U.S. SENATE Republican Policy Committee

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The Economic Realities of Deficits

Executive Summary

- **The purpose of this paper is to demonstrate that the President's tax-relief proposal should not be opposed on the basis that it will increase the size of the deficits. This paper will demonstrate that the President's proposal will foster economic growth through tax reductions on work, savings, and investment, which will increase federal revenues, which, in turn, will reduce deficits.**

- **The currently projected federal deficits are primarily due to the recent economic slowdown and to increased federal spending (both related and unrelated to the ongoing war on terrorism).** The economic slowdown that began near the end of the Clinton Administration has led to a reduction in projected federal revenues. In fact, according to Congressional Budget Office (CBO) numbers from January, the majority of the reduction in revenues for fiscal year 2002 was a direct result of the economic downturn. Specifically, the economic downturn was responsible for 68 percent of the current deficit, while increased federal spending was responsible for 15 percent of the deficit (and tax relief was responsible for 17 percent).[1]

- **The significance of federal budget deficits can only be measured by their relationship to the economy.** The Republican party has long advocated balanced budgets and will do so in the future. It was Republican Congressional policies that returned America to budget surpluses for the first time since 1969.[2] All things being equal, balanced budgets are preferred. These are extraordinary times, however. America was attacked on September 11th at great cost to our economy, the United States is conducting an ongoing war on terrorism, and the economy continues to be sluggish. Because of these unforseen circumstances, America is currently experiencing a budget deficit. But referring to a deficit as "large" or "small" without comparing

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[1] RPC calculations based on information compiled by Congressional Research Service (memo to RPC dated February 27, 2003).

[2] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004," Executive Office of the President, Office of Management and Budget.

it to the size of the economy (as measured by Gross Domestic Product, or "GDP") renders the label arbitrary and subjective at best. When viewed as a percentage of GDP, the current deficit projection for fiscal year 2003 (2.8 percent) is nearly two percentage points lower than the deficit picture in 1991 (4.5 percent). Furthermore, according to March 2003 CBO projections, if the President's budget is enacted, the deficit as a percentage of GDP will continue to fall an additional 2.2 percentage points to a mere 0.6 percent in the year 2013.[3]

- **Policymakers interested in reducing the deficit should concentrate on fostering economic growth through restrained spending and the passage of tax relief that enhances economic incentives. This formula will spur economic growth and eliminate deficits in the long run.** Economic history, including the Mellon/Coolidge tax reductions of the 1920s, the Kennedy tax relief package of 1964, the Reagan tax reductions of 1981, and the Capital Gains tax reduction of 1997, demonstrates this phenomenon. The Bush tax relief plan would continue this trend to the benefit of all Americans.

Introduction

The purpose of this paper is to demonstrate that the President's tax relief proposal should not be opposed on the basis that it will increase the size of the deficit. It will demonstrate that the President's proposal will foster economic growth through tax reductions on work, savings, and investment, which will increase federal revenues which, in turn, will reduce deficits.

Opponents of the President's economic package point with supposed alarm to the federal budget's current and projected deficits. They claim that the existence of these deficits, per se, is proof of the failings of his economic policies and should preclude most of his proposed tax relief. These arguments are misguided. The re-emergence of deficits has little to do with the President's actions. They are primarily due to the poor economy that the President inherited, a national emergency that resulted from the terrorist attack on September 11th, 2001, and the continuing war on terrorism. Additionally, the deficit and future deficit projections are exacerbated by the continued, and seemingly unrestrained, growth in *non-defense discretionary spending unrelated to the war on terrorism*.

The President understands that the federal government's first priority is to confront the threat to our nation's homeland security. Taking the necessary steps required to address that threat in this weak economic period will lead to short-term deficits. While balanced budgets are preferable, short-term deficits must be viewed in perspective. The supposedly historic deficits currently projected neither portend the disastrous effects that many claim, nor require their elimination at any cost. Rather, the latter action would prove to be extremely detrimental to the economy.

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[3] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004," and "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," Congressional Budget Office, March 2003.

In fact, ***the best way to achieve deficit reduction is to restrict spending and allow the economy to grow, thus increasing revenues; the best way for that to happen is to increase the incentive to work and invest through properly structured tax relief***.

The American public understands this economic truism. In a recent poll by Luntz Research Companies, Americans were asked whether they believed tax relief or increased government spending was the better choice for the federal government to help increase economic growth. Fully 68 percent chose the tax-relief option, while only 20 percent chose increased government spending.[4]

Understanding Deficits

A budget deficit results when outlays exceed revenues – in other words, when the federal government spends more than it collects in taxes in the course of a fiscal year. Conversely, when the government collects more in revenues than it spends, the result is a budget surplus. For the past several decades, the primary discussions regarding federal budget deficits have focused on what is referred to as the consolidated budget. The consolidated budget provides an accounting for all revenue – from all sources – and includes all federal outlays. While some object to including trust fund revenues in deficit projections, these revenues are obligated in some form or another every year and therefore must be included in deficit projections to obtain an accurate accounting of deficits or surpluses. Because consolidated budget numbers are the most accurate, they will be used in this paper.[5]

In the 68 years since the end of World War II, America has only had a unified budget surplus 12 times.[6]

Current Budget Deficit Projections

The most recent budget projections were released by the Congressional Budget Office on March 7, 2003. The table below illustrates the projected deficit/surplus for the federal budget through the year 2013. (Note that baseline projections assume no changes in current law that would affect revenues or outlays.)

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[4] Luntz Research Companies survey conducted January 16-21, 2003.

[5] Heniff, Bill Jr., "Basic Federal Budgeting Terminology," Congressional Research Service, March 5, 2001. Regarding consolidated budgets, Heniff explains that the consolidated budget consists of the two main types of government funds – federal funds and trust funds. Federal funds comprise general government receipts not earmarked for any specific government activity, while trust funds are designated by law to a particular purpose – the highway or Social Security trust funds, for instance.

[6] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004."

