214 Massachusetts Avenue, N.E.
Washington, D.C. 20002-4999
(202) 546-4400
http://www.heritage.org

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BALANCED BUDGET TALKING POINTS #9: WHY TAX RELIEF IS NECESSARY IN A BALANCED BUDGET

William W. Beach
Visiting Fellow in Tax Analysis
and
John S. Barry
Policy Analyst

Some policymakers maintain that tax relief is out of place in the quest for a balanced budget. They argue that tax cuts cannot be justified because they make the goal of a balanced budget even harder to reach.

But contrary to this view, the inclusion of tax cuts should be viewed as a critical component of any balanced budget plan. The reason is that reducing or eliminating tax relief on income from capital would lower potential economic growth significantly and would not in fact make room for new spending.

Economists at The Heritage Foundation recently used one of the principal econometric models of the U.S. economy to project the economic and fiscal effects of eliminating the tax relief elements of the congressional balanced budget act. This analysis shows:

- ✓ **The congressional balanced budget plan with tax cuts, as vetoed by President Clinton, would add $112 billion more to Gross Domestic Product (GDP)** over the next seven years than the same congressional plan *without* tax cuts.
- ✓ **The reductions in taxes on capital (including the capital gains tax relief) accounts for $66 billion of this additional GDP** and leads to a stronger economy in the long run.

Heritage Foundation economists conducted this analysis of the congressional balanced budget plan using the econometric model developed by Laurence H. Meyer & Associates. Laurence H. Meyer & Associates is a nationally recognized consulting firm specializing in economic analysis.[1] The Meyer model is used by many major public agencies and private firms, in-

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1 For a full analysis of the Balanced Budget Act of 1995 as passed by Congress and vetoed by President Clinton, see William W. Beach and John S. Barry, "What a Balanced Federal Budget with Tax Cuts Would Mean to the

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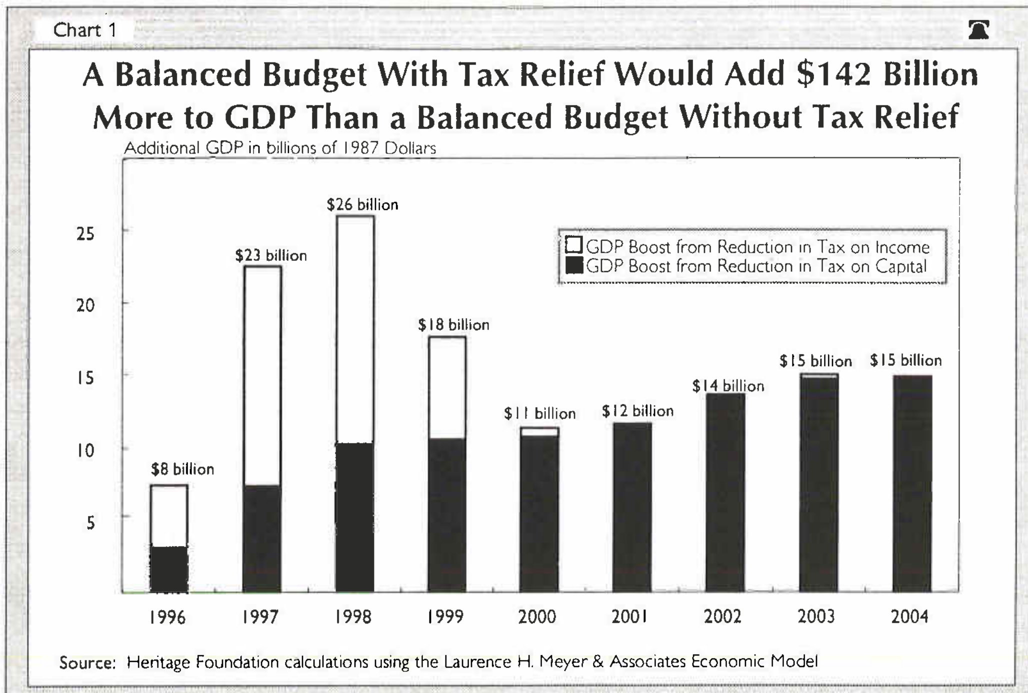
cluding the President's Council of Economic Advisers, the Office of Management and Budget, the Board of Governors of the Federal Reserve, the Congressional Budget Office, the National Association of Realtors, and the National Association of Home Builders.[2]



The congressional tax relief plan includes a reduction of taxes on families and on capital. The lower taxes on family income include primarily the $500-per-child tax credit, a reduction in the marriage penalty, and the adoption tax credit. The lower tax rates on income from capital include tax changes affecting capital gains, individual retirement accounts, the alternative minimum tax, and the estate and gift tax provisions.

