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Been There, Done That — Didn't Work:

The Dole Economic Plan

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Presidential candidate Robert Dole proposes to repeat the supply-side experiment of the 1980s. History and economic theory suggest that his plan will:

- Fail to boost economic growth and employment;
- Increase the federal deficit;
- Force cuts in basic programs on which millions of Americans depend;
- Shift income from the middle class to the rich;
- Bring undesirable social consequences in its wake.

The centerpiece of the Dole plan is a 15% reduction in federal tax rates. While he claims that his plan is about wages, it does nothing to address the economy's real problem, which is the decline in before-tax wages. If the wage trends of the last 15 years continue, then in 1998, when the proposed Dole tax cut is fully phased in, the typical worker will still have lower after-tax wages than he or she does today. This is not a promising picture.

The Reagan Record: Slow Growth, Rising Deficits

To gauge the impact of the Dole tax cuts, it is necessary only to examine the effect of the 1980s experiment with supply-side economics, when tax rates were cut by 25%. That tax cut, like Dole's, was supposed to produce more investment, jobs, economic growth, and a balanced budget. The table on the next page, which lists the average annual growth rates for business cycles of the 1960s, '70s, and '80s, shows the record of that experiment.

As can be seen, the economic performance of the 1980s did not come close to that of the 1960s. It did not even match the growth of the oil-shock decade of the 1970s.

It is worth noting that this table measures growth from business-cycle peak to business-cycle peak. Such a measurement is the *only* accepted basis for making economic comparisons. These comparisons are not always convenient, since business cycles do not coincide with presidential terms, but they provide the only means to disentangle the effects of economic policy from the cyclical movements of the economy. Making claims about economic performance based on the movement from a low point in the business cycle (or "trough") to a cyclical peak would be comparable to claiming that the rise in temperature from winter to summer established the case for global warming.

Average Annual Growth: How the '80s Compared

Business Cycle	Investment	Jobs	GDP
1959-69	6.82%	2.83%	4.35%
1973-79	4.66	2.65	2.87
1979-89*	2.43	1.85	2.74

* With Reagan tax cut in effect.

Since the Reagan-era tax cuts had no effect on growth, their impact was exactly what one would have expected: a large drop in tax revenue from projected levels. According to the Congressional Budget Office, the structural deficit (the deficit adjusted to eliminate the impact of unemployment) rose from 1.7% of gross domestic product in 1981 to 4.2% in 1985 and 1986. This increase in annual deficits fed the quadrupling of debt during the 1980s, making the United States the world's largest debtor nation. If not for the interest on debt incurred during the Reagan years, today's budget would show a large surplus.

Combined with the Federal Reserve Board's tight-money policies, the rise in real interest rates had a devastating impact on U.S. manufacturing. The dollar rose in value by as much as 50% against the currencies of our major trading competitors, making it virtually impossible for many firms to compete in domestic and international markets. As a result, the U.S. trade deficit in manufactured goods soared to $160 billion in 1987, a record 3.4% of GDP. The dollar has fallen in value since then, but U.S. manufacturers have yet to recover their competitive position, and the merchandise trade deficit is still more than 2.0% of GDP.

Why it Failed: The Theory of Supply-Side Economics

The supply-side promise is that lower marginal tax rates will increase work, saving, and investment, thereby creating more jobs and faster economic growth. Why this promise fails to materialize is no mystery.

With regard to work, if current wage trends continue, the reduction in tax rates will have the effect of reversing about one year's decline in before-tax wages for the typical worker. This increase is not going to provide much additional incentive for work, even for those in a position to control their work hours.

The impact of the cut in taxes on saving is also questionable. While a lower tax rate may increase the after-tax return to saving, it does not necessarily induce people to save more. If people pay fewer taxes on their savings, then they can afford to save less and still get as much income as before. Most evidence shows that this effect largely offsets the incentives created by a lower tax rate.

In addition, the macroeconomic impact could offset the benefits of the decision by some individuals to save more. If people save more, then they must consume less. Less consumption means lower consumer sales, and lower sales depress business investment and employment. Lower employment in turn reduces family incomes. Lower employment and family income mean less saving, not more.

Furthermore, higher saving does not guarantee higher investment within the United States. U.S.

savings go into a world capital market. Whether these funds are invested in the United States depends on the decisions of firms doing business here. Profit rates are already at historic highs (Baker 1996), yet investment is at near record lows when measured as a share of GDP. It is difficult to see how a small increase in domestic saving, and a resulting decline in interest rates, will reverse this situation. Empirical research has shown that interest rates are relatively unimportant as a determinant of business investment, and that sales growth and cash flow are more important (Fazzari 1994).

The least justifiable tax cut in the Dole plan is the capital gains tax break. This cut will also have a minimal impact on saving and investment, with the added problem that a preferential tax rate for capital gains will revive the tax shelter industry. The benefits of capital gains relief are concentrated on the highest-income taxpayers (See Baker 1995). According to the Citizens for Tax Justice, two-thirds of total capital gains are reported on individual tax returns by people whose incomes exceed $200,000. In contrast, only 7.