CBO's Budget Projections Under its Baseline *in billions of dollars*													
'02	**'03**	**'04**	**'05**	**'06**	**'07**	**'08**	**'09**	**'10**	**'11**	**'12**	**'13**	**'04-'08**	**'04-'13**
-158	-246	-200	-123	-57	-9	27	61	96	231	405	459	-362	891
Source: "The Budget and Economic Outlook: Fiscal Years 2004-2013," Congressional Budget Office, March 2003													

CBO also projected future deficits/surpluses assuming passage of the President's budget. The table below illustrates these projections.

CBO's Budget Projections Assuming Passage of the President's Budget *in billions of dollars*													
'02	**'03**	**'04**	**'05**	**'06**	**'07**	**'08**	**'09**	**'10**	**'11**	**'12**	**'13**	**'04-'08**	**'04-'13**
-158	-287	-338	-270	-218	-173	-166	-153	-141	-154	-106	-102	-1,164	-1,820
Source: "The Budget and Economic Outlook: Fiscal Years 2004-2013," Congressional Budget Office, March 2003													

It is important to remember that the above table includes estimates for President Bush's entire budget, not simply his economic growth plan. These budget estimates include the cost of increased domestic discretionary spending, funding for the war on terror, the addition of a prescription drug benefit to Medicare, and many other initiatives. As will be described in more detail later in this paper, it is the President's economic growth plan that will begin reducing deficits by 2005 through increased revenue generated by enhanced economic activity.

The Economically Correct Way to View Deficits

It cannot be argued that today's deficit is the largest in history when one correctly measures the size of our current and projected deficits. The nominal value of deficits viewed by themselves is meaningless. What is significant about deficits – economically speaking – is their size in relation to the economy (GDP).

Put more directly, the size of deficits as a percentage of GDP is more significant than their existence in general, or their size in the abstract. Referring to a deficit as "large" or "small" without comparing its relationship to the size of the economy renders the label arbitrary and subjective at best. As one CRS report puts it, "strictly speaking, economics generally has little to say regarding whether or not a budget deficit is a good thing or not."[7]

This is analogous to judging a family's debt. A family earning $250,000 a year can afford to carry a $150,000 mortgage more easily than a family earning $50,000 a year. Likewise, neither family – regardless of income – should incur debt greater than a fixed percentage of its annual income.

Opponents of the President's plan often compare the current deficit projection with historical, non-inflation-adjusted deficits. However, by failing to adjust for inflation and the growth of the economy, their comparisons are worthless at best, and disingenuous at worst. For instance, the President's opponents point out that the federal budget deficit in 1976 was $73 billion, $207 billion in 1983, $269 billion in 1991, and this year's budget deficit – assuming passage of the President's budget – is projected to be $304 billion by OMB and $287 billion by CBO.[8]

To some, this would suggest that today's deficits are significantly larger than of those shown from the 1970s, 1980s, and 1990s. This ignores inflation however. When the deficits from the 1970s, 1980s, and 1990s are adjusted to constant, 2003 dollars they tell a different story. Adjusted for inflation the deficit in 1976 was actually $233 billion, the deficit in 1983 was $378 billion, while the deficit in 1991 was $359 billion.[9]

Their comparison also fails to properly measure deficits. By using a legitimate measurement – deficit as a percentage of GDP – the currently projected budget deficit is actually the smallest of the four, with the 1976 deficit equaling 4.2 percent of GDP, the 1983 deficit equaling 6 percent of GDP, the 1991 deficit equaling 4.5 percent of GDP and the projected deficit for 2003 – even with passage of the Bush budget – equaling merely 2.8 percent of GDP as projected by OMB and 2.7 percent of GDP as projected by CBO.[10]

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[7] Cashell, Brian W., "The Economics of the Federal Budget Deficit," CRS Report for Congress, March 19, 2002.

[8] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004," and "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," Congressional Budget Office, March 2003.

[9] Inflation adjustment calculated using the inflation calculator on the Bureau of Labor Statistics website, www.bls.gov.

[10] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004," and "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," Congressional Budget Office, March 2003.

Historically Accurate View of Deficits			
Year	**Deficits**		
	Non-inflation Adjusted Dollars *in billions*	2003 Inflation Adjusted Dollars *in billions*	As a Percentage of GDP
1976	$73	$233	4.2
1983	$207	$378	6.0
1991	$269	$359	4.5
2003 (OMB)	$304	$304	2.8
2003 (CBO)	$287	$287	2.7
Source: "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004," and "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," Congressional Budget Office, March 2003.			

To reiterate, when viewed historically, our current and projected deficits are rather moderate in size. In fact, today's projected deficits as a percentage of the economy (GDP) are dwarfed by the deficits of the 1970s and 1980s. **Furthermore, under the President's budget, CBO estimates that deficits as a percentage of GDP will drop to 1.2 percent in 2008, and to a mere 0.6 percent in 2013.**[11]

Myth: Deficits Cause Inflation

While some opponents of the President's budget are quick to suggest it, there exists no evidence that deficits cause inflation.

Inflation is primarily a function of monetary policy (the supply of money in the market), not fiscal policy (tax and spending policy). As long as the Federal Reserve (Fed) does not significantly enlarge the money supply, deficits should not precipitate higher inflation. As American Enterprise Institute Fellow Peter Wallison put it, "There is no link between deficits and inflation as long as the Fed doesn't enlarge the money supply. . ."[12]

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[11] "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," Congressional Budget Office, March 2003.

[12] Wallison, Peter J., "Repeal Tax Cuts? There They Go Again," American Enterprise Institute, http://www.aei.org.

