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ONE YEAR LATER: HOW THE CLINTON TAX HIKE IS HARMING AMERICA

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INTRODUCTION

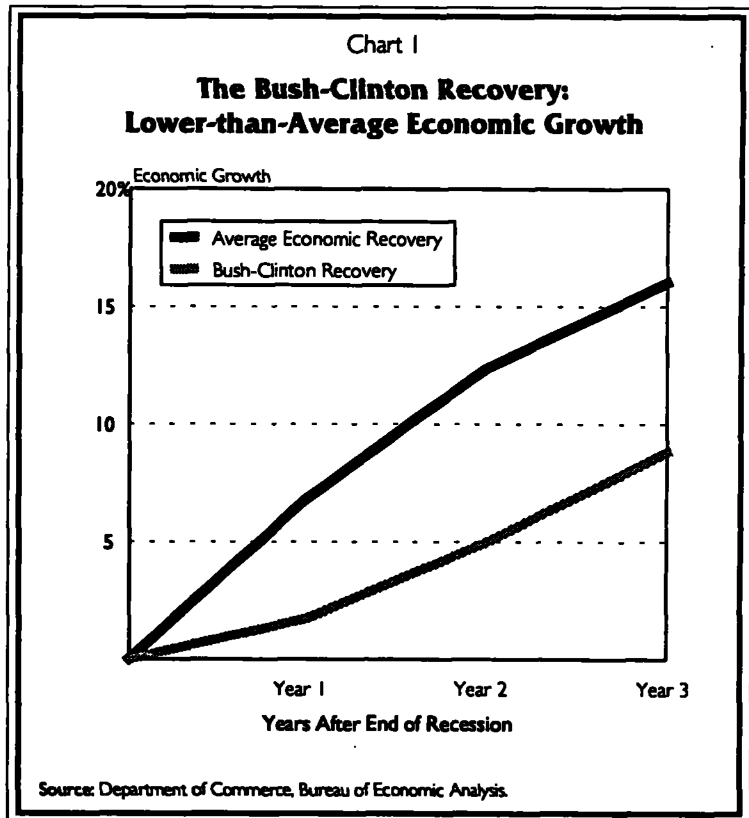
This week marks the first anniversary of 1993's record tax hike and the ill effects already are becoming apparent. The Clinton Administration's own numbers show that economic growth and job creation remain considerably below levels normally found at this stage in a business cycle. The White House figures also reveal that if any deficit reduction does occur, it will be only temporary and largely unrelated to the President's economic policy. Worst of all, the Administration's budget numbers confirm that government spending remains out of control, with rising deficits in future years entirely due to the unchecked growth of domestic spending programs.

These dismal results should not be surprising. Other Presidents who have followed high-tax policies also have experienced disappointing economic performances as a result. Large payroll tax increases and bracket creep during the Carter Administration, for instance, helped stifle a robust economy and create the phenomenon known as stagflation. George Bush also inherited a strong economy, but his acquiescence to a large tax increase in 1990, combined with other significant reversals of his predecessor's policies, helped put an end to the longest peacetime expansion in America's history.

The Clinton Administration insists that its tax plan is working and that history will not repeat itself. Unfortunately, the rosy picture being painted by the White House falls apart upon closer examination. Consider the following claims:

CLAIM #1: The Administration's economic policy has restored economic growth.

REALITY: This assertion ignores the fact that the recession ended in the spring of 1991. And even though President Clinton's tax plan did impose retroactive tax increases on small businesses, investors, upper-income individuals, and the estates of dead Americans, even the White House is hard-pressed to argue that a tax increase beginning January 1, 1993, caused a recession to end nearly two years earlier. The Administration can legitimately claim that 1991 should not count as a recovery because the economy experienced almost no growth, expanding by less than three-tenths of one percent during the year. The same cannot be said for 1992, however, since the economy expanded at a 3.9 percent clip. Growth in 1993, the year of the Clinton tax increase, slipped back to 3.1 percent and the Administration's new projections show only 3.0 percent growth in 1994. As such, the best the Administration can claim is that last year's budget deal has not yet caused the economy's performance to slow down much compared to the growth levels President Clinton inherited.

