# The Heritage Lectures

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# Shaping America's Economic Course

*By Jack Kemp*

The Heritage Foundation

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# Shaping America's Economic Course

## By Jack Kemp

While I've always considered myself an ideological soulmate to all of you at Heritage, this year I'm especially proud to be able speak as one of you. I'm now serving as a Distinguished Fellow at The Heritage Foundation, where I hope to help Ed Feulner and Heritage continue the great tradition of intellectual leadership of the conservative cause.

This leadership was never more important, nor more required, than today, when we face a new president and a new liberal Congress so hostile to our ideals of limited government, low taxes, controlled spending, and entrepreneurial capitalism through free markets, free trade, and free enterprise.

Recently, The Heritage Foundation has turned its intellectual firepower on exposing Clintonomics for what it really is—a mix of Ronald Reagan's rhetoric and Jimmy Carter's economics. As Tom Edsall of *The Washington Post* admitted, Clinton talks right while walking left.

As you know, Senate Republicans led by Bob Dole have put on an impressive show of unity by blocking President Clinton's so-called stimulus package of pork-barrel spending. All conservatives owe Senator Dole and Senate Republicans a debt of gratitude.

For Republicans, this is opposition government at its best—using the only institutional means available to sidetrack a spending program which would not grow the economy, it would grow the government; which wouldn't create jobs or reduce the deficit, it would erode jobs and expand the deficit.

Through their legislative actions, Republicans demonstrated that the party has the power to play a constructive role in shaping America's economic course during the Clinton years.

**Debate Over Principles.** I believe Senator Dole, Senator Trent Lott, and other Republican leaders have put the future of the entire Clinton tax plan in doubt. By doing so, they have created an opening to allow the GOP to start a real debate over economic growth and the role of government in our society.

In my view, this new debate should not be over whether we're going to spend $16 billion or $6 billion on a spending-driven stimulus package. Instead, for the good of the economy and the good of the country, America needs a real debate over the principles of what creates a growing economy.

Does government create jobs, or do entrepreneurs? Does government spending spur growth, or do lower tax rates, less regulation, and spending limits? Can government direct investment better than the private sector? The answers to these questions provide the keys to designing a strategy for long-term growth in America.

President Clinton's "New Economic Policy" simply won't work. It won't work because it is based on the false premise that people won't change their behavior when faced with higher tax rates. Take a look at the specific assumptions at the heart of his plan.

Will raising taxes reduce the deficit? No, it will weaken our economy and increase the deficit. This has been the history of every tax increase enacted over the past decade. As Dan Mitchell of

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The Heritage Foundation has pointed out, substantial tax increases were enacted in 1982 and 1990 for the purpose of deficit reduction. Yet in every case, the deficit went *up*, not down, in the year following these tax increases.

**Lessons From History.** The 1990 budget agreement serves as a good case study because it so closely mirrors Clinton's New Economic Policy. The assumption behind this plan was that higher taxes, especially on the rich, would lead to more government revenues, lower deficits, and greater economic growth.

Well, the facts show exactly the opposite.

Taxes went up, the economy went down, and millions of middle-class and low-income workers lost their jobs in the recession. The deficit increased from 3.1 percent of gross domestic product (GDP) in 1990 to 5 percent by 1992 because the anticipated tax revenues failed to materialize, as they always do when taxes are raised, and the size of government expanded. Slower economic growth, compared with the four years prior to the budget agreement, cost the Treasury an estimated $180 billion in lost revenues in 1992 alone.

This experience demonstrated once again that the best way to reduce the deficit is to expand the tax base by creating new jobs and new businesses. Few remember that the budget deficit was declining before the 1990 budget deal. Measured in 1987 dollars, the deficit fell by more than 60 percent from 1986 to 1989, from $227 billion to $142 billion, or from nearly 5.5 percent of GDP to around 2.5 percent of GDP.

Will we see lower interest rates as a result of this package? No, even if the history of tax increases is repealed and higher taxes reduce the deficit, there is no guarantee of lower interest rates.

The Heritage Foundation studied the correlation between interest rates and deficits over the past twenty years and found that they have moved in the opposite direction 76 percent of the time. Between 1989 and 1993, for example, the deficit increased from $152 billion to an estimated $327 billion while yields on three-year Treasury notes dropped from 9.41 percent to around 4.35 percent.

Low interest rates are a function of investors' confidence that the value of the dollar will be preserved. The monetary policies of Federal Reserve Chairman Alan Greenspan and Fed Governor Wayne Angell—which have brought us close to price stability—are responsible for lower interest rates, not Bill Clinton's promise of higher taxes.