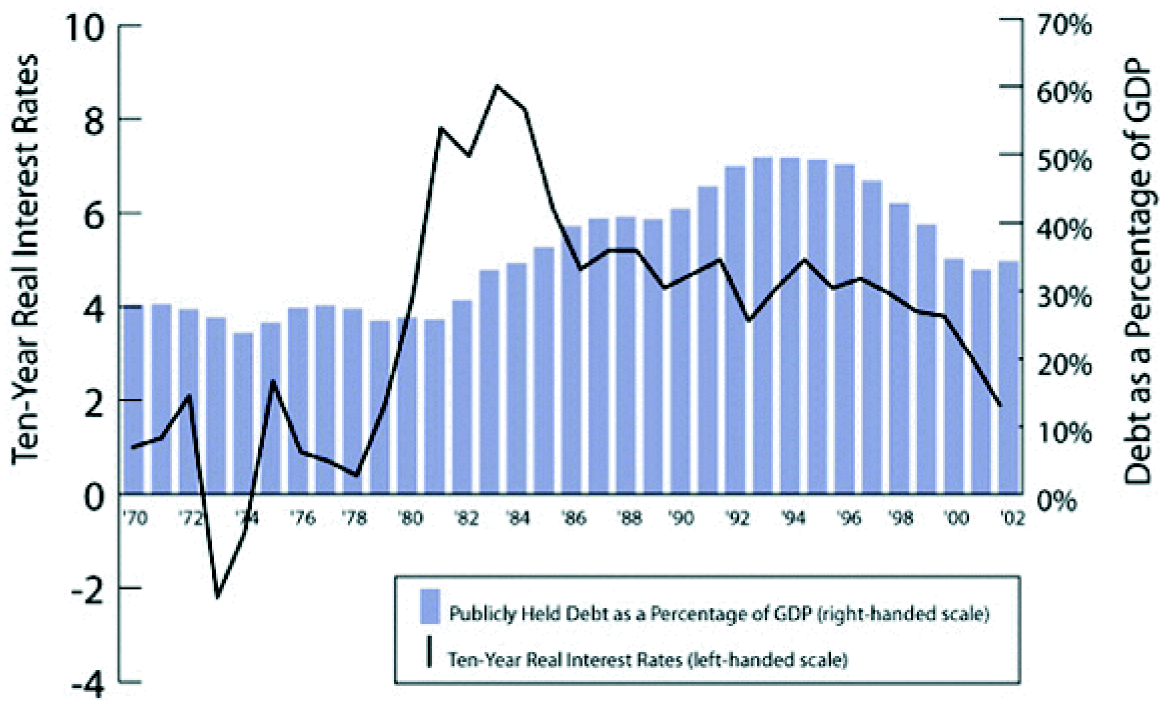
The evidence bears this out. As the following chart illustrates, there is no correlation between rising deficits and rising inflation: while deficits were increasing between 1980 and 1983, inflation was decreasing; conversely, when deficits actually decreased in 1984, the corresponding rate of inflation increased. Again in 1987, deficits were precipitously lower than the previous year, yet the rate of inflation was significantly higher than the previous year. Attempting to link inflation rates to the existence and size of deficits appears to fail completely.

Deficits and Inflation During the 1980s		
Year	**Deficit** (in billions)	**Inflation Rate**
1980	$73.8	13.5%
1981	$78.9	10.3%
1982	$127.9	6.2%
1983	$207.8	3.2%
1984	$185.3	4.3%
1985	$212.3	3.6%
1986	$221.2	1.9%
1987	$149.7	3.6%
1988	$155.1	4.1%
1989	$152.4	5.1%
Source: RPC calculations from BLS and OMB records.		

Myth: Deficits Cause Interest-Rate Hikes

Opponents of the President's plan also have attempted to link deficits, and their resulting increase in debt, to higher interest rates. They claim that deficits and national debt will crowd out private-sector borrowing, leading to higher interest rates and consequently slower growth. While this hypothesis is not without merit, there exists no credible evidence definitively linking deficits to higher interest rates.

Ten-Year Real Interest Rates and Publicly Held Debt as a Percentage of GDP



Source: The Tax Foundation

Again, there appears to be no definitive link between debt and interest rates. The debt increases with long-term deficits; like deficits, its significance must be measured by its size in relation to the economy (GDP). In fact, as the above chart demonstrates, during the 1980s interest rates declined while debt ballooned.

According to a recent study by the American Enterprise Institute, interest-rate movements are determined by changes in growth and changes in expected inflation. As economist John H. Makin explains, "In case some nervous congressmen and senators need reminding, while the budget deficit has swung from a surplus of about 2 percent of GDP to a deficit of about 2 percent of GDP over the past several years, long-term interest rates have fallen by over a full percentage point because inflation has come down and growth has remained low."[13]

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[13] Makin, John H., "More Tax Cuts, Please," American Enterprise Institute, February 1, 2003, http://www.aei.org.

The same study contends that the economic plight of Japan provides an instructive example of the relationship – or lack thereof – between interest rates and deficits. For several years, Japan has been running excessive deficits (more than 8 percent of GDP) while their debt-to-GDP ratio has risen by more than 150 percent. (Running long-term deficits can lead to increased debt as a percentage of the economy if not accompanied by significant economic growth.) Yet Japan's interest rates have simultaneously fallen to 0.9 percent on 10-year government notes – further evidence suggesting that there is no link between deficits, debt, and interest rates. The study notes:

> "Japan's average growth rate has been negative over the past several years while prices have actually been falling. Therefore, short-term interest rates are virtually zero, as low as they can go, while long-term interest rates at below 1 percent are reflecting a risk premium demanded by investors who fear the ultimate inability of the Japanese government to service its massive and rising debt. The corollary to the sad story of Japan is that its government and residents should, indeed, be hoping for higher interest rates, not because of smaller budget deficits but because of higher growth and stable prices."[14]

The Real Reasons for a Return to Deficits

As President Bush noted during his presidential campaign, a return to deficits would occur only in the event America were to experience a recession, a national emergency, or a war. Unfortunately, through no fault of President Bush, America is now experiencing all three of these worst-case scenarios.

Economic Downturn Reduces Revenues

The economic slowdown that began near the end of the Clinton Administration has led to a reduction in projected federal revenues. In fact, as previously noted, CBO numbers illustrate that the majority of the reduction in revenues for fiscal year 2002 was a direct result of the economic downturn: the economic downturn is responsible for 68 percent of the reduction in projected surpluses.

[14] Makin.

It may seem self-evident, but it is worth reiterating that the factor most closely linked to revenue flows into Washington is economic growth. A recent study for the Heritage Foundation notes:

> "When the economy is growing, more people are working, salaries are increasing, and businesses are making more profits. With more income, there are more tax revenues even if tax policy is unchanged. On the other hand, with economic stagnation, fewer people are working and paying taxes, and there is less business income to tax. Economic growth is required to increase tax revenue. Therefore, economic growth is the main determinant of whether the federal budget is in surplus or deficit, particularly since the federal government has not shown the ability to limit spending."[15]

Once again, rather than focusing on the nominal deficit picture as a measure of economic health, policymakers should be concentrating on building a stronger economy that will yield higher revenues, which in turn will lead to deficit reduction.