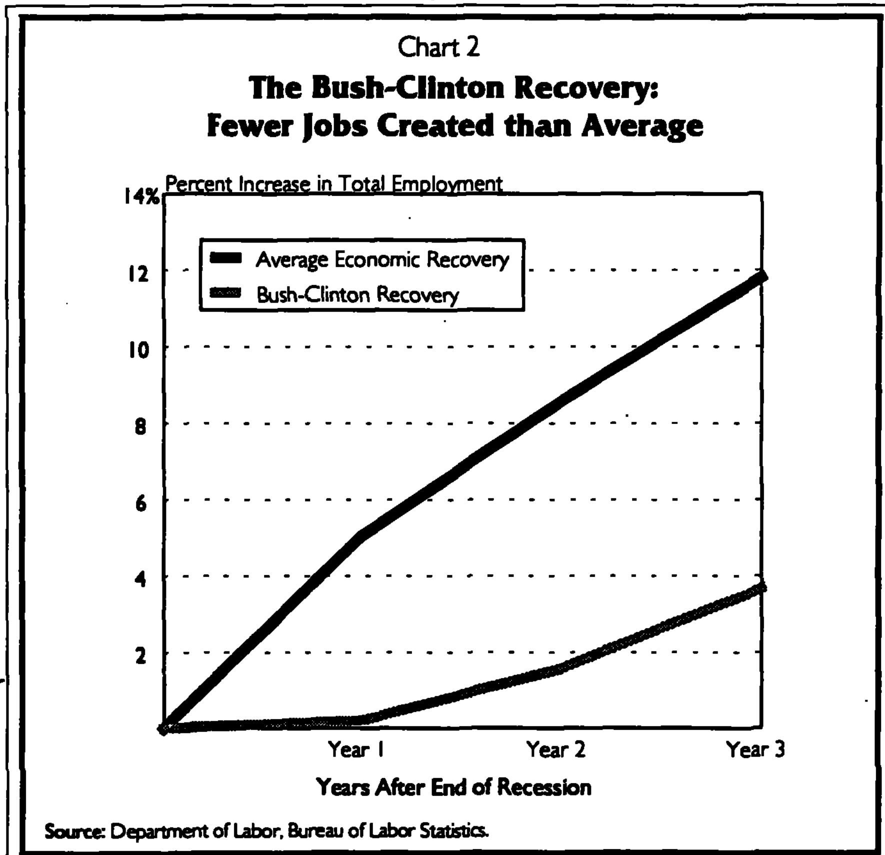


The real story, however, is that the recovery under both Bush and Clinton has been woefully inadequate. In the post-World War II period, the U.S. economy traditionally has experienced strong recoveries after an economic downturn, with real growth averaging 5.34 percent for the three years following a recession's end. But the economy's performance this time has fallen far short of past recoveries, with growth averaging only 2.94 percent in the last three years. In other words, economic growth has been barely half as strong as that normally experienced at this stage of a business cycle. Average growth during this expansion has not even reached the average of 3.1 percent for the post-World War II era—a figure which includes recession years.

Instead of taking credit for ending the recession and restoring economic growth, the Administration should be trying to explain why the economy's performance has been so weak. The reason for the poor growth figures, of course, is that the White House is pursuing policies similar to those that helped cause the recession in the first place. Presidents Bush and Clinton both raised taxes. They both increased government spending and they both increased the burden of regulation and imposed costly mandates. As a result, the economic downturn and subsequent weak recovery should not come as a surprise. Policies which raise the cost of productive economic activity inevitably result in less job creation, lower savings, and reduced investment.

CLAIM #2: The Administration's economic policy has helped create new jobs.