The Benefits of Reducing Taxes on Family Income

The cornerstone of the reductions in taxes on family income is the $500-per-child tax credit. The immediate benefit of the $500-per-child tax credit included in the congressional balanced budget is an increase in household disposable income. Although $500 may seem insignificant in light of the entire federal budget, it is a substantial benefit to individual families. As demonstrated by previous Heritage analysis, a family with a newborn baby could save the entire $500 each year for eighteen years and afford the tuition costs at an average public university.[3] Alternatively, an average family with two children could use the $1,000 credit to purchase one month's supply of food and mortgage.[4] This additional private sector savings and consumption made possible by the $500-per-child tax credit and other reductions in family income taxes will benefit the economy.

Economy," Heritage Foundation *F.Y.I.* No. 69, November 14, 1995.

2 Laurence H. Meyer & Associates long has earned top honors for forecasting accuracy when compared against similar firms. In 1993, it earned the "Blue Chip" forecasting award for the years 1989-1992. LHM&A was ineligible for the award in 1994, but again was rated the most accurate forecasting firm in the United States.

3 John S. Barry, "Balanced Budget Talking Points #3: What a Balanced Federal Budget with Tax Cuts Would Mean for Family College Costs," Heritage Foundation *F.Y.I.* No. 77, December 4, 1995.

4 Scott A. Hodge, "Balanced Budget Talking Points #4: The $500-per-Child Tax Credit Means One Month's Food and Mortgage for a Typical American Family," Heritage Foundation *F.Y.I.* No 75, December 4, 1995

The Benefits of Reducing Taxes on Capital

The cornerstone of the reductions in taxes on capital is the capital gains tax relief. Owners of appreciated assets sell those assets largely for one of two reasons: either to meet extraordinary expenses (educational, medical, or other large and non-recurring costs) or to move their money from an inferior to a superior investment. When government takes less of this income, household spending stimulates economic activity and more efficient investment fuels economic growth.

Not surprisingly, the impact of a capital gains tax cut on investment and economic growth is more important in the long run than its role in allowing households to pay big bills. Two reasons for this relative importance stand out. First, reducing the tax on capital gains lowers the cost of moving an investment from an average company to one that is exceptionally productive and well run. This lowering of the "switching" costs means that investors will play a larger role in promoting well run, productive companies. Thus, the economy as a whole is likely to be more efficient. Second, lower taxes on capital cause the cost of capital to fall. Lenders, for example, do not require quite as much interest on their capital loans in order to recoup the taxes they paid when they made the capital available to a borrower. Lower capital costs usually mean more investment by businesses in labor-saving equipment, which commonly results in increased labor productivity. This increased productivity gets translated into higher wages and, through the wonders of the division of labor, more jobs.

The following table compares the level of various economic indicators that result from the congressional balanced budget plan with tax relief and the congressional balanced budget plan without tax relief. Specifically,

✓ **Gross Domestic Product would be $13.7 billion more** in the year 2002 as a result of the congressional plan *with* tax relief compared to the same plan *without* tax relief.

✓ **Real disposable income would be $23.1 billion more** in the year 2002 as a result of the congressional plan *with* tax relief compared to the same plan *without* tax relief.

Removing capital gains tax relief from the congressional balanced budget will not allow increased federal spending. The capital gains tax relief element of the congressional balanced budget plan actually *reduces* the deficit in every year through 2002. There are two reasons for this. First, a reduction in the capital gains tax rate will produce more declarations of capital gains and thus increase government revenue from the capital gains tax. Second, the capital gains tax reduction creates a stronger economy, thus increasing the federal tax base.

Economists estimate that trillions of dollars in unrealized capital gains (perhaps as high as $7.5 trillion) exist in the portfolios of American taxpayers.[5] Some economists have estimated that significant capital gains rate changes could produce substantial economic benefits and create revenue windfalls for federal and state governments. In an article last year for the *American Economic Review*, Leonard Burman and William Randolph, two leading tax economists on the staff of the Congressional Budget Office, estimated the response of taxpayers to rate reductions as being on the order of 6 to 1. That is, for every one percent drop in the rate, capital gains realizations would rise by 6 percent.[6] The federal government would collect tax revenues on these "windfall" capital gains that under the current tax rate would not have been declared.

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5 See, for example, Jude Wanniski's testimony before the Senate Finance Committee on March 15, 1995, as cited in Stephen Moore and John Silvia, "The ABCs of the Capital Gain Tax," Cato Institute *Policy Analysis* No. 242, October 4, 1995.

6 Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," *American Economic Review*, Vol. 84, No. 4 (September 1994), p. 803.