<u>Costs of 9/11 to the Economy</u>

In May of 2002, the Joint Economic Committee issued its report on the economic effects of the terrorist attack of September 11th and found a number of short-term and long-term economic costs to the nation.[16]

The short-term costs to the economy from the attacks included:

- **Immediate loss of human and nonhuman capital:** The loss of human life and the loss of buildings and other infrastructure, combined with cleanup and repair, was estimated to cost between $25 billion and $60 billion.

- **Effects of uncertainty on consumer and investor behavior:** The uncertainty and apprehension that affected the financial markets is a prime example. The study estimates lost economic output in the immediate aftermath of the attack at $47 billion and lost stock market wealth at $1.7 trillion.

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[15] Riedl, Brian M., "What Really is Turning the Budget Surpluses into Deficits," The Heritage Foundation, Backgrounder 1515, January 30, 2002.

[16] "The Economic Costs of Terrorism," Joint Economic Committee, United States Congress, May 2002.

- **Effects of retrenchment on specific industries or localities:** In addition to affecting the entire economy, the attacks of September 11th had a particularly detrimental effect on certain segments of the economy, including the airlines, travel, tourism, insurance, lodging, restaurants, and many others. The study estimates that as many as 1.6 million jobs in 2002 were lost due to the terrorist attacks.

The long-term costs to the economy from the attacks included:

- **Increased costs of security ("terrorist tax"):** Costs such as travel delays, additional security checks and inspections, higher insurance costs, higher construction costs, more regulations, and a myriad of others were estimated to reduce GDP by 0.3 percent and cost businesses $151 billion.

- **Anti-terrorist expenditures crowding out more productive activity:** After September 11th, the government increased spending on security and fighting terrorism. As a result, economic resources now directed to shoring up security were diverted away from more productive private-sector activity. In other words, money spent on security crowds out more productive private investment. The report estimates that these increased security costs would reduce output and productivity by approximately 0.6 percent.

As the report demonstrates, the September 11th attack on America had a significantly detrimental effect on the economy. Such an unexpected blow to the economy will, by definition, reduce expected revenue flows. These lower-than-expected revenues, combined with the increased spending in response to the attacks, exacerbated America's return to deficits.

Continuing Cost of War Against Terrorism Reduces Budget Surpluses

Not only did the September 11th attack on our country lead to increased deficits, so too have the legislative responses to the attacks.

In August of 2002, CBO estimated that legislation[17] enacted in response to September 11th increased 2001 spending by approximately $3 billion and reduced revenues by $500 million. The agency further estimated a 2002 spending increase related to September 11th of $34 billion and a net revenue decrease of $200 million. CBO estimates that in fiscal year 2003, spending increases related to September 11th will total $21 billion with a revenue loss of $900 million.

[17] For a comprehensive list of the legislation enacted in response to September 11th, see: Letter to the Honorable John M. Spratt Jr., Ranking Democratic Member, Committee on the Budget, from the Congressional Budget Office, August 29, 2002.

In total, over the 2001-2007 period (the estimated budgetary impact of the enacted legislation to that point is negligible after 2007), CBO estimates that legislation related to September 11th will result in about $76 billion in increased spending and about $5 billion in lost revenue.[18] However, surely such expenditures as increases in defense spending, increased funding for the Federal Emergency Management Agency and the Justice Department, aid to New York City, tax relief for victims of the attack, and other related legislation were justified in the minds of most Americans.

Unfortunately, this justified new spending was not offset by fiscal restraint in non-defense, discretionary spending unrelated to September 11th, as the next section will illustrate.

<u>Other Significant Increases in Government Spending Further Reduce Surpluses</u>

One of the primary reasons for the disappearance of projected surpluses has been the significant increase in government spending. Every dollar the government spends today is a dollar that will not appear in upcoming surpluses. According to previously cited CBO numbers, increased discretionary spending (both defense and non-defense) is responsible for 15 percent of the increase in the deficit for fiscal year 2002.

Furthermore, both non-defense discretionary and defense discretionary spending are expected to rise by approximately 8 percent in fiscal year 2003.[19]

When current spending is compared to other historic levels of government spending, it gives lie to any suggestion that Washington is maintaining fiscal discipline. Viewed as a percentage of the economy (GDP), federal outlays are nearly as high today as they were in the final year of Johnson's "Great Society" – 20.5 percent of GDP in 1968 compared to 19.9 percent in 2003.[20]

While profligate spending in Washington is not new, the following charts demonstrate that the appearance of surpluses in 1998 triggered a significant increase in spending – and thus a reduction in future surpluses.

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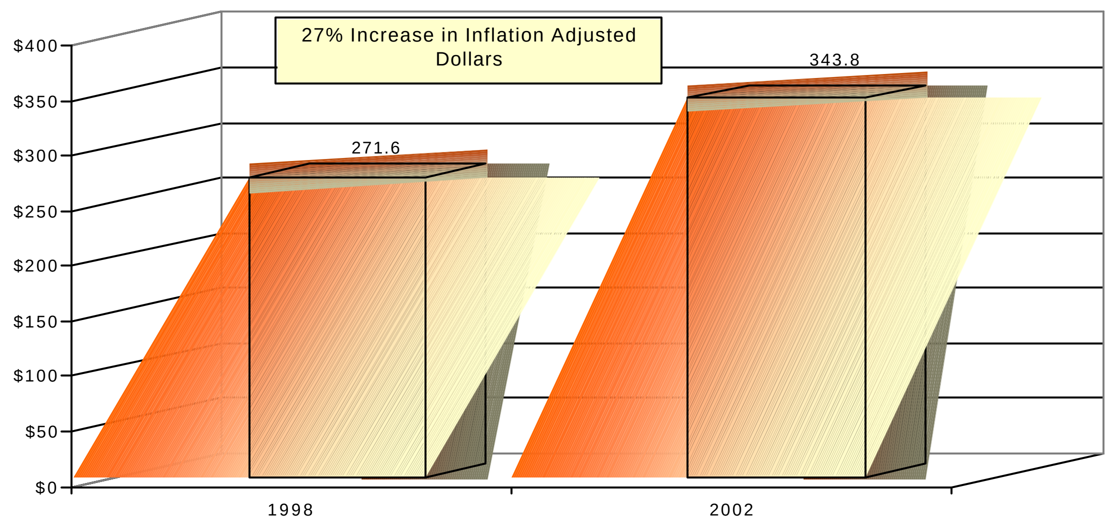
[18] Letter to the Honorable John M. Spratt Jr., Ranking Democratic Member, Committee on the Budget, from the Congressional Budget Office, August 29, 2002.

