Tax Policy, Economic Growth and American Families

Introduction

Over the past decade and a half, Americans have been presented with two radically different visions of the role of government. The first vision, articulated and implemented by President Reagan in the 1980s, declares that government taxation and burdensome regulations are harmful to the natural market forces that generate economic growth. Since economic growth is the only way to truly create jobs and raise incomes, policies that reduce taxes and government intervention are the keys to higher living standards for all Americans.

President Clinton espouses the second vision, which maintains that the expansion of government does not have harmful effects on the economy and, in fact, may actually be a source of economic growth. Proponents of this vision believe that it is largely through government policies that people can be made better off. According to this vision, tax increases, such as those enacted in 1990 by President Bush and in 1993 by President Clinton, are valid and effective means by which to achieve such policies. When tax increases are not politically feasible, continued deficit spending is the next-best alternative.

In one sense, President Clinton's fiscal policies are a continuation of the Bush Administration's fiscal policies -- both administrations sought to reduce the budget deficit by raising taxes. President Clinton's agenda, however, is far more harmful than his predecessor's, as evident by Clinton's massive 1993 tax increase, his attempt in 1994 to socialize health care, and Clinton's original budget plan this year that proposed hundreds of billions of dollars in new debt for the United States.

Clinton's tax-and-spend policies have been in place for almost three years and it is now possible to compare the record of the pro-economic growth policies advocated by Republicans to the pro-government growth policies of President Clinton and the Democrats. The best comparison of these policies is a side-by-side examination of the economic recovery under President Reagan in the 1980s and the current recovery under Presidents Bush and Clinton.

Summary

With four years of data on the current economic recovery (extending back to the Bush Administration), it is now possible to tally up the scorecard and compare the Bush/Clinton recovery that started in 1991 with the Reagan recovery that began in 1982.[1] President Clinton has boasted that his policies have spurred economic growth, added jobs, and helped the middle class. However, the data show that the Bush/Clinton recovery is weak compared to the Reagan recovery along several important measures. Both economic growth and job creation in the current recovery lag behind the Reagan recovery by two full years. The middle class is suffering an actual loss in real median family income, while during the Reagan recovery it gained. Moreover, tax revenues increased more rapidly under Reagan's tax cuts than under the Bush/Clinton tax increases.

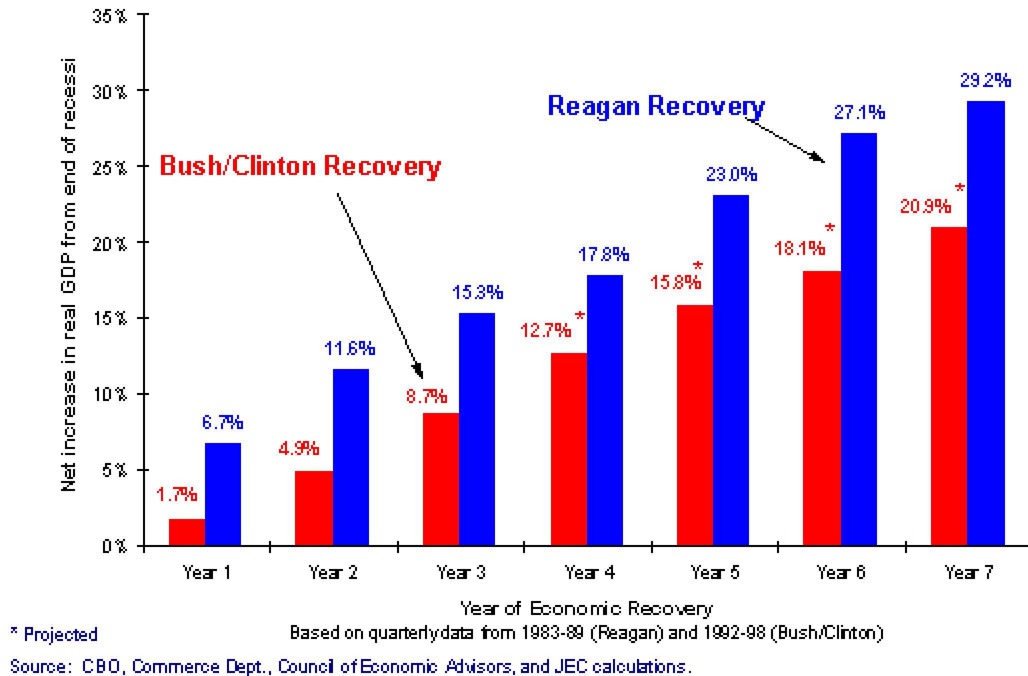
The most outstanding policy differences between the two recoveries are in the realm of tax policy. Reagan instituted across-the-board reductions in tax rates, while Bush and Clinton both pushed massive tax increases. The most disturbing conclusion is that the 1990 and 1993 tax increases have cost Americans far more than the extra earnings collected by the IRS; they have cost the economy at least two years of growth. Comparing the two recoveries:

- Real GDP grew more in five years under Reagan (23 percent cumulative growth) than it is projected to grow in seven years under Bush/Clinton (21 percent cumulative growth).
- After four years, 4 million more jobs were created under Reagan than under Bush/Clinton.
- Federal revenues, adjusted for inflation, grew much faster under Reagan (33 percent cumulative growth) than projected under Bush/Clinton (20 percent cumulative growth).
- Real per capita disposable income grew more in two years under Reagan than in all four years combined thus far in the Bush/Clinton recovery (8.2 percent versus 7.8 percent).
- Median family income grew in all of the first three recovery years under Reagan, compared to three consecutive declines under Bush/Clinton.

In other words, during the economic expansion following Reagan's tax cuts, the economy grew faster, experienced stronger revenue growth, created more jobs, and saw more rapid income growth than the current expansion under the high tax policies of Presidents Bush and Clinton.

Economic Growth Spurred by Tax Cuts, Slowed by Tax Increases

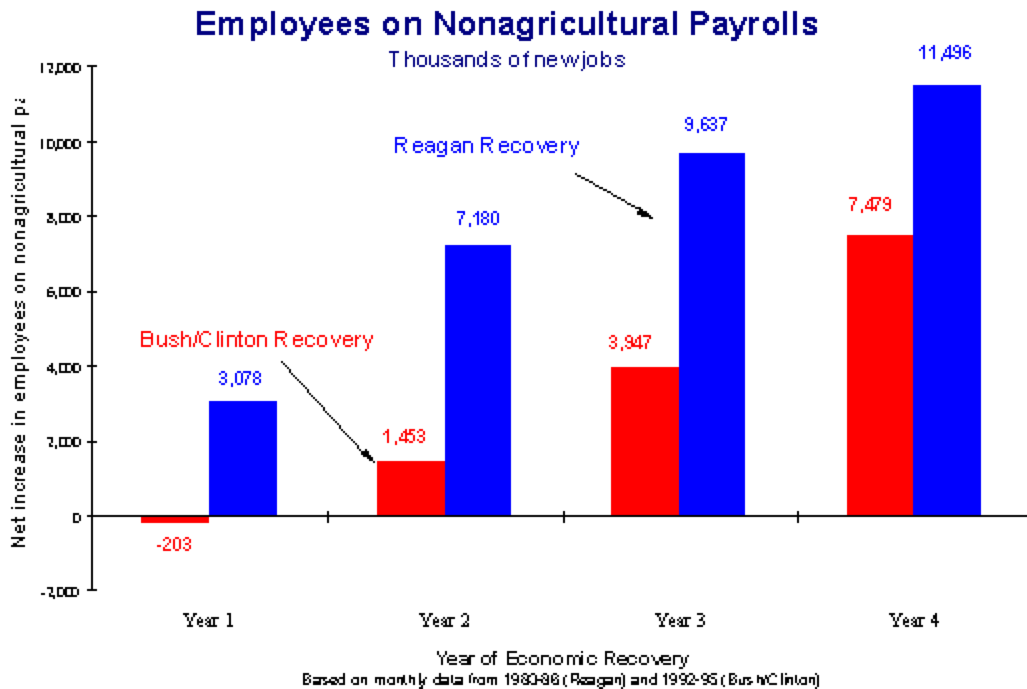
Nothing illustrates the negative effect of tax increases as well as comparing economic growth following Reagan's 1981 tax cuts and the tax increases in 1990 and 1993. Both the tax cuts and the tax increases had profound effects on the subsequent economic recoveries, which began in 1982 and 1991, respectively. To assess the magnitude of such effects, Figure 1 compares the cumulative percentage growth in real GDP from the low-point of each recession. Comparing the cumulative real GDP growth experienced in the 1980s and 1990s, it is evident that Reagan's tax cuts led to a strong, healthy recovery, with GDP growing 29 percent in just 7 years.[2] Over the same time span following the Bush/Clinton tax increases, real GDP is expected to increase only 21 percent.[3] In fact, the economy after Reagan's tax cuts grew more in 5 years than the Bush/Clinton recovery will in 7 years. In other words, the burden of tax increases on the economy has "cost" the American economy 2 years of growth.



