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WHY PRO-GROWTH TAX CUTS ARE NEEDED IN A BALANCED BUDGET PACKAGE

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INTRODUCTION

It is common to hear prominent policymakers in Washington argue that reaching a balanced budget would be much easier if only proposed tax cuts were eliminated or delayed. On the face of it, this sounds plausible: If \$98 billion of tax cuts were abandoned, would not balance then be \$98 billion easier to reach?

Added to this is a widespread assumption that all tax changes are alike in how they affect the deficit and the economy. So negotiations take place on Capitol Hill about tax packages of a certain amount over so many years, as though the composition of the measure had no tangible economic effect upon Americans other than to change the deficit outlook.

A Heritage econometric analysis using a leading model of the economy, however, shows that this simplistic view misunderstands the relationship between tax increases, or reductions, and the generation of tax revenues. Certain tax reductions (such as across-the-board cuts in income tax rates or cuts in the capital gains tax rate) stimulate the economy, and a faster-growing economy not only strengthens tax receipts—recouping some of the revenue losses normally associated with tax cuts—but also produces more jobs and higher income. Ignoring the real economic effects of deficit reduction options means ignoring their effects on ordinary Americans.

Thus, as the Clinton Administration and many congressional leaders talk about “belt-tightening” and “shared sacrifices,” it is important to recognize that tax cuts can be combined with spending reductions to produce a balanced budget *while also* achieving a stronger, faster-growing economy.

To illustrate the impact of tax changes within a deficit reduction package, Heritage analysts used the WEFA Group’s U.S. Macroeconomic Model to compare the economic and deficit consequences of the following alternative packages:

- ❶ President Clinton's February 1997 deficit reduction plan;
- ❷ The identical plan *without* the President's tax reduction package; and
- ❸ The identical plan with the same dollar amount of tax cuts, but with pro-growth tax cuts substituted for the President's tax plan. The package substituted for the White House tax plan was a 50 percent reduction in the capital gains tax rate and repeal of the death tax (known technically as the estate tax).

In using the WEFA model, Heritage analysts incorporated assumptions dealing with revenue reflow associated with capital gains tax reductions, changes in the labor force resulting from lower taxes, and the small but important reductions in the cost of capital that stem from repeal of the death tax (see Technical Appendix for details). No other significant economic assumptions were incorporated into the model.

Even though President Bill Clinton's tax proposals are not well-designed to stimulate economic expansion, the Heritage analysis shows that the effect of removing the package is clear and harmful. If Congress were to pass the President's plan without his proposed tax reductions, the economy would weaken significantly compared with the effect of his plan with tax reductions, and yet the "payoff" in improved deficit reduction would be disappointing. If, on the other hand, Congress were to pass the President's plan *with pro-growth tax cuts*, the economy would gain strength until 2001, when the President's spending reductions phase in. Specifically:

- The cumulative **federal deficit** improves by only \$11.6 billion over five years *without* the President's tax cuts, when compared with the Congressional Budget Office (CBO) estimate of the deficit under current law. The President's plan, with his targeted \$98 billion tax cuts, actually worsens the deficit by \$141.33 billion while only marginally improving economic performance (see below). In other words, every dollar in targeted tax cuts produces \$1.44 in new debt. Replacing the President's tax package with \$167 billion of pro-growth tax cuts, however, means the economy would grow significantly while adding only \$52.5 billion to the baseline deficit, or 31 cents in deficit for every dollar in tax cuts.
- **The income tax base**, which is the pool of household and business income from which federal revenues are drawn, would shrink in the President's plan without tax cuts by \$101 billion over the five-year period from fiscal year (FY) 1998 through FY 2002. This helps explain the disappointing effect on the deficit of eliminating the tax cut. Pro-growth tax cuts in the President's plan would cause the tax base to *grow* by \$247 billion over this same period.
- If the President's tax package were stripped from his tax plan, **jobs in the private sector** would drop by an annual average of 132,000 below the level they would achieve in the President's plan with tax cuts. Employment would grow, however, by an annual average of 287,000 if the pro-growth tax package were substituted for his tax plan.
- Inflation-adjusted **disposable personal income**—the funds out of which households buy all their food, shelter, medical care, and educational services—would slow by \$144 billion over five years if the President's tax plan were eliminated. But pro-growth tax cuts would result in disposable income growth of \$159.6 billion over this same period.