[19] "The Budget and Economic Outlook: Fiscal Years 2004-2013," Congress of the United States, Congressional Budget Office.

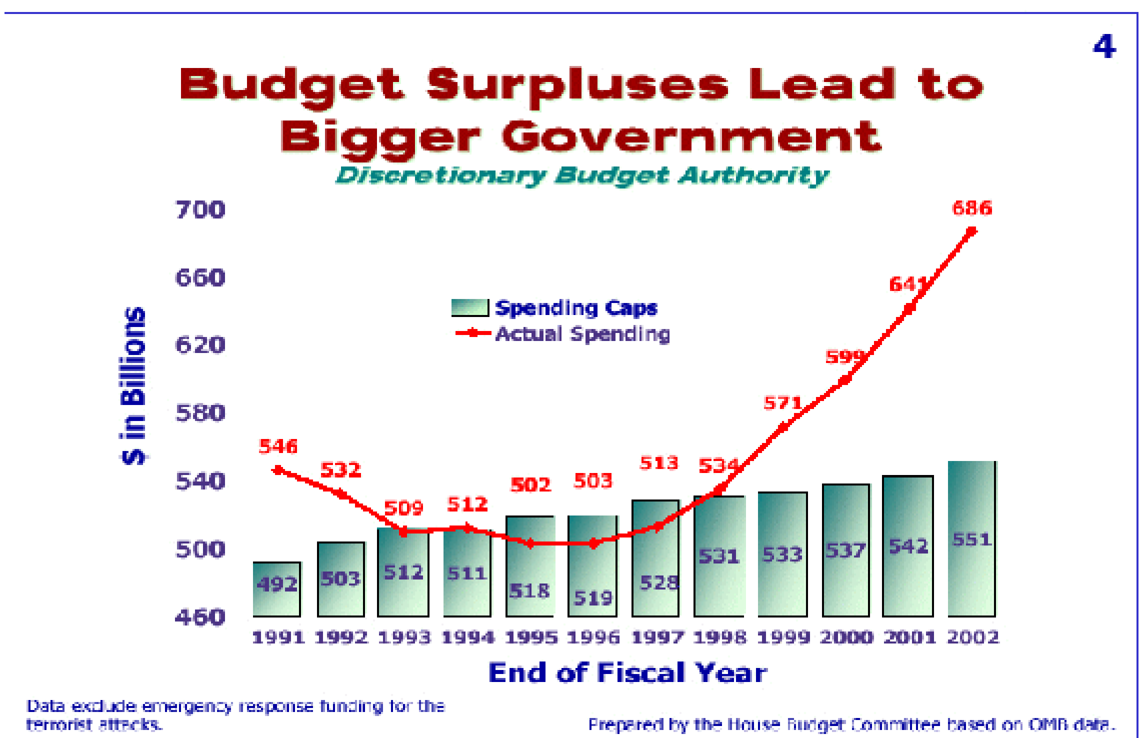
[20] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004."

Increase in Non-Defense Discretionary Spending Since Surpluses Appeared
(in billions of 1996 dollars)



source: Office of Management and Budget, FY 2003 Budget

While surpluses are viewed as inherently an economic good, there is evidence to suggest that, nevertheless, budget surpluses may lead to more government spending, which in turn siphons money out of the private sector where it is utilized much more efficiently and to a far greater benefit to the American taxpayer. The following chart from the House Budget Committee illustrates the relationship between budget surpluses and bigger government.



Deficit-Hawk Double-Standard Exposed

Senate opponents of the Bush economic growth proposal often justify their opposition with the charge that it will increase the deficit. They apply a double standard, however, by their consistent support for more and more federal spending. During the debate over the fiscal year 2003 omnibus appropriations bill earlier this year, many of the same people who claim to be concerned about deficits voted to increase federal spending by as much as $502 billion over the next 10 years. The table below recounts the amendments to raise spending and their associated costs.

Efforts to Increase Spending in the FY 2003 Omnibus Spending Bill

Amendment	One-Year Cost	10-Year Cost	Total Added to Deficit
Byrd	$5 billion	$70 billion	$70 billion
Kennedy	$6 billion	$84 billion	$154 billion
Hollings/Murray	$347 million	$5 billion	$159 billion
Harkin	$500 million	$7 billion	$166 billion
Byrd	$11 billion	$154 billion	$320 billion
Dodd	$1.5 billion	$21 billion	$341 billion
Reed	$5.8 billion	$6 billion	$347 billion
Daschle	$3 billion	$3 billion	$350 billion
Nelson (FL)	$600 million	$8 billion	$358 billion
Murray	$120 million	$2 billion	$360 billion
McCain/Kennedy	$165 million	$2 billion	$362 billion
Durbin	$18 million	$2 billion	$364 billion
Clinton	$8 billion	$112 billion	$467 billion
Kennedy	$ 586 million	$8 billion	$484 billion
Cantwell	$678 million	$9 billion	$ 493 billion
Bingaman	$60 million	$1 billion	$494 billion
Nelson (FL)	$500 million	$7 billion	$501 billion
Lautenberg	$100 million	$1 billion	$502 billion

Source: Senate Republican Conference

Opponents of the Bush tax relief plan cannot have it both ways. They test the limits of credibility when they oppose tax relief under the guise of opposing an increase in deficits while simultaneously supporting hundreds of billions in increased spending that clearly would exacerbate deficits. On the other hand, the Bush budget – even with the economic difficulties facing it – is projected to reduce the deficit by 38 percent by 2008.[21]

Tax Relief Too Back-Loaded to Be a Significant Contributor to Current Deficits[22]

As Members of Congress well know, the majority of the first Bush tax relief package has yet to take effect. In fact, only 8 percent of the 2001 tax relief plan has taken effect.[23] Therefore, it cannot be the primary cause of the deficits.

