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FIFTEEN REASONS WHY THE CLINTON TAX PACKAGE IS BAD FOR AMERICA'S FUTURE

(Updating *Backgrounder* No. 932, "Taxes, Spending, Gimmicks, and Snake Oil: Why Bill Clinton's Budget Is Bad for America," March 16, 1993.)

The House and Senate last week decided by the narrowest of margins to impose the largest tax increase in world history on the American economy. The Clinton Administration claims that this tax hike is needed to "put America's economic house in order." Yet at no time has the Administration produced a single example of a tax increase that has had a positive impact on the American economy. Instead of putting forth substantive arguments in favor of the underlying economics of the President's plan, the White House dwells on the plan's supposed "fairness."

Supporters claim that the legislation will reduce deficits by $328.6 billion over the next five years. The vast majority of the "savings" come from the imposition of a record tax hike. The bill is projected to raise at least $262 billion of additional revenue through 1998. The remaining $66 billion of savings in the bill come from so-called spending cuts. Many of these "cuts," however, are highly questionable.

While no legitimate economic arguments have been advanced in favor of the tax increase, there are several reasons why adoption of the Clinton tax package would be bad for America. Among them:

REASON #1: The budget plan does not reduce federal spending.

Supporters of the tax hike argue that the so-called deficit reduction package contains spending cuts, and so would curb the public sector. But they are using the dishonest Washington definition of a spending cut—increasing spending at a slower rate than previously planned. According to the Congressional Budget Office (CBO), the budget will climb from $1.443 trillion this year to $1.756 trillion in 1998 under the recently approved plan. Because both defense spending and deposit insurance spending are expected to fall, this $313 billion spending increase goes exclusively to domestic spending programs. Indeed, domestic spending is projected to grow more than twice as fast as inflation over the next five years.

REASON #2: The tax increase will stimulate more spending.

While the Administration's own numbers show spending climbing by more than $300 billion over the next five years, spending almost certainly will climb by an even greater amount. History repeatedly demonstrates that lawmakers respond to higher taxes by increasing spending for politically favored programs. Indeed, a 1991 Joint Economic Committee study found that every $1 of higher taxes between 1947 and 1990 was associated with $1.59 of new spending. There is every reason to expect that this tax hike will have the same effect.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

REASON #3: Even using the dishonest Washington definition of a spending cut, the package has $3.92 of revenue increases for every $1 of "spending cuts."

The President keeps asserting that his "deficit reduction" package contains nearly $500 billion of deficit reduction, with spending cuts outweighing tax increases. This claim is completely untrue. According to the Democrat-controlled Congressional Budget Office and Joint Committee on Taxation, the legislation contains $328.6 billion of deficit reduction. Of this total, the CBO and JCT admit that new revenues comprise 79.7 percent of the total.

REASON #4: While the majority of Clinton's tax increases are retroactive to January 1 of this year, almost all the spending cuts are nothing more than promises to take action in the future.

Supporters of the package admit that the CBO and JCT numbers are correct. But the White House argues that the budget plan will produce $496 billion of deficit reduction because future cuts in annually appropriated spending and assumed interest savings will generate an additional $166.4 billion of "spending cuts." But again, history suggests strongly that there is almost no likelihood that Congress will follow through on these promised savings. Ronald Reagan is still waiting for the $3 of spending cuts he was promised for every $1 of tax increases back in 1982. More recently, Congress just reneged on the tiny amount of spending cuts that were promised in exchange for the huge tax increase in 1990. The White House's assumed interest savings also are suspect, especially since tax increases traditionally are followed by larger rather than smaller deficits. Like the plan Congress just approved, the 1990 budget deal was supposed to reduce five-year budget deficits by nearly $500 billion. Instead, government borrowing over the five-year period rose by a total $700 billion compared with pre-budget-deal estimates, a cumulative "error" of $1.2 trillion with a commensurate increase in interest outlays.

REASON #5: Of the few Washington-defined spending cuts in the legislation, many are budget gimmicks or hidden revenues.