One reason for these results is that the President's lopsided plan pushes nearly all spending reductions to the last two years of the five-year period and his tax reduction proposals, such as tax credits for children, education, and training, do little to support economic growth between now and the end of FY 2002. Were he to recommend a set of pro-growth tax policy changes, such as cuts in the capital gains tax rates and repeal of the death tax, the economic and budget effects would be very different and beneficial.

SACRIFICES VERSUS BENEFITS

There are two related economic reasons why combining spending reductions with tax reductions is a better strategy for reaching a balanced budget than spending cuts alone.

- Reducing the level of federal spending slows the economy in the short run until the private sector picks up the economic slack, and a tax cut can offset this effect. The “fiscal effect” associated with reductions in spending commonly means higher unemployment rates, lower wage growth, and fewer new jobs in the short term. But a tax package designed to spur investment and growth will speed up the private sector and reduce the period of economic transition. Reducing tax rates on labor and capital promotes economic expansion, thus increasing available tax revenues, while spending cuts reduce inflation pressures and promote stable interest rates.
- If taxes are too high, they can damage the long-term health of the economy. The tax increases of 1990 and 1993, which reversed the low tax policies of the Reagan years, have combined to produce the slowest economic expansion since World War II. No recovery from recession has been as sluggish as the recovery from the 1991 recession. Despite talk of an “overheated” economy, the average growth rate during this recovery has been only 13.7 percent, which compares unfavorably with the average of 25.7 percent for the past three expansions.¹ Thus, even when seeking a balanced budget, it is wise also to promote economic growth through well-crafted tax cuts. This will achieve deficit reduction while assuring a strong economy.

A CASE STUDY: THE PRESIDENT’S PLAN WITH THREE “TAX SCENARIOS”

The importance of tax cuts to balancing the budget can be illustrated simply by using the President’s own budget message submitted to Congress in early February. When the President’s relatively modest tax cuts are taken out of his budget plan, slowdown occurs in all of the key economic indicators. When the President’s tax reduction initiatives are replaced with pro-growth tax cuts, the economy grows across all fronts.

The President called for \$146 billion in spending reductions between FY 1998 and FY 2002. Over 75 percent of these reductions, however, are scheduled to occur in the last two years of the five-year plan. In fact, during the first two years of the plan, FY 1998 and FY 1999, the President actually proposes spending increases. The President also called for \$98 billion in tax cuts, primarily for individuals, and \$76 billion in tax increases, primarily for businesses.²

Both the CBO and The Heritage Foundation concluded that the President’s plan fails to balance the budget by the end of FY 2002.³ Although it is unclear precisely how the CBO evaluated the economic effects of the President’s budget plan, Heritage’s analysis used the WEFA Group’s U.S. Macroeconomic Model to score the recommended spending and tax policy changes dynamically.⁴

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- 1 *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1997), Table B-2, p. 302; WEFA Group forecast of deflated gross domestic product for 1996 (available upon request from the author); Mark Wilson, “Why Americans Are Right to Be Anxious in Clinton’s Lackluster Economy,” *Heritage Foundation F.Y.I.* No. 96, April 19, 1996, p. 3.
 - 2 Office of Management and Budget, *The Budget of the United States Government, Fiscal Year 1998* (Washington, D.C.: U.S. Government Printing Office, 1997).
 - 3 Congressional Budget Office, “Preliminary Analysis of the President’s Budgetary Proposals for Fiscal Year 1998,” prepared at the request of the Senate Committee on Appropriations, March 3, 1997; William W. Beach and John S. Barry, “The Economic and Deficit Implications of President Clinton’s FY 1998 Budget,” *Heritage Foundation F.Y.I.* No. 133, February 27, 1997.