Major Tax Code Changes

Provision:	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Tax Rates:											All Changes Repealed
39.6%	38.6%*			37.6%		35%					
36%	35%*			34%		33%					
31%	30%*			29%		28%					
28%	27%*			26%		25%					
15%											
	10%**										
Marriage Penalty Relief:					Phase-In Begins				Phase-In Complete		
Child Tax Credit: ($500)	$600				$700				$800	$1,000	
Death Tax Exemption: ($675,000)		$1 mil		$1.5 mil		$2 mil			$3.5 mil	Tax Repealed	
IRA Contribution Limit: ($2,000)		$3,000			$4,000			$5,000			
College Tuition Credit:		$3,000		$4,000		Repealed					

* Effective July 1, 2001
** Effective January 1, 2001

Source: Republican Study Committee

Meanwhile, the Job Creation and Worker Assistance Act of 2002 – a tax relief package passed to help victims of September 11th and to boost the economy – was not large enough to be primarily responsible for the deficits. According to CBO numbers, the Economic Growth, Tax Relief and Recovery Act of 2001 and the Job Creation and Worker Assistance Act of 2002 reduced revenues in fiscal year 2002 by $81 billion – accounting for a mere 17 percent of the increase in the deficit.

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[21] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004."

[22] Includes President Bush's Economic Growth, Tax Relief and Recovery Act of 2001 and the Job Creation and Worker Assistance Act of 2002, and other minor tax provisions.

[23] RPC calculations of revenue estimates in PL 107-16.

Fostering Economic Growth – and Thereby Eliminating Deficits

"Every member of the economic team must understand that budget deficits are the result of slow economic growth, not its causes. They must convincingly articulate how raising tax rates will only slow growth and produce larger deficits, that the only way to get the deficit down is to get economic growth up and that the only way to raise economic growth is through sound tax policies complemented with a price-stable monetary policy . . ."

– Jack Kemp, Townhall.Com, December 12, 2002

A deeply held misconception about the effects of deficits on the economy cause some to improperly focus their attention on how to quickly eliminate them in order to assist economic growth. Instead, ***they should be concentrating on fostering economic growth through restrained spending and the passage of tax relief that enhances economic incentives. Together these policies will, in turn, create economic growth, increase federal revenues, and therefore, reduce deficits in the long run. This is exactly what the President's package does.***

A study of 20 countries over a more than 40-year period by Harvard Professor Alberto Alesina and Columbia Professor Roberto Perotti found that "successful deficit reductions relied largely on spending cuts rather than tax increases" and that "unsuccessful efforts relied largely on tax increases." In fact, "direct taxes on households are actually cut during successful" deficit reductions.[24]

The Key to Economic Growth

The key to promoting economic growth is to reduce taxes that inhibit productive economic activity. In the case of the President's plan, a reduction in marginal rates and the elimination of the double taxation of dividends will reduce the government-imposed punishment for success and entrepreneurship. (The economic benefits of the President's plan were further explained by former Senator Phil Gramm in testimony before the Senate Finance Committee. His testimony is included at the end of this paper.)

Also important to economic growth is restraining government spending by adhering to President Bush's proposed 4-percent spending increase. As the President noted, there is no reason government shouldn't be able to live within the same budget restrictions as the average American family: "Federal spending should not rise any faster than the paychecks of American families."[25]

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[24] Alesina, Alberto, and Roberto Perotti, "Budget Deficits and Budget Institutions," NBER Working Paper 5556, National Bureau of Economic Research, May 1996.

[25] President Bush, State of the Union Address, January 2003.

Every dollar the federal government spends (almost always very inefficiently) is a dollar that won't be spent in the private sector to help boost economic growth. In a seminal study examining the relationship between government spending and economic growth, Dr. Richard Vedder, a professor of economics at Ohio University, notes:

> "There is good evidence that government spending impedes economic development in two ways. First, when government exerts greater command over real resources, it crowds out the private sector. This usually causes a shift of resources to less productive uses. Second, in order to buy more resources, government must impose taxes on capital and labor. Since taxation reduces the return to producers, it discourages work, savings and investment."[26]

Again, the private sector "spends" money much more efficiently than government. Therefore, as much money as possible should be returned to taxpayers in the effort to help the economy grow at its full potential.

<u>Historical Examples of Tax Relief Fostering Economic Growth</u>

- **Mellon/Coolidge tax relief of the 1920s:**

  By reducing tax rates, the Mellon/Coolidge tax reductions spurred economic growth, which increased revenues which, in turn, increased surpluses.

  Facing excessive tax rates, Treasury Secretary Mellon and President Coolidge began a series of across-the-board tax reductions. Rates were reduced in 1921, 1924, and 1926. The top marginal rate (income and surtax) was reduced from 73 percent to 25 percent.[27]

  The tax reductions allowed the U.S. economy to grow rapidly during the mid- and late-1920s. Between 1922 and 1929, real gross national product grew at an annual average rate of 4.7 percent and the unemployment rate fell from 6.7 percent to 3.2 percent. The Mellon tax relief restored incentives to work, save, and invest, and discouraged use of tax shelters.[28]

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[26] Vedder, Richard, "Economic Impact of Government Spending: A 50-State Analysis," National Center for Policy Analysis Policy Report No. 178, April 1993.

[27] de Rugy, Veronique, "Tax Rates and Tax Revenue: The Mellon Income Tax Cuts of the 1920s," The Cato Institute, February 2003.

[28] de Rugy.