REALITY: As is the case with economic growth, job creation has been unusually weak during this expansion. If the current expansion were producing an average number of jobs for a recovery, total employment would have jumped by 11.79 percent since the recession ended. But with tax increases and new regulations raising the cost of hiring new workers (not to mention the threat of an employer mandate in health reform), total employment has increased by only 3.19 percent in the last three years. Thus, while the White House likes to boast that more jobs have been created to date during the Clinton years than were created during the entire Bush Administration, officials should instead be trying to explain why the nearly identical economic policies of the two Administrations have caused the rate of job creation in this recovery to be less than one-third the usual rate at this stage of a business cycle. This poor performance means millions of Americans are unemployed today who would have been working during an average recovery.



CLAIM #3: The Administration's fiscal policy is bringing down the deficit.

REALITY: Projected short-term reductions in the budget deficit are largely unrelated to the President's policies. If final figures bear out the Administration's estimates, the

three-year decline in government borrowing will be the result of three factors. First and foremost, the deficit is falling because the economy has finally climbed out of the recession, albeit slowly. And even though the expansion is very tepid by historical standards, incomes have risen slightly, some jobs have been created, and corporate profits have staged a mild recovery. All these factors mean the government collects more tax revenue. The expansion also has caused a slight decline in how fast some government programs, such as unemployment insurance and food stamps, are growing. But as discussed earlier, the economy is growing much slower than normal. As such, the White House's economic policies actually are causing the deficit to be higher than it would be if normal economic conditions applied.

The second reason for projected lower deficits is the cost shift for the bailout of the deposit insurance system. The large one-time costs of the savings and loan (S&L) deposit insurance bailout artificially swelled the deficit between 1989 and 1992, adding $149 billion to the national debt in that four-year period. The government now is selling off the assets of seized S&Ls, however, and this is expected to generate $60.3 billion of revenue for the government between 1993 and 1997. This huge shift, from a big budget expense to a significant revenue source, lowers the reported budget deficit. Bill Clinton had the good fortune to capture the White House just as the shift took place, but it certainly is not due to his policies. More important, it clearly has no impact on the long-term deficit.

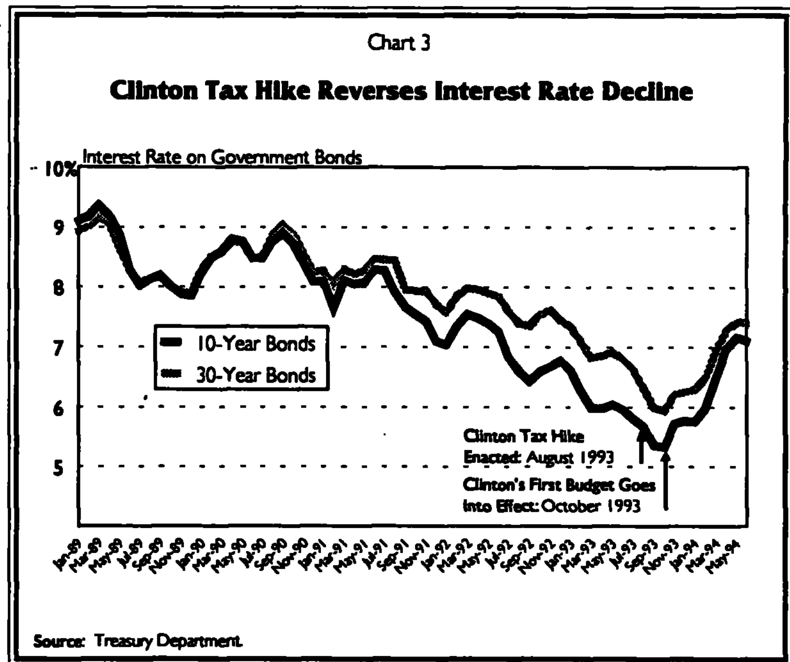
The third reason the budget deficit is falling, and the one reason the Administration can take credit for, is the large reduction in defense spending. The Pentagon's budget is expected to go down from $292.4 billion in 1993 to $257 billion in 1997, a decline of $35.4 billion. With the Administration's foreign policy in disarray, these sharp cuts may not be wise policy, but they do contribute to deficit reduction.

CLAIM #4: The Administration's tax bill has produced low interest rates.