To put the consequences of slow growth in perspective, consider what would have happened had the current recovery matched the Reagan recovery. Real GDP is expected to be $7.2 trillion in 1998. If the economic expansion that began in 1991 were to match the growth under Reagan, real GDP would be $500 billion higher in 1998 and $2.8 trillion higher over 1992-98. Real GDP "lost" to slow growth would amount to over $7,300 per American family of four in 1998.

Job Creation Falters Under Bush/Clinton Tax Increases

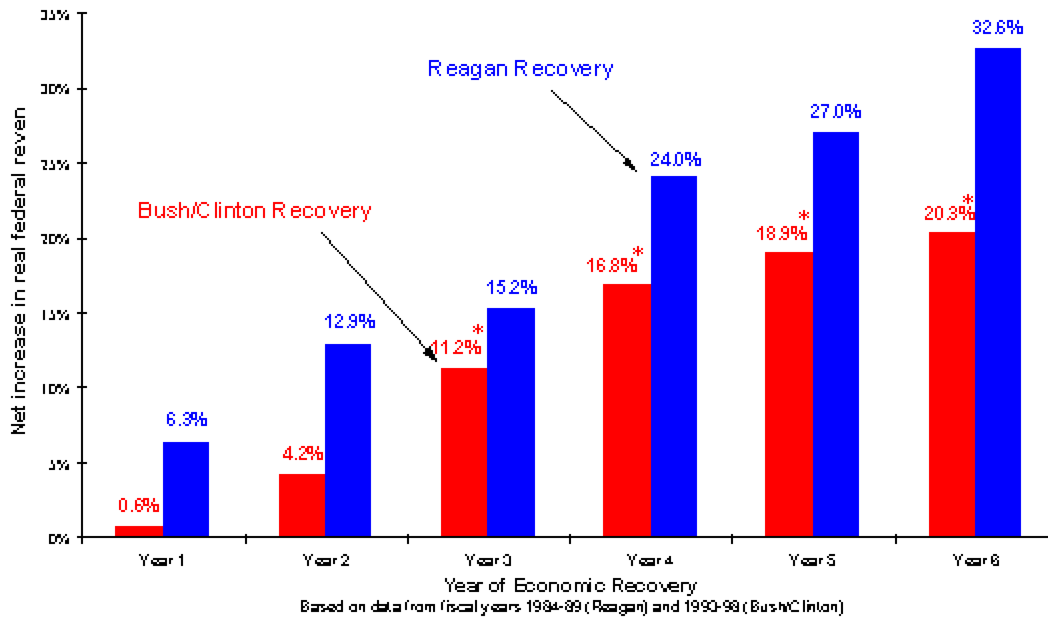
The effects of higher taxes and increased government regulation have been painfully felt by working Americans, particularly those who have not been able to find jobs. Just one year after emerging from the recession, employment grew 3.5 percent under Reagan. [4] At the same point in the current recovery, employment actually fell 0.2 percent. Under the Bush/Clinton recovery, 7.5 million jobs have been created in the past four years (Figure 2). While this may seem substantial, it pales in comparison to the 11.5 million jobs created in the first four years of the Reagan recovery.



The 2 year growth gap in real GDP is reflected in the figures for job creation. Two years of the Reagan recovery nearly match four full years of job growth under Bush/Clinton. During the first four years of the Reagan recovery, there were an average of 240,000 jobs created each month. In the four year period following the 1990-91 recession, the average monthly job growth was just 156,000. In other words, for every two jobs created between 1992-95, three jobs were created under Reagan between 1983-86.

Real Revenue Growth Under Reagan Out-Paced Bush/Clinton

Contrary to the claims of Democrats, tax cuts under Reagan were not the cause of persistent budget deficits. As Figure 3 shows, real revenue grew much faster in the Reagan recovery than in the Bush/Clinton recovery. Under Reagan, federal revenue, in inflation-adjusted dollars, grew at an average annual rate of 4.8 percent, compared to 3.2 percent growth under Bush/Clinton.[5] After six years of economic expansion, real revenues under Reagan (with tax cuts) grew a cumulative 32.6 percent. Even with two tax increases, Bush/Clinton revenues are projected to increase just over 20 percent in six years, a feat Reagan accomplished two years quicker.