Most importantly for the purpose of this paper, this increase in economic activity increased revenues, which greatly increased government surpluses. (Thanks to outlays that were approximately ***5000 percent less*** than spending today in inflation-adjusted dollars, the 1920s never saw a budget deficit.[29]) In 1920, the federal government had a surplus of $292 million. In 1927, the year after the last of the Mellon tax reductions was enacted, the United States had a surplus of $1.2 billion.[30]

In addition to increasing surpluses, the economic growth benefited *all* Americans. It is often assumed that broad reductions in income tax rates only benefit the rich and thrust a larger share of the tax burden on the poor. But detailed Internal Revenue Service data shows that the across-the-board rate reductions of the early 1920s – including large reductions at the top end – resulted in greater tax payments and a larger tax share paid by those with high incomes.

As the marginal tax rate on high-income earners was reduced sharply from 60 percent or more (to a maximum of 73 percent) to just 25 percent, taxes paid by this group soared from roughly $300 billion to $700 billion per year. The share of overall income taxes paid by the group rose from about one-third in the early 1920s to almost two-thirds by the late 1920s. (Note that inflation was virtually zero between 1922 and 1930, thus the tax amounts shown for that period are essentially real changes).[31]

While the Mellon/Coolidge tax reductions didn't technically reduce deficits, this is only because budget deficits didn't exist during the 1920s. The economic benefits of the tax relief did, however, result in larger surpluses, which are effectively the same as reduced deficits.

- **Kennedy tax relief of 1964:**

By reducing tax rates, the Kennedy tax relief plan increased economic growth, which increased revenues and in turn eliminated deficits.

The Kennedy tax relief, passed posthumously in 1964, provided economic benefits similar to those of the Mellon/Coolidge package of the 1920s: it reduced marginal individual income tax rates across the board – most importantly reducing the top marginal rate from 90 percent to 70 percent; it further reduced the corporate income tax rate from 52 percent to 50 percent; and it expanded an investment tax credit that had been passed in 1962. Again, the common thread

[29] RPC calculations from BLS and Historical Tables data.

[30] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004."

[31] de Rugy.

binding the elements of this tax relief package is a reduction of the penalty for hard work and investment. As a result, the economy – and thus all Americans – benefitted.[32]

In 1965, the year immediately following passage of Kennedy's tax package, GDP rose by 8 percent. Five years after passage of the Kennedy tax package, GDP had risen by 48 percent. Civilian unemployment fell from 5.2 percent in 1964 to 4.5 percent in 1965 and fell again to 3.5 percent five years later in 1969.

Federal revenues also grew following passage of the Kennedy tax relief package. Five years after the Kennedy tax cut, federal revenues had risen 66 percent, from $112 billion in 1964 to $186 billion in 1969. During that same period, the federal government moved from a $5.9 billion deficit to a $3.2 billion surplus.[33]

Again, increasing the incentive to work and invest by reducing marginal rates allowed the economy to take off and eliminate budget deficits.

- **Reagan tax relief of 1981:**

The Reagan tax package, which provides another example of tax reductions resulting in increased revenues, spurred the economy for nearly two decades.

The Economic Recovery Tax Act (ERTA) of 1981 pulled America out of the turmoil of the economic disaster and unprecedented stagflation of the 1970s. Like the Mellon/Coolidge and Kennedy tax reductions before it, the Reagan tax relief plan reduced the penalty on hard work, savings, and investment.

One of the specific provisions included in his ERTA was an across-the-board reduction in marginal rates, with the bottom rate dropping from 14 percent to 11 percent and the top rate falling from 70 percent to 50 percent. The Act also increased contribution limits for individual retirement accounts, and reformed depreciation rules for corporations. The bill further created a new investment incentive through a research and development tax credit.[34]

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[32]Kiefer, Donald W., "Tax Cuts and Rebates for Economic Stimulus: The Historical Record," CRS Report for Congress, January 2, 1992.

[33] Data on GDP, unemployment, and federal revenues from *Economic Report of the President*, January 2001.

[34] CRS, "Federal Tax Policy, 1980-89: A Brief Overview."

In 1982, GDP had risen a mere 4 percent, while five years after passage of the Reagan tax cuts, GDP had risen 42 percent. Meanwhile, civilian unemployment fell from 7.6 percent in 1981 to 7 percent in 1986. Finally, federal revenues grew by 28 percent between 1981 and 1986.[35]

While the Reagan tax reductions allowed the economy to grow out of the stagflation of the 1970s, deficits, too, grew during this time – not due to a dearth of revenues but rather to a 46-percent increase in federal outlays.[36] Had Congress shown some fiscal restraint, deficits surely would have diminished.

- **Capital gains tax relief of 1997:**

  The most recent example of tax reductions helping the economy grow demonstrates the economic benefit of reducing taxes other than marginal income tax rates.

  In 1997, Congress reduced the marginal rate at which capital gains are taxed. As the following chart demonstrates, when the maximum statutory tax rate on long-term capital gains was reduced in 1997, the amount of capital-gains revenues – and their percentage as a function of GDP – actually increased rather significantly. By reducing the amount of gains the government confiscated, the new rate increased the incentive for individuals to conduct business transactions that are taxed under the capital gains tax that they would not have normally conducted. In other words, the government collects more revenues taxing 20 percent of a transaction that occurs than it would at 28 percent if the transaction never had taken place because the market found rates too confiscatory.

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[35] Data on GDP, unemployment, and federal revenues from *Economic Report of the President*, January 2001.

[36] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004."

Realized Capital Gains and Taxes Paid on Capital Gains
(billions of dollars)

Year	Realized Capital Gains	Taxes Paid on Capital Gains	Realized Gains as % of GDP	Maximum Statutory Tax Rate (%) on long-term gains
1990	123.8	27.8	2.13	28.0
1991	111.6	24.9	1.86	28.0
1992	126.7	29.0	2.00	28.0
1993	152.3	36.1	2.29	28.0
1994	152.7	36.2	2.17	28.0
1995	180.1	44.3	2.43	28.0
1996	260.7	66.4	3.34	28.0
1997	364.8	**79.3**	4.39	**20.0**
1998	455.2	**89.0**	5.18	**20.0**
1999	552.6	**111.8**	5.96	**20.0**
2000	620.0	**126.0**	6.27	**20.0**

Source: "Capital Gains Tax Rates and Revenues," CRS Report for Congress, March 25, 2002

> In 1997, the United States had a deficit of nearly $22 billion. After reducing capital gains taxes that year, America experienced four straight years of surpluses.[37]

Again, if economically detrimental tax rates are reduced, economic growth will increase, which will increase federal tax revenues, which in turn very often leads to the reduction or elimination of deficits.