REALITY: Interest rates actually have been rising steadily ever since the Administration's budget package was approved. As indicated in Chart 3, interest rates began a steady decline in 1989. This trend came to a halt, however, with the enactment of the President's budget package. To be fair, the increase in interest rates following adoption of the tax increase has very little to do with fiscal policy and is related more to fears in financial markets of future inflation. Nonetheless, the White House can hardly

Chart 3

Clinton Tax Hike Reverses Interest Rate Decline



Source: Treasury Department

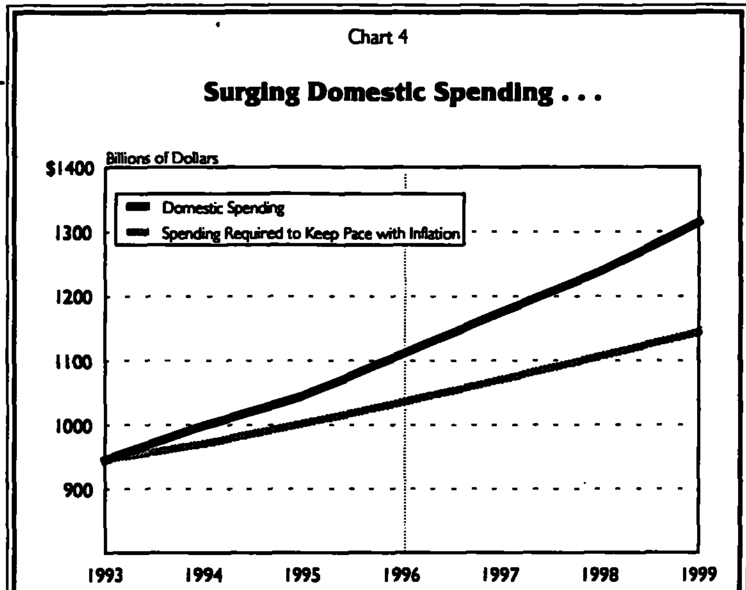
claim that its fiscal policy is resulting in lower interest rates when rates actually have been rising.

THE REAL STORY

The White House has been trying to convince voters that last year's tax increase is working. But, every claim made by the Administration proves false upon closer scrutiny. Yet the problem is not merely the lack of good news on the consequences of 1993's record tax hike. What is of greatest concern is that, as has been the case with previous Administrations steering through large tax increases (such as those of Hoover, Carter, and Bush), the Clinton tax hike is imposing heavy costs upon the economy. Most notably:

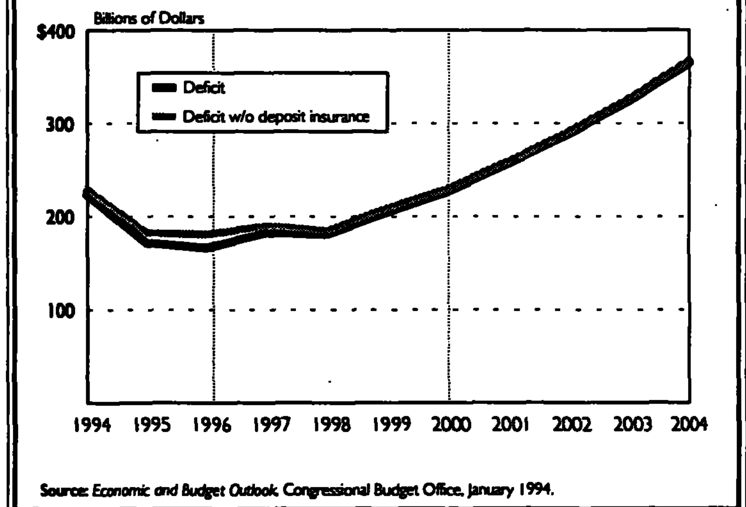
Chart 4

Surging Domestic Spending . . .



Source: *Mid-Session Review of the Budget*, Office of Management and Budget, July 1994.

. . . Soon Leads to Rising Deficit



Source: *Economic and Budget Outlook*, Congressional Budget Office, January 1994.