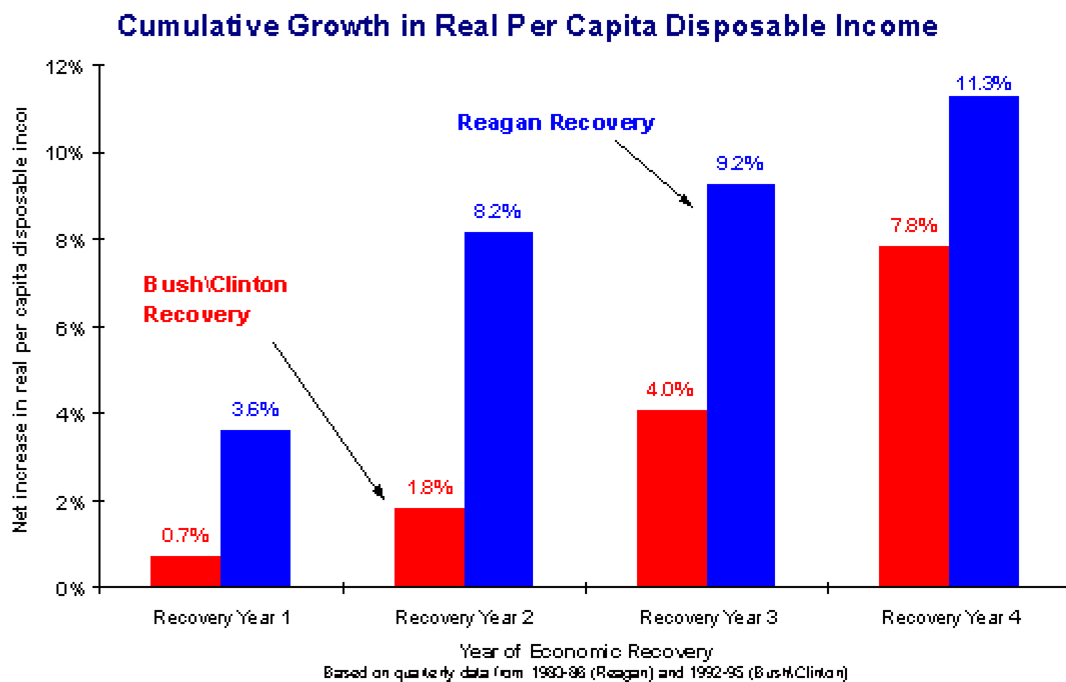


Even measured in absolute terms, revenue growth was much greater under Reagan than under Bush/Clinton. After six years of economic expansion, Reagan real revenues were $277 billion higher than at the end of the recession. Projected revenues under Clinton show that six years after the 1990-91 recession ended, revenues will be just $225 billion higher.

The reason for this is simple: The growth of revenues is tied to growth of the economy. Tax cuts stimulate economic growth, which in turn means that incomes are higher than they would be otherwise. Conversely, tax increases hinder growth and constrain economic expansion. Thus, revenue during the Reagan recovery actually grew faster than revenue in the Bush/Clinton recovery, despite the fact that Reagan instituted tax cuts while Bush and Clinton raised taxes.

Higher Taxes Mean Less Disposable Income

Examination of disposable income further reinforces the negative role of taxes. Measured on a per capita basis in inflation-adjusted dollars, the Reagan recovery far outstripped the Bush/Clinton recovery in growth in disposable personal income, as illustrated in Figure 4. Real per capita disposable income grew a total of 11.3 percent in the first four years of the Reagan recovery.[6] Over an equivalent time period in the Bush/Clinton recovery, real per capita disposable income grew a meager 7.8 percent. Real per capita disposable income grew more under Reagan in two years (8.2 percent) than it did in four years under Bush and Clinton (7.8 percent).



Disposable income is defined as the amount of income that is left to individuals after paying taxes. As such, growth in disposable income is crucial for maintaining a rising standard of living. The anemic growth in disposable income under Bush/Clinton is indicative of two trends. First, higher taxes mean that Americans have to send a greater portion of their incomes to the federal government. Second, higher taxes stifle economic growth, which in turn means that the overall economy as well as individual incomes do not grow as fast as they would otherwise.