Will raising tax rates to over 40 percent on wealthy Americans force them to pay their fair share? No, raising tax rates won't hurt the rich. They can shift their money out of productive investments that create jobs into tax shelters which have little or no economic benefit for the nation. Or they can avoid paying taxes by investing in tax-free municipal bonds or by shifting their earnings to non-taxed perks and fringe benefits.

Harvard economist Martin Feldstein estimated that if higher rates caused people to reduce their taxable income by just 10 percent, three-quarters of Clinton's expected revenue gains would disappear.

The lesson of the Reagan-Kemp-Roth tax rate cuts—and the Kennedy tax rate cuts for that matter—is that lower tax rates on wealthy Americans increase their share of the tax burden. In 1990, the wealthiest 5 percent of taxpayers paid 43 percent of all taxes, up from 36.4 percent in 1980.

For Bill Clinton, raising tax rates will be a Pyrrhic victory when the middle class and low-income Americans are forced to bear a greater share of the tax burden in the name of soaking the rich and class envy.

The point needs to be made once again that a fiscal policy committed to punishing success, penalizing investment, and discouraging family saving will cost jobs and reduce economic growth. Our economic policy should be aimed at nurturing and expanding the recovery, not burdening American workers, investors, and businesses with higher taxes and more government regulation.

If the whole Clinton model is wrong, it's time to propose alternatives. That's why Empower America—the organization Bill Bennett, Jeane Kirkpatrick, Vin Weber, and I co-founded—has formed an alliance with over 100 national and state organizations to oppose the Clinton tax increases. We believe that expanding economic growth, jobs, and opportunity for all our people must be the goal of America's economic policy.

To achieve this goal, we must build a strong foundation of rewards and incentives for entrepreneurship and productivity with lower tax rates, sound money, less government regulation, and open trade.

We must also respect the first and last rule of sound tax policy: Tax something more, and you'll get less of it; tax something less, and you'll get more of it.

Conservatives are strongly united in their opposition to the Clinton economic plan, but we have yet to unite on an alternative. In that spirit, here are some ideas designed to create and sustain a growing, entrepreneurial economy in the 1990s.

**First, encouraging investment, entrepreneurship, and job creation.** In a global economy—where $1 trillion in capital crosses national borders daily seeking the highest return—America simply cannot compete while imposing the highest tax on business formation in the industrial world.

It is an undeniable fact that we cannot create more employees without first creating more employers. How do we create more employers? By unleashing and expanding the supply of capital available to start new businesses and create new jobs.

We should begin by phasing out the tax on capital gains for any asset held for two or three years. While we're at it, we should completely eliminate the capital gains tax and the Alternative Minimum Tax for anyone who invests and creates jobs in America's distressed inner cities. As Heritage's Stuart Butler has said, we need to greenline our nation's pockets of poverty for success instead of poverty and dependency.

In addition, we should immediately index retroactively for inflation all barriers to the creation of new businesses and the expansion of existing businesses. This includes indexing not only capital gains taxes, but depreciation allowances, corporate tax rates, and retirement plans such as IRAs and 401(k)s.

These proposals will increase the rewards for those entrepreneurs and investors who create the most jobs and opportunities. They stand in sharp contrast to the Clinton industrial policy of trading off a temporary Investment Tax Credit, which favors machines over people, for a permanent increase in the corporate tax rate.

**Second, providing tax relief for working Americans.** The 1990 budget agreement started a trend—which President Clinton apparently wants to continue—toward higher tax rates combined with more inefficient tax loopholes. Our goal should be to move in the opposite direction toward a flatter, fairer tax system—one that rewards, not punishes, working, saving, and investing.

To encourage job creation, we should adopt the main thrust of Senator Moynihan's plan to reduce the payroll tax rate—currently the greatest tax burden on middle income workers. This proposal would expand employment by lowering the cost of hiring additional workers and increasing the reward for working.

**Third, firm caps on federal spending.** Spending restraint should be part of an overall philosophy of limited government. We should be committed to reducing the cost and burden of government whether the budget is in deficit or surplus.

Congressman John Kasich and Senator Hank Brown each have produced specific spending reduction plans which demonstrate beyond all doubt that we can cut the deficit without raising taxes. And The Heritage Foundation has proposed spending reductions including $275 billion once supported by top Clinton OMB officials Leon Panetta and Alice Rivlin.

In addition to cutting wasteful spending, we should establish strong budget caps to ensure that federal expenditures do not grow faster than the economy. For instance, capping the growth of entitlements, except Social Security, at the rate of inflation plus population growth would save $257 billion over five years.