Table 1

Economic Effects of Three Different "Tax Scenarios"

	FY1998	FY1999	FY2000	FY2001	FY2002	Over Five Years
Gross Domestic Product (Inflation Adjusted)						
Change from Baseline with Administration's Tax Cuts	8.44	-1.61	-7.91	-7.91	-24.31	Total -33.31
Change from Baseline without Tax Cuts	-3.69	-10.54	-14.60	-14.60	-23.48	-66.90
Change from Baseline with Pro-Growth Tax Cuts	17.54	14.80	5.00	-4.90	-21.35	11.09
Difference Between Pro-Growth and No Tax Cuts	21.23	25.34	19.60	9.70	2.13	77.99
Difference Between Pro-Growth and Administration's Tax Cuts	9.10	16.41	12.91	3.01	2.96	44.40
Private Employment						
Change from Baseline with Administration's Tax Cuts	238,000	213,000	126,000	127,000	-47,000	Average 131,400
Change from Baseline without Tax Cuts	39,000	56,000	-16,000	15,000	-99,000	-1,000
Change from Baseline with Pro-Growth Tax Cuts	376,000	480,000	322,000	255,000	2,000	287,000
Difference Between Pro-Growth and No Tax Cuts	337,000	424,000	338,000	240,000	101,000	288,000
Difference Between Pro-Growth and Administration's Tax Cuts	138,000	267,000	196,000	128,000	49,000	155,600
Unemployment Rate						
Change from Baseline with Administration's Tax Cuts	5.47	5.678	5.823	5.928	6.032	Average 5.786
Change from Baseline without Tax Cuts	5.613	5.788	5.921	6.005	6.067	5.879
Change from Baseline with Pro-Growth Tax Cuts	5.439	5.553	5.751	5.905	6.064	5.742
Difference Between Pro-Growth and No Tax Cuts	-0.174	-0.235	-0.170	-0.100	-0.003	-0.136
Difference Between Pro-Growth and Administration's Tax Cuts	-0.031	-0.125	-0.072	-0.023	0.032	-0.044
Disposable Personal Income (Inflation Adjusted)						
Change from Baseline with Administration's Tax Cuts	35.98	18.18	11.98	11.61	4.52	Total 82.26
Change from Baseline without Tax Cuts	1.21	-5.37	-14.50	-17.66	-25.69	-62.01
Change from Baseline with Pro-Growth Tax Cuts	41.15	39.54	30.34	28.41	20.14	159.58
Difference Between Pro-Growth and No Tax Cuts	39.94	44.91	44.84	46.07	45.83	221.59
Difference Between Pro-Growth and Administration's Tax Cuts	5.17	21.36	18.36	16.80	15.62	77.32
Income Tax Base (Inflation Adjusted)						
Change from Baseline with Administration's Tax Cuts	12.59	14.53	15.40	20.55	21.04	Total 84.11
Change from Baseline without Tax Cuts	1.68	0.39	-4.16	-4.67	-10.18	-16.92
Change from Baseline with Pro-Growth Tax Cuts	24.76	40.69	48.34	58.27	58.17	230.24
Difference Between Pro-Growth and No Tax Cuts	23.08	40.29	52.50	62.94	68.35	247.16
Difference Between Pro-Growth and Administration's Tax Cuts	12.17	26.16	32.94	37.72	37.13	146.12
Federal Deficit						
Forecasted Deficits with Administration's Tax Cuts	-158.55	-156.63	-153.26	-130.79	-117.00	Cumulative Deficit Change -141.33
Forecasted Deficits without Administration's Tax Cuts	-132.08	-137.90	-126.32	-94.74	-72.25	11.62
Forecasted Deficits with Pro-Growth Tax Cuts	-152.62	-151.77	-137.13	-103.88	-81.99	-52.49
CBO Forecasted Deficits	-124.17	-128.95	-123.76	-98.84	-99.18	
		Forecasted FY 1997 Deficit=-78.1				

Source: Heritage calculations using the WEFA Group U.S. Macroeconomic Model.

The Heritage analysis found that the Clinton plan's additional spending in the first two years (FY 1998 and FY 1999), when combined with the President's targeted tax cuts, increased inflation. This led to an increase in the federal funds rate according to the WEFA model. This increase in the key federal funds rate boosted federal interest costs, which worsened the deficit picture despite sharp spending cuts in the plan's last two years. When these increased costs to government were coupled with the economic slowdown produced by higher taxes on business, the plan's effort to reach balance by the end of FY 2002 fell dramatically short of that goal.

Even so, the one beneficial feature of the President's proposal is its tax reductions, however weak. Although it would have been better for the economy if the President had proposed more aggressive, pro-growth tax policy changes, his tax reductions would strengthen the economy somewhat and support his efforts at achieving fiscal balance when compared with his plan without the tax cuts.