Income Equality Tied To Economic Growth

One criticism that is raised against the Reagan years is that there was a rise in income inequality. The historical record, however, does not support such a conclusion. Data collected by the Federal Reserve reveal that there was, at worst, no significant change in income inequality between 1983 and 1989.[7] Moreover, IRS data indicate that the wealthy paid an increasing share of income taxes during the 1980s.[8]

These observations are consistent with economic theory. In a slowdown or a recession, the wealthy can take care of themselves through their savings and investments. Data show that the wealthy derive a much greater portion of their income from capital investments.[9] Low-income individuals, however, derive most of their income from wages and salaries, which typically decline during recessions. Since they have less savings to draw on, low-income individuals bear the burden of anemic growth far more than the wealthy. Low-income individuals are further hurt by the fact that wage and salary growth is contingent on economic growth.

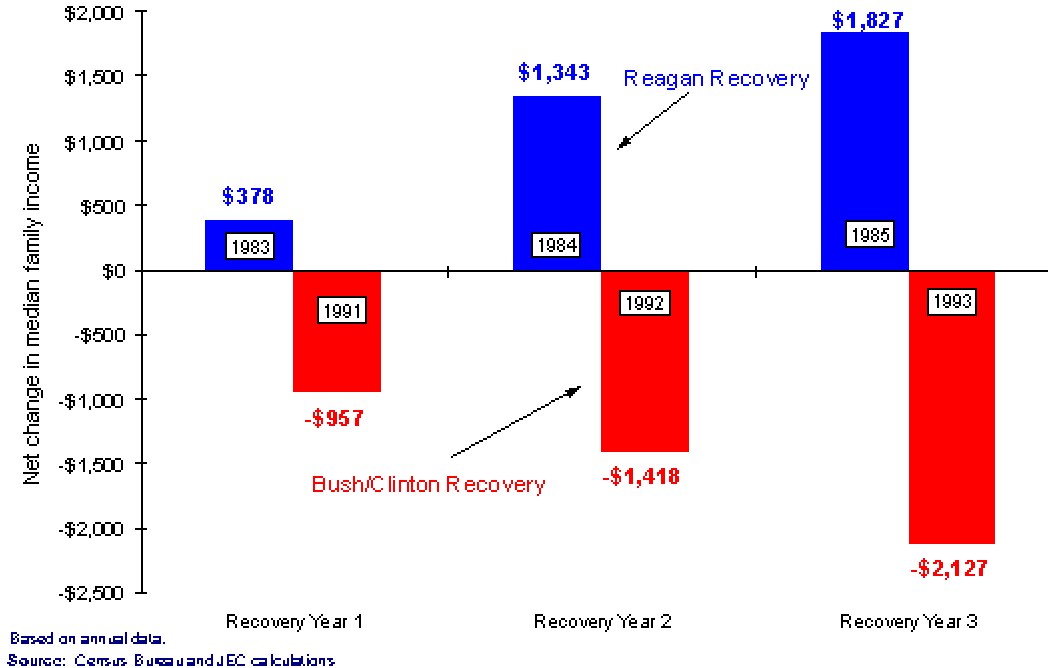
Critics of the Reagan years assert that cutting taxes on capital is unfair because more of the benefits (in terms of taxes returned to taxpayers) go to individuals with higher incomes. Cutting

taxes on saving and investment, however, has implications beyond just the effect on tax returns, particularly with regard to which people are affected. Lower taxes on capital serve to encourage its use. More capital leads to higher wages, increased incomes, and more high-quality jobs. By raising real wages, a reduction in taxes on capital encourages greater workforce participation and spurs investments in human capital, education, and training. Whenever the economy's stock of capital increases, the relative income shares of those already wealthy decline. As a result, the gains from economic growth are spread more evenly across the population.

In fact, data from the 1980s show that a good deal of the alleged rise in inequality is attributable to greater workforce participation. Most studies on income inequality rely on data compiled from tax returns. These studies often point to the fact that the income of some tax returns increased faster than others (even if most households increased in wealth). The problem with these numbers is that they fail to account for increased female labor force participation. Women who were not working previously chose to enter the labor market, since lower taxes on the product of labor increased the net compensation of their work. With two earners, families with these new labor force entrants saw rapid increases in their family income, creating the appearance of inequality. In reality, these number's simply reflect the fact that more people were working.[10]

Median Family Income Falls Under Policies of Higher Taxes

For the typical American family, slower economic growth may seem an abstract economic theory. The effects of slower growth, however, have been undeniably felt by working American families. The increase in taxes during the Bush/Clinton recovery has lead to a noticeably negative effect on family income (Figure 5). In 1991 alone, the median family income, adjusted for inflation, fell by $957.[11] In 1992 and 1993, real median family income dropped by $461 and $709, respectively, resulting in a net fall of $2,127 in inflation-adjusted income during the current recovery.