Of the $66.8 billion in "spending cuts" in Clinton's budget, nearly half of those savings actually represent provisions that are best characterized as revenue increases or budget gimmicks. The legislation, for instance, requires the Federal Reserve Board, the District of Columbia government, and the Postal Service to give money to the Treasury. These new revenues are counted as spending cuts. The bill purports to save nearly $9 billion by limiting federal employee retirement costs. The "savings" are achieved, however, only by pushing the costs into future years.

Other phoney items in the package include the widespread use of provisions that do nothing more than extend current law. Lawmakers frequently build automatic spending increases into government programs and then take credit for "deficit reduction" when they delay or cancel these as-yet-nonexistent spending hikes. These provisions, which include more than $7 billion of Medicare "cuts," do not reduce the size of government compared with current levels.

REASON #6: The deficit will rise if the plan is enacted.

The President talks about deficit reduction, yet his own Office of Management and Budget predicts that the record tax hike will result in higher deficits. According to OMB figures, the deficit will climb to an all-time record of $431 billion by 2003 now that the tax increase has been approved. The White House claims the package will result in a falling deficit for at least a couple of years, but past experience shows that the opposite likely will happen. Taxes were raised for the purpose of deficit reduction in 1982, 1984, 1987, and 1990. In every case, the deficit rose the following year.

REASON #7: The legislation will disproportionately harm small business.

Most businesses in America do not file taxes under the corporate income tax code. Eighty percent of businesses, primarily subchapter S corporations, proprietorships, and partnerships, instead pay taxes through the personal income tax code. The Clinton plan dramatically increases the tax burden on successful small

businesses by creating two new higher personal income tax rates, 36 percent and 39.6 percent, and by extending the Medicare payroll tax to all income, thus boosting taxes on income by another 2.9 percent. This record tax increase will have an especially adverse impact on small business investment since such firms largely rely on retained earnings to expand their operations.

REASON #8: The tax hike will cost jobs.

The Congressional Budget Office earlier this year estimated that the economy, left alone, would create 9.4 million new jobs over the next four years. The Administration recently admitted that the number would be 1.4 million jobs short of this figure under the Clinton tax hike. Independent economists and forecasters have made similar job loss projections. Many of the jobs losses will occur because the retroactive increase in taxes on personal income will have a devastating impact on many small businesses. Although most small firms do not generate enough income to be directly affected by the higher tax rates, the 10 percent of businesses that have been responsible for most new jobs are also the ones with enough taxable income to be directly penalized.

REASON #9: The higher tax rates on personal income will depress savings and investment.

The White House apparently believes that most Americans will not mind paying higher taxes themselves if they believe "rich" people are being punished even more harshly. This approach may or may not be smart politics, but it is definitely bad economics. The majority of income earned by those making above $200,000 per year is not wages and salaries. Instead, "rich" Americans receive the bulk of their income from sources such as dividends, interest, and capital gains. Faced with large increases in tax rates on income, these taxpayers will tend to re-arrange their portfolios, taking steps to limit their tax liabilities. These steps include transferring money out of private investments, the returns on which are subjected to the higher tax rates, and into tax shelters such as municipal bonds, where the returns are exempt from federal taxes. Clinton's economic advisors apparently assume that the economy will not be harmed if investors put less venture capital in the Microsofts of tomorrow and more into shoring up the debt of places like New York City. Moreover, since higher tax rates will make consumption more attractive because of the reduced after-tax returns to savings and investment, the higher tax rates are sure to lead to a drop in the overall level of capital formation in the economy. This, in turn, will depress wage levels and income growth for all Americans.

REASON #10: The higher tax rates on income likely will lose revenue for the government.

Because higher-income taxpayers do have a large degree of discretion over their sources of income and when that income is received, they will tend to react to the higher tax rates in ways that shrink their taxable income. Tax experts, such as Harvard University Professor Martin Feldstein, estimate that as much as three-quarters of the expected revenue gain will disappear because of behavioral changes on the part of affected taxpayers. But the revenue loss is not confined to these behavioral changes. Higher tax rates on income tend to cause savings and investment to fall, a development which will reduce the economy's growth rate and cause incomes to be lower than they otherwise would have been. This economy-wide shrinking of the tax base will mean further revenue losses for the government.