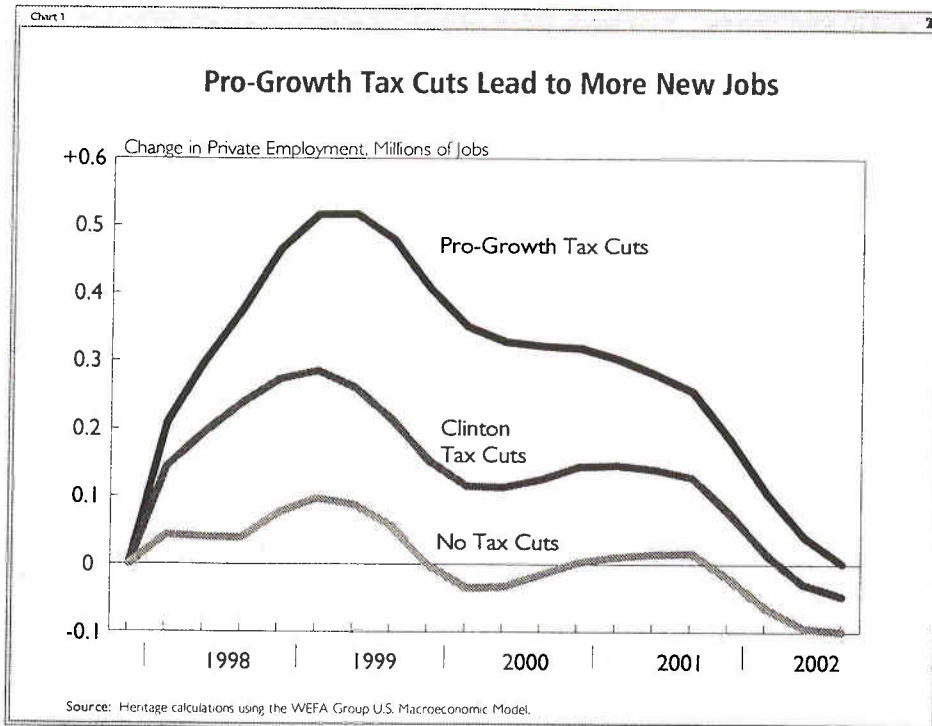
The Heritage analysis tested the importance of the President's proposed tax reductions and the effects of pro-growth tax cuts to the President's plan by using the same economic model it employed when analyzing the President's overall deficit reduction plan. This economic model was prepared for Heritage by the WEFA Group. It consists of the standard WEFA U.S. Macroeconomic Model and special settings for key economic and fiscal variables that exactly reflect all the CBO's economic and deficit assumptions as stated in its January 1997 forecast, *The Economic and Budget Outlook for 1997 through 2007*.⁵ Therefore, simulations of proposed spending and tax changes using this CBO version of the WEFA model can be viewed as dynamic scoring using CBO assumptions.⁶

Table 1 shows key economic variables and how they differ from the CBO baseline in simulations of the President's plan with and without tax reductions, and with tax policy changes for capital gains and taxable estates: the three "tax scenarios" of our analysis. For example, we subtracted all federal government purchases from gross domestic product (GDP) to see how the combined total of household, business, and foreign purchases fared under a plan with each of the tax scenarios. As Table 1 shows, the "private" GDP fell below baseline in four out of the five years with or without the President's tax cuts. This measure of economic health was twice as weak in an economy without tax reductions, however, and nearly three times stronger with pro-growth tax cuts.

The same is true of private-sector employment, only more dramatically. With the Clinton package in place, the economy without tax cuts produces hardly any new jobs, while the economy with the President's tax cuts shows significant employment gains. With his tax cuts, the economy averages 131,000 additional jobs per year; without tax cuts, employment falls. The President's plan with pro-growth tax reductions leads to annual average employment gains of 287,000, however, or twice the rate of employment growth with the President's tax cuts.