Based on annual data.
Source: Census Bureau and JEC calculations

During the Reagan recovery, real median family income increased by $378 in the first year alone. Median family income rose $965 in the second year of the Reagan recovery and another $484 in Year 3. Overall, real median family income was $1,827 higher after the first three Reagan expansion years.

Conclusion

An examination of economic growth, job creation, federal revenue collection, and two measures of personal income reveals an unmistakable trend: The current economic recovery pales in comparison to the Reagan recovery along all measures. When Clinton praises the state of the economy, saying, "We are getting our economic house in order...we are moving in the right direction," it is important to keep everything in perspective. The economy is growing, but far below the potential demonstrated under Reagan.

With the burden of higher taxes weighing the economy down, the economy cannot be expected to expand by the leaps and bounds it did in the 1980s. While Clinton's top economic adviser, Laura D'Andrea Tyson, expresses satisfaction with our progress, stating that "the prospects for a sustained period of economic growth remain strong," contentment with our position will have cost our economy a cumulative total of $2.8 trillion by 1998.

This analysis was prepared by Dan Miller, economist, and William K. MacReynolds, senior economist, with research assistance provided by Lewis Weinger.

Endnotes

1. The official starting and ending points of the recessions are July, 1981 to November, 1982, and July, 1990 to March, 1991.

2. Figures in percent indicate the net increase in real GDP (1993 dollars) since the end of the recovery, based on quarterly data. The low points of the recoveries are the fourth quarter of 1982 for the Reagan recovery, and the first quarter of 1991 for the Bush/Clinton recovery. Sources: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Vol. 73 (September, 1993), p. 52; Council of Economic Advisers, Executive Office of the President, *Economic Indicators*, May, 1995, p. 2.

3. CBO estimates for real GDP were used for the years 1994-98. Quarterly data were interpolated using CBO's annual real GDP figures. Source: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1996-2000* (Washington, DC: Government Printing Office, January, 1995) p. xiv.

4. Employment figures are based on surveys of employers that collect data on the number of nonagricultural employees on employer payrolls. Figures reflect change in nonagricultural employment from the end of the recession. Monthly data are published by the Department of Commerce in the *Survey of Current Business*, various editions.

5. Historical and projected revenues were converted to 1993 dollars using the GDP deflator. The GDP deflator is based on calendar years from 1982 to 1997. Since revenues are in fiscal years and economic growth in calendar years, revenues for a recovery year were taken for the fiscal year that began soonest after the end of the recession. Thus, the first year of revenues after the 1981-82 recession is fiscal year 1984, and after the 1990-91 recession is fiscal year 1992. Sources: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1996-2000* (Washington, DC: Government Printing Office, January, 1995) p. 58; and Council of Economic Advisers, Executive Office of the President, *Economic Report of the President 1995* (Washington, DC: Government Printing Office, February, 1995) p. 278.

6. Real disposable income figures are based on quarterly data in 1993 dollars. Numbers indicate cumulative increase in real per capita disposable income since end of recession (fourth quarter 1982 and first quarter 1991). Source: Council of Economic Advisers, Executive Office of the President, *Economic Indicators*, January, 1994 and May, 1995, p. 6.

7. John Weicher, "Getting Richer (At Different Rates)," *Wall Street Journal*, June 14, 1995.

8. Committee on Ways and Means, U.S. House of Representatives, *The 1993 Green Book* (Washington, DC: Government Printing Office, 1993) p. 1515.

9. Gary Robbins and Aldonna Robbins, "Capital, Taxes, and Growth," National Center for Policy Analysis, Policy Report No. 169, January, 1992, p. 4.

10. A description of this phenomenon is provided in: Diana Furchtgott-Roth, "Working Wives Widen 'Income Gap,'" *Wall Street Journal*, June 20, 1995.

11. Data on median family income is only available on an annual basis and therefore do not reflect the actual trough of the respective recessions. However, the selection of recession years with respect to median family income is advantageous to the Bush/Clinton recovery, since cumulative growth (theoretically) is compared to a lower starting point relative to the Reagan recovery. All numbers are in 1993 dollars. Source: U.S. Bureau of the Census, Current Population Reports, Series P60-188, *Income, Poverty, and Valuation of Noncash Benefits:* 1993 (Washington, DC: Government Printing Office, 1995) p. D5.