Governments around the world, from Mexico and Argentina to Eastern Europe, as well as America's largest corporations, are downsizing and streamlining to become more efficient and productive. It's time the U.S. government did the same. We could begin by privatizing government functions like Amtrak, the National Endowment for the Arts, the Corporation for Public Broadcasting, the Rural Electrification Administration, and the Small Business Administration, among others.

Congress should also adopt institutional changes which would make it easier to block useless spending and more difficult to raise tax rates. A line-item veto, which Governor Clinton used in Arkansas, would give the President the ability to eliminate pork-barrel projects and help us balance the budget by cutting wasteful spending without raising taxes.

**Fourth, implementing a free enterprise anti-poverty program.** Today, low-income Americans remain segregated in a "second economy" that perpetuates poverty instead of encouraging self-sufficiency and economic independence. The fault lies not with the values of the poor, but with the welfare system that prevents low-income Americans from realizing their God-given human potential.

No longer can policies which empower government bureaucracies rather than families and individuals claim any moral or practical authority. We conservatives should support a serious anti-poverty program based on the proven values of entrepreneurship, homeownership, strong families, and education.

We should establish enterprise zones in every distressed urban and rural community and eliminate the capital gains tax for anyone who works, saves, or invests in a zone. We should give every resident of public housing the right to help manage his or her community and work toward homeownership. We should expand educational voucher programs so that all families—not just the rich—can send their children to the schools of their choice. We should allow low-income people to save and accumulate assets, currently illegal under federal Aid to Families with Dependent Children (AFDC) laws, and end the penalties for getting married and forming families.

These proposals would extend the benefits of entrepreneurial capitalism and private property ownership to America's most impoverished communities while helping low-income people get jobs and return to the economic mainstream. Conservatives must show people and families of all backgrounds that our policies and ideas will work for them.

**Fifth, expanding trade and opening markets to growth.** Protectionism forces companies to compete in Washington for government favors instead of competing in the marketplace to build better products and deliver better services. Open trade forces governments to compete to lower taxes and reduce regulations to make their economies more competitive in the global marketplace.

The liberalized trading policies of Presidents Reagan and Bush helped expand the global export market to $3.1 trillion, or nearly 15 percent of worldwide output, by 1989. Unfortunately, the Clinton Administration seems intent on paying lip service to these policies while favoring a zero-sum course of confrontation by the U.S. matched by retaliation by our trading partners.

Already, the Clinton Commerce Department has slapped tariffs averaging 27 percent on imported steel, driving up the price of this important basic material. The Administration has also threatened to raise tariffs on mini-vans by 1,000 percent—a huge blow to American families.

And while President Clinton publicly claims to support the North American Free Trade Agreement, he seems more interested in imposing environmental and social policies on Mexico than in expanding trade in our hemisphere.

For over forty years, the United States has been the worldwide champion of free and open trade. The global trading system helped anchor Germany and Japan in the family of democratic nations following World War II and led to expanded economic growth unprecedented in human history. Our generation should be no less ambitious.

We should negotiate a series of free trade agreements to open new markets for U.S. goods and services. These agreements should extend not just to Latin and South America, but should include the Pacific Rim states and the former communist nations as well.

We should also take a more active role in completing the Uruguay round of the General Agreement on Tariffs and Trade (GATT), currently floundering for lack of leadership. This would expand economic growth at home and help secure the success of democracy and entrepreneurial capitalism abroad.

**Sixth, relieving the tax burden on families.** Republicans must also champion tax reform that recognizes the family as America's paramount value-shaping institution. Economic growth is not an end in itself. The moral, spiritual, and cultural health of our nation is inextricably linked with the strength of the American family. That strength is being undermined by government policies, both economic and social, which are biased against marriage and families with children.

The American family is the most overtaxed institution in America. To help relieve this burden, we should phase in an increase in the personal exemption, which has failed to keep pace with inflation over the years. Our ultimate goal should be to restore the value of the exemption to the Truman level, which in current dollars would be over $6,000. This would be part of an overall plan to support the family which would include policies such as educational choice to allow parents to control where their children attend school.

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Candidate Clinton promised a plan for economic growth, but President Clinton delivered a package which will slow the recovery and hurt American families. If the Clinton Administration bases its policies on the assumption that higher taxes, more government spending, and more regulation will help the economy grow, no amount of salesmanship or soaring rhetoric will make the plan work.

And as long as we have The Heritage Foundation, we can be sure that the Americans people will understand the real impact of President Clinton's economic and social policies.