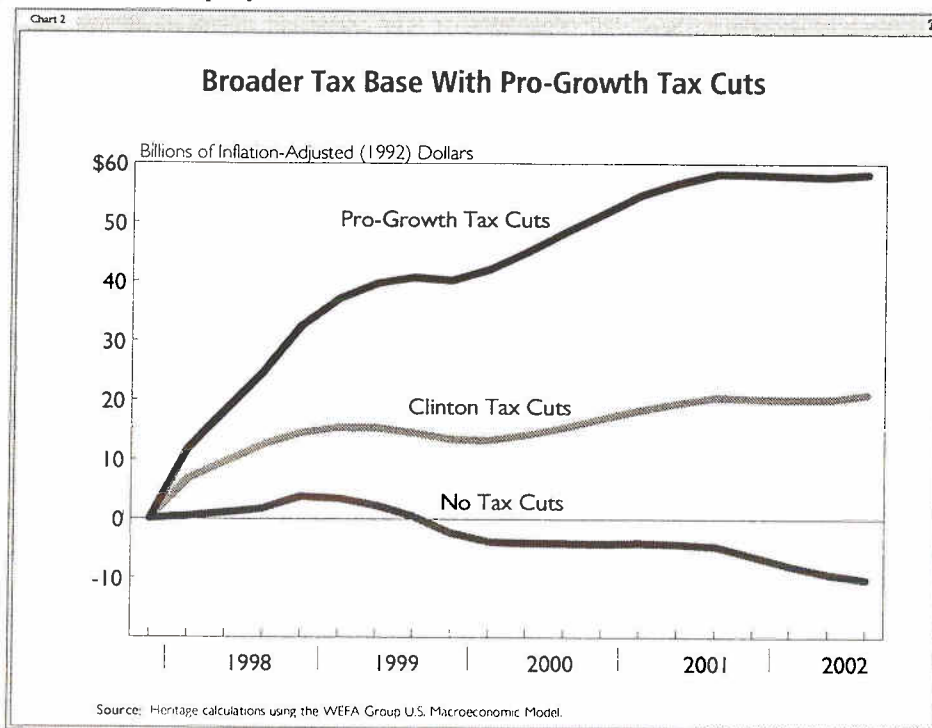
The unemployment rate also turns out to be better with tax cuts than without them. Table 1 shows that the Clinton budget with his proposed tax cuts supports an economy with generally lower rates

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- 4 This study was prepared by The Heritage Foundation using the WEFA Group's Mark 11 U.S. Macroeconomic Model. The methodologies, assumptions, conclusions and opinions herein are entirely those of The Heritage Foundation. They have not been endorsed by, and do not necessarily reflect the views of, the owners of this model. The WEFA U.S. Macroeconomic Model is a widely respected economic model that can be used to simulate the effects on economic behavior of significant budgetary and economic policy moves by Congress and the President. It is used by a number of government agencies and *Fortune*-500 companies to study the effects of policy changes.
 - 5 Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1998–2007* (Washington, D.C.: U.S. Government Printing Office, January 1997); Tables 1.1 and 2.8, chapters 1 and 2.
 - 6 See Beach and Barry, "The Economic and Deficit Implications of President Clinton's FY 1998 Budget," p. 7, for a more detailed discussion of WEFA's modifications to their model and Heritage's use in analyzing the President's budget.