✘ **Rising budget deficits.**

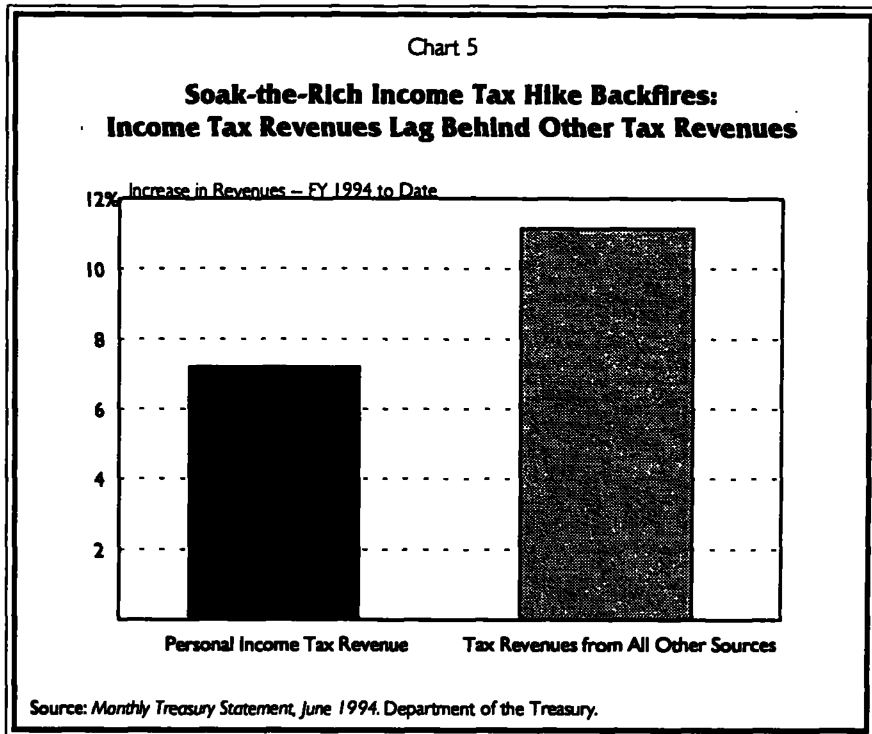
According to the Administration's own forecast, the budget deficit resumes its upward climb in 1996. The Congressional Budget Office, estimates that budget deficits will swell to more than $360 billion by the year 2004.

✘ **Surging domestic spending.**

As Chart 4 shows, the reason for rising deficits is the alarming growth of domestic spending programs. These programs, which are rising 78 percent faster than needed to keep pace with inflation, are projected to increase by a total of $229 billion over the four years of the Clinton Administration. Significantly, if spending for these programs simply held to the rate of inflation beginning in 1995, the five-year savings would be more than $367 billion and the budget deficit would fall to $70.1 billion by 1999.

✘ Soak the rich tax hike backfiring.

The lion's share of new taxes in last year's tax package is supposed to come from increased income taxes on small businesses, savers, investors, and the well-to-do. Critics of the proposal pointed out at the time that higher tax rates would discourage productive economic activity and could actually cause tax revenue to be lower than it would be if taxes were not boosted. Known as the supply-side effect, this revenue shortfall results when taxpayers reduce their work effort, change their behavior, shift their investments, or take other steps to protect their earnings from excessive taxation. As a result, projections of tax revenues based on models which assume taxpayers are oblivious to changes in the tax code almost always will be grossly optimistic. This effect was seen after the 1990 tax increase. Compared with projections made before the tax increase was approved, the 1990 deal actually caused tax revenues to fall by more than $3 for every $1 the 1990 tax bill was supposed to raise.