Economic Indicators: Congressional Balanced Budget With and Without Tax Relief

		1996	1997	1998	1999	2000	2001	2002	2003	2004
Real Gross Domestic Product (billions $1987)	BBA with tax relief	$5,676	$5,810	$5,933	$6,070	$6,232	$6,418	$6,575	$6,733	$6,912
	BBA without tax relief	$5,669	$5,787	$5,908	$6,053	$6,221	$6,407	$6,562	$6,718	$6,897
	Difference	$8	$23	$26	$18	$11	$12	$14	$15	$15
Real Personal Disposable Income (billions $1987)	BBA with tax relief	$4,073	$4,148	$4,213	$4,301	$4,404	$4,517	$4,620	$4,730	$4,847
	BBA without tax relief	$4,064	$4,123	$4,187	$4,279	$4,383	$4,495	$4,597	$4,705	$4,820
	Difference	$9	$25	$26	$22	$20	$21	$23	$25	$26
Real Consumption Expenditures (billions $1987)	BBA with tax relief	$3,775	$3,856	$3,929	$4,015	$4,117	$4,226	$4,324	$4,427	$4,537
	BBA without tax relief	$3,769	$3,838	$3,908	$3,997	$4,101	$4,211	$4,308	$4,410	$4,519
	Difference	$6	$17	$21	$19	$16	$15	$16	$17	$18
Real Nonresidential Fixed Investment (billions $1987)	BBA with tax relief	$828	$874	$919	$968	$1,022	$1,085	$1,138	$1,183	$1,241
	BBA without tax relief	$826	$865	$907	$959	$1,017	$1,081	$1,134	$1,178	$1,235
	Difference	$3	$9	$12	$9	$5	$4	$4	$5	$6
Total Industrial Production (1987=100)	BBA with tax relief	125.5	128.6	131.4	134.7	138.4	142.8	146.3	149.7	153.6
	BBA without tax relief	125.2	127.8	130.5	134.0	138.0	142.4	145.8	149.1	153.0
	Difference	0.3	0.8	0.9	0.7	0.4	0.4	0.5	0.6	0.6
Purchases of New Autos (billions $1987)	BBA with tax relief	$75.3	$76.3	$75.3	$76.1	$77.1	$80.3	$83.2	$85.8	$88.4
	BBA without tax relief	$74.6	$75.0	$74.2	$75.5	$77.0	$80.1	$82.8	$85.2	$87.9
	Difference	$0.7	$1.3	$1.1	$0.6	$0.1	$0.2	$0.4	$0.6	$0.5

Source: Heritage Foundation estimates using the Laurence H. Meyer & Associates Macroeconometric Model.

Notes: BBA = Balanced Budget Act; dollar amounts are rounded.

The congressional tax relief proposal, including the capital gains tax reduction, would allow individuals and owners of capital to keep more of the money they otherwise would have paid in taxes. This additional private sector savings and spending would be allocated more efficiently than had the federal government spent the money and thus will lead to a stronger economy. A stronger economy, in turn, means a larger tax base from which the federal government can draw revenue.

The important complement to this analysis is that, contrary to popular belief, additional spending opportunities for the federal government would not be available if the capital gains tax relief element of the congressional balanced budget plan is eliminated. In fact, additional spending reductions would be necessary in the future to offset the potential revenue foregone by elimination of the capital gains tax reduction.

TECHNICAL ASSUMPTIONS

To conduct the simulation of the congressional budget plan, Heritage economists adjusted only those elements of the Laurence H. Meyer & Associates baseline forecast that deal with federal spending and federal tax policy.

The analysis is based on spending reductions specified in the Balanced Budget Act of 1995, passed by Congress and vetoed by President Clinton on December 6. For specific assumptions concerning these spending reductions see, William W. Beach and John S. Barry, "What a Balanced Federal Budget with Tax Cuts Would Mean to the Economy," Heritage Foundation *F.Y.I.* No. 69, November 14, 1995.

The major components of the congressional tax relief package were accounted for in the following manner:

- ☞ A 50 percent exemption of individual capital gains was assumed for taxation purposes through 2004. The maximum corporate capital gains tax rate was reduced from 35 percent to 28 percent.
- ☞ The average effective tax rate on individuals was reduced according to the annual value of the $500-per-child tax credit.
- ☞ Other provisions of the congressional tax relief package were accounted for by changing the effective tax rates on wages, dividends, and individuals.

The analysis in this paper is based on the November economic forecast and projection of Laurence H. Meyer & Associates. This is the most recent economic forecast available from Laurence H. Meyer & Associates.

Note: Reduction in tax on income includes: family tax relief, the reduction in the marriage penalty; and the adoption tax credit.
Reduction in tax on capital includes: tax changes affecting capital gains, IRAs, the alternative minimum tax, and the estate and gift tax provisions.