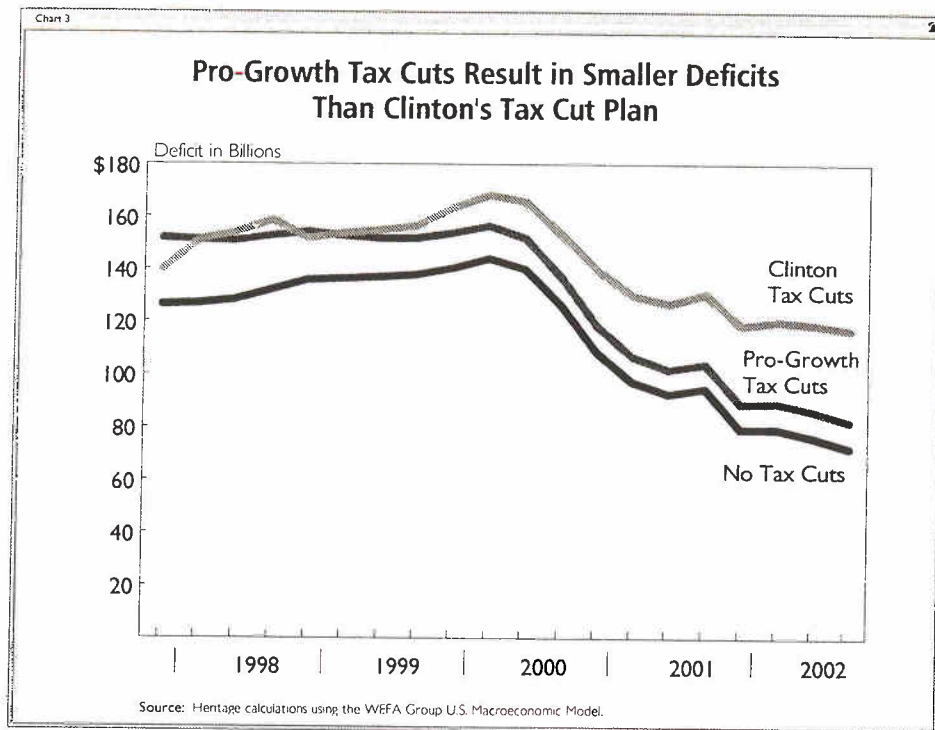


of unemployment. Surprisingly, perhaps, the Administration's budget with pro-growth tax cuts results in about the same unemployment rates, despite more than twice the rate of employment growth.

In fact, unemployment in the pro-growth scenario averages 5.74 percent, or .14 percent below the "no tax cut" scenario's 5.88 percent. To understand the implication of this seemingly small difference, it is important to recognize that a drop of .14 percent in the unemployment rates takes nearly 190,000 people off the unemployment rolls.



The interplay of economic factors reflected by these economic variables on Table 1 also shapes the pool of income from which the federal government draws its revenue. When this pool expands as a result of public policy changes, federal revenues typically rise. When this pool shrinks,



revenues typically drop. Even the President's poorly structured plan reflects this truth. With tax cuts, the income tax base grows by a total of \$84.1 billion inflation-adjusted dollars; without tax cuts, it shrinks by \$17 billion. The difference between these two plans, one with tax cuts and the other without tax cuts, is \$101 billion in the tax base. The tax base grows by \$230 billion with pro-growth tax cuts, however, or by more than twice the amount.

CONCLUSION

Models of the general economy similar to the WEFA U.S. Macroeconomic Model are intended to shed light on complex policy questions. They can guide decision making by indicating the direction and general magnitude of economic change that is likely to ensue once a course of action is taken. On tax cuts in a budget plan, the WEFA model as used by The Heritage Foundation indicates that tax cuts do more than stimulate the economy and strengthen the tax base; they also enhance the benefits associated with a strategy of balancing the budget.

What do the differences among the "three scenarios" tell policymakers about the correct policy path for balancing the federal budget?

- A budget plan that contains targeted tax cuts gives a modest boost to the economy, but not enough to counter the economic slowdown caused by spending reductions. The result is Scenario One: The deficit worsens significantly.
- A budget plan with no tax reductions achieves more deficit reduction but at the cost of jobs, wages, and economic well-being. The result is Scenario Two: The economy worsens.
- A budget plan that contains pro-growth tax cuts, however, supports the growth of new investment and jobs. The result is Scenario Three: After five years, the deficit is nearly as low as the no-tax-cut Scenario Two and the economy is substantially stronger than Scenario One, the President's current budget proposal.

TECHNICAL APPENDIX

The three simulations described in this paper were constructed from a set of tax simulation and macroeconomic models routinely employed by Heritage to analyze the effects of tax and spending changes on the financial condition of the federal government and on the general economy. The basic simulation of the Administration's tax reductions proposals is identical to the simulation of the President's FY 1998 budget that Heritage published on February 27 of this year.⁷ The Technical Appendix in that paper describes in detail the approach we took in estimating the fiscal and economic effects of that proposal. The "no-tax-cut" and the "pro-growth" simulations modified the basic simulation by eliminating the President's proposed tax cuts and by substituting his tax reductions with a 50 percent reduction in the capital gains tax rate and repeal of the federal estate (death) tax.