Conclusion

The lessons of the past are clear. Increasing incentives to work, save, and invest allows the economy to grow – benefitting all Americans and eventually eliminating budget deficits. President Bush has proposed a sound economic plan that will create economic growth, new jobs, a better standard of living for all, and a reduction in deficits. Congress should not unduly focus on short-term deficits, but

[37] "Historical Tables: Budget of the U.S. Government, Fiscal Year 2004."

instead, should concentrate on returning America to economic prosperity by adopting President Bush's long-term economic plan.

Appendix

On February 12, 2003, Phil Gramm, Vice Chairman of UBS Warburg and former U.S. Senator, testified before the Senate Finance Committee regarding the President's economic growth package. The former Chairman of the Senate Committee on Banking, Housing, and Urban Affairs and professor of economics at Texas A&M, Senator Gramm is considered an expert on federal tax and budget policy. As a service to all Republican Senators, the Republican Policy Committee has reproduced his testimony.

Testimony Before the Senate Finance Committee
Wednesday, February 12, 2003
by
Phil Gramm
Vice Chairman, UBS Warburg

Mr. Chairman and Members of the Finance Committee, I am honored to have the opportunity to testify before you today on a subject of great importance to every American: How can we get the economy into high gear, how can we put our people back to work, and how can we rebuild confidence in our equity markets to strengthen the foundation of our retirement programs and our financial security?

The Downturn

In the 20th century, America experienced two basic types of recessions. In the second half of the century, we experienced inventory cycles. On a more or less regular basis, economic signals were mixed up and unsold inventories mounted. Orders were cut back, the economy retrenched, and over time the excess inventories were consumed. In time, orders would flow again and the economy would recover. In such an environment, it was literally true that the bigger the boom that built up the excess inventories, the bigger the bust that followed. The deeper the recession, the stronger the recovery would be when it took hold.

In the first part of the 20th century, America experienced a series of financial panics due to the difficulty of converting bank deposits into currency and variations in the demand for money generated by the seasonal nature of agriculture.

The downturn we suffer from today is quite different. It is largely the product of a speculative bubble in the equities market. In fact, it is only a small over-statement to say that the financial panics of the 19th and early 20th century were a by-product of an agricultural economy, and the inventory cycles of the middle and late 20th century were the by-product of an industrial economy. The current downturn can be categorized with only a slight exaggeration as the first post-industrial recession in American history.

This is relevant because while we know a great deal about financial panics and inventory cycles, we find ourselves today in less charted waters. Consumption spending has been largely unaffected by the downturn, and the housing boom continues largely unabated. Wage rates have continued to rise as have total wages, even as unemployment has gone up. The current downturn is almost exclusively a product of a collapse in investment.

All this suggests that since consumption has stayed strong throughout the downturn, traditional pump priming to stimulate consumption will probably be ineffective as an economic stimulant. Since weak investment spending is the problem, any effective stimulus plan should have stimulating investment as its primary goal.

The President's Stimulus Plan

By sheer fiscal size alone, the President's proposal will have a very modest impact, since over a ten-year period its aggregate value is less than 2.4% of projected current services federal spending. The strength of the President's proposal is largely in the incentives it creates for new investment spending -- investment funded by private funds that are not now being invested.

The elimination of the double taxation on dividends will have a positive and significant impact on private investment, raising the after-tax return on capital and increasing investment. The elimination of the double taxation on dividends in and of itself should produce a one-time increase in aggregate equity values in the range of up to 5%. The overall efficiency of investment expenditures in both the short and long term will improve as the current distortions, which encourage corporations to reinvest earnings even when rates of return on investment outside the company exceed internal rates of return, are eliminated. Eliminating the current bias against the payment of dividends will increase dividend payments and make the internal condition of corporations more transparent. The elimination of the double taxation on dividends will help small businesses that are currently discouraged from adopting a corporate structure even if it would allow them greater access to capital. It will eliminate the current tax bias against equity investment, which has encouraged non-economic use of debt rather than equity and made many corporations more vulnerable during downturns. The elimination of the dual taxation on dividends is both an effective stimulant and sound economic policy, which will speed up the recovery and increase longer term growth.

The President's proposal to accelerate the tax cut scheduled to occur in 2004 and 2006 will not alter middle and long-term revenues but will stimulate the economy. The highest tax rate is, in reality, the small business tax rate since the earnings of proprietorships, partnerships and sub-chapter S corporations are taxed at the highest individual rate. Dollar for dollar, accelerating the reduction in the highest rate is probably the most effective stimulus in the President's plan.

Had Congress anticipated how sluggish the recovery would be, it almost certainly would have implemented the tax cut more rapidly, and I urge you to accelerate the entire tax cut and make it retroactive to January 1, 2003. In a static sense, revenues will fall this year, but the longer-term revenue picture, even in a static model, will remain unchanged since the tax cuts will occur anyway in 2004 and 2006. If the recovery can be strengthened, the mid -term revenue picture will be dramatically enhanced. With estimated revenue losses due to the recession this year projected to equal five times the average annual cost of the President's stimulus proposal, the potential gains to be derived from enhancing the recovery are obvious.

Tripling the level of investment expenditures by small business that can be expensed and charged against current earnings will encourage small businesses to retool and, in the process, help grow the economy now.

The uncertainty surrounding the current recovery and the lack of predictability of its behavior strongly argue for a more activist policy. If the recovery could be accelerated, net additional job creation over the next three years in the two million range is not unachievable. Anything that helps to restore the $6.7 trillion decline in equity values, which has occurred over the last three years, will greatly benefit the economy and the federal treasury. The sooner a stimulus package is passed the better. All of its provisions should be made retroactive to January 1, 2003 for maximum short-term effect. Finally, let me reiterate that lagging investment is the problem and those provisions that directly affect investment will have the greatest impact.

Phil Gramm
Vice Chairman, UBS Warburg