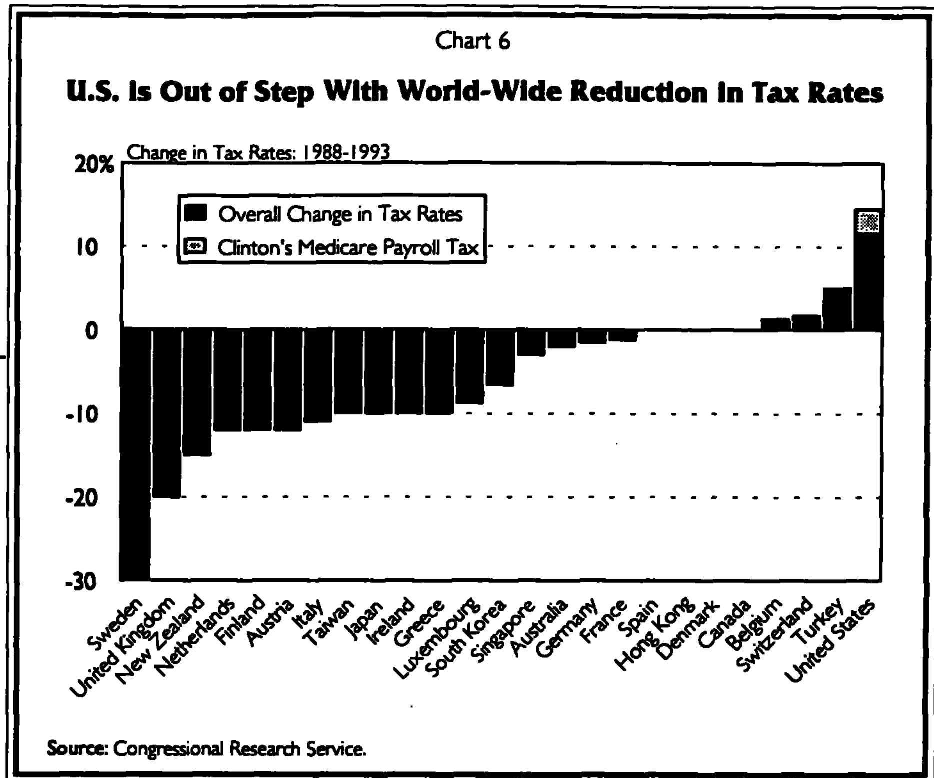


Source: *Monthly Treasury Statement, June 1994.* Department of the Treasury.

Since the Clinton economic program is so similar to that enacted during the Bush Administration, it should come as no surprise that history seems to be repeating itself. According to the Treasury Department, personal income tax revenues are growing slower than other sources of tax revenue this fiscal year. Nine months into the fiscal year, personal income tax revenues are only 7.2 percent above their level at this point last year. Tax revenues from other sources, by contrast, are coming in at 11.2 percent above last year's levels. Revenues from the tax that was raised the most have been growing far slower than revenues from tax sources which were increased by lesser amounts or not at all. The gap between personal income taxes and other taxes is concrete evidence that "soaking the rich" simply does not work. What makes these numbers particularly significant is that some of the income tax revenue came from the retroactive tax increase, which is one tax increase that avoids the supply-side effect since it raised rates on income that was already earned.

The Administration should have anticipated that higher income tax rates would be associated with slower income tax collections. In the 1980s, when tax rates were slashed, income tax collections soared, and the share of taxes paid by the rich rose.

✘ Out of step with world trends.



In an increasingly global economy, changes in domestic policies can have a significant impact on international competitiveness. During the 1980s, policy makers in the U.S. understood and took advantage of this phenomenon, cutting tax rates and encouraging a surge in job-creating foreign investment in America. In recent years, other countries have followed the U.S. example, lowering their tax rates, oftentimes dramatically. Tragically, U.S. politicians seem to have forgotten the lessons of the 1980s. As seen in Chart 6, the United States has been raising tax rates during a period when most other nations are doing just the opposite.

CONCLUSION

Policies that did not work for Herbert Hoover, Jimmy Carter, and George Bush are not working any better for Bill Clinton. The economy's weak performance, the dismal job creation numbers, and projections of higher spending and deficits are the inevitable results of a fiscal policy based on this flawed model. Critics maintained that the 1993 tax hike would harm the prospects for a solid recovery, not enhance them. They are already being proved correct.

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