Even though the basic simulation is described in our earlier analysis of the President's budget plan, it is useful to describe very briefly the approach we took in analyzing the Clinton Administration's budget proposal. In brief, Heritage economists introduced the President's revenue and expenditure recommendations to a special version of the WEFA Group U.S. Macroeconomic Model that contained the CBO's January 1997 fiscal and economic assumptions. That is, we changed all of the federal expenditure estimates for FY 1998 through FY 2002 and all of the revenue estimates for those years to match exactly what the President proposed. Comparing these new future outlays with those already contained in the WEFA model gave us the President's plan: his expected budget savings and revenue changes. Heritage made no other changes in the model. The first line for each economic indicator in Table 1 above shows results from that simulation.

Our second simulation (the President's plan without tax reductions) was a simple modification of the basic simulation. We restored to their original values all of the tax settings in the WEFA model that previously had been changed to reflect the Administration's proposed tax reductions. We made no change in the President's proposed tax increases on businesses or in any of his expenditure recommendations. Likewise, no other variable in the model was changed for this "no-tax-cut" simulation. The second line for each economic indicator in Table 1 shows the results of this simulation.

Constructing the third simulation (the President's plan with pro-growth tax cuts) was somewhat more complicated. First, we estimated the static revenue changes that would result from a 50 percent reduction in the capital gains tax rate and repeal of the death (estate) tax. These two policy changes yield a static revenue reduction of \$167.5 billion over the five fiscal years of 1998 through 2002: Capital gains rate reductions "costs" \$77.5 billion and repeal of the estate tax "costs" \$90 billion. Second, we reduced the average effective tax rate in the WEFA U.S. Macroeconomic Model to reflect these revenue reductions. This rate fell by .43 points, or by 3.7 percent.⁸

Third, we adjusted the income tax base to reflect a higher level of capital gains declarations. The base was increased to reflect Burman and Randolph's estimated elasticities associated with significant capital gains rate reductions.⁹ For the first year after a 50 percent cut in the tax rate, the base grows by a ratio of 6 to 1, or by 300 percent. Thereafter the base is permanently higher by a ratio of

7 Beach and Barry, "The Economic and Deficit Implications of President Clinton's FY 1998 Budget."

8 The average value over this five-year period for the WEFA model's effective personal income tax rate is 11.6 percent. For an explanation of why the average effective personal income tax rate is an appropriate variable to use in assessing the revenue effects of death tax repeal, see William W. Beach, "The Case for Repealing the Estate Tax," Heritage Foundation *Backgrounder* No. 1091, August 21, 1996, pp. 24-26.

9 See 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).

3 to 1, or by 150 percent above its current level of declarations. Burman and Randolph found in their study that the transitory elasticity, or that effect on the base of declarations following a rate change, is about 6.42. Absent any increases in the tax rate on capital gains, capital gains declarations appear to settle at a higher level and remain relatively unaffected by the tax rate, except as the rate itself is affected by inflation. Thus, their analysis indicated a “permanent” elasticity of less than one, or .42. We chose to keep the level of additional declarations constant throughout the second through fifth years of the simulation, thus allowing only changes in price level for capital assets and the performance of corporate equities and bonds to affect the base.

Fourth, we assumed that a repeal of death taxes and a reduction of the tax rate on capital gains would have a positive influence on labor force participation decisions and reduce the cost of capital. Thus, we increased the general labor force participation rate in the WEFA model by .2 of 1 percent. About one-third of this increase in labor force participation stems from an assumed effect of death tax repeal on long-run work and leisure decisions.¹⁰ Participation rates were held constant over the simulation period. On the cost of capital, we assumed that corporate borrowing costs would drop, and we embodied this assumption in a 3 percent decrease in the corporate AAA bond rate. Thus, if the baseline rate is 6.7 percent, a 3 percent decrease would bring the rate to 6.49 percent. It is worth noting that the cost of capital decreased by slightly more than 6 percent in the simulation.

HERITAGE STUDIES ON LINE

Heritage Foundation studies are available on the Internet. The Heritage Foundation's home page address on the World Wide Web is www.heritage.org. Also, www.heritage.org/heritage/taxsite/ is Heritage's comprehensive source for the latest on tax reform. Bookmark these sites and check them daily for new information.

¹⁰ See Beach, “The Case for Repealing the Estate Tax,” pp. 24–26, for a discussion of how death tax repeal might affect labor force participation decisions.

