contrast, last year's budget deal was a huge step in the wrong direction. In spite of, or more likely because of, its record tax increase, tax collections between now and 1995 are projected to be lower than they would have been before the tax hike was enacted. Worse, the fiscal 1992 budget, submitted earlier this month by the White House, shows that federal spending this year will consume more than 25 percent of America's output, nearly three percentage points higher than it was at the end of Ronald Reagan's second term. With the exception of World War II, the government has never taken a greater level of resources out of the productive sector of the economy.

The victims of the current recession and of last year's budget deal are the hundreds of thousands of Americans already out of work, the millions who will soon be out of work, the tens of millions of Americans who face a lower standard of living, and the millions of entrepreneurs and investors who have seen their expectations dashed. For them, hope is offered by the Wallop/DeLay-Tallon bill.

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