REASON #11: The legislation is unfair, taxing Americans on income they earned in the past.

Of all the tax increases in the Clinton package, the increase in income tax rates is the most damaging to economic growth. The harm created by these tax rate increases is compounded, however, by a capricious decision to make those higher rates effective January 1st of this year. By taxing people on income they earned more than seven months ago, even before Clinton took office, the Administration is making a mockery of the most elementary principles of tax fairness. Ironically, had the Administration made the tax effective just one day earlier, December 31, 1992, they could have generated even more money by taxing income that wealthy individuals, such as the President's wife and Robert Rubin, the Chairman of the President's Economic Council, shifted from this year to last year—no doubt to minimize their expected tax liability.

REASON #12: Not a single government program, agency, or department is eliminated.

The federal government will spend more than $1.5 trillion next year according to the Administration's numbers. This record budget will fund fourteen cabinet level departments, dozens of major agencies, and literally hundreds of programs. Notwithstanding the seemingly inevitable failure of government programs to solve the problems which they were created to address, not a single activity of government is eliminated as part of this budget package.

REASON #13: The "Deficit Reduction Trust Fund" is so phoney that even high-ranking Administration officials admit it is a gimmick.

One of the more amusing elements of the Clinton plan is the Administration's declaration that it will put all the new taxes in a "Deficit Reduction Trust Fund." Alice Rivlin, Deputy Director of the Office of Management and Budget, has admitted openly that it will have no effect. Other White House officials admit privately that the trust fund is nothing more than a political ploy to mislead voters into believing that the new tax revenues will not result in more spending. Since the Administration's own figures show the deficit increasing after the plan's enactment, the President's claim that new taxes will not be used for new spending is clearly false.

REASON #14: The budget plan increases welfare spending by more than $20 billion.

Recognizing that voters are upset with wasteful and counterproductive government spending, White House officials go out of their way to argue that the budget package contains deep spending cuts. Not only is this not true, as discussed above, but the Clinton plan actually uses some of the new tax revenue to boost welfare spending. Spending for the Earned Income Tax Credit is slated to increase by $19.1 billion. The Food Stamp program, spending on which already has increased by more than 50 percent in the last four years, will receive an additional 2.5 billion.

REASON #15: The Clinton package is a repeat of the failed 1990 budget deal.

The New York Times editorialized last week that Clinton's budget plan is "exactly what Congress did under President Bush three years ago." While the newspaper's editors were wrong to conclude from this that higher taxes are desirable, they were right to note the similarities between the two budget plans. Both packages contained record tax increases, including "soak-the-rich" increases in income tax rates and boosts in the gasoline tax. And like the 1990 budget deal, the Clinton plan promises to make future spending cuts. The similarities between the two plans are particularly ominous since, by all objective measures, the 1990 budget deal was a catastrophic failure. The economy began to stall shortly after the 1990 budget summit began (just as it has slowed today in anticipation of the Clinton tax hike) and then fell into recession. The 1990 tax hike triggered the largest domestic spending increase ever. Combined with falling revenues due to an economy weakened by the then-record tax increase, this surge of new spending pushed the budget deficit to an all-time high. Unemployment, meanwhile, went up, and more than one million Americans lost their jobs. Family incomes, after rising consistently during the Reagan boom, suffered one of their worst-ever declines.

CONCLUSION

No country ever has taxed and spent its way into prosperity. Large tax increases accompanied by higher spending were tried by Herbert Hoover, Lyndon Johnson, Jimmy Carter, and George Bush. In every case, an economic downturn followed. Nonetheless, the Administration and its supporters in Congress seem determined to repeat the mistakes of the past. The result, unfortunately, is all but certain: Higher taxes will lead to higher spending, larger deficits, more unemployment, and lower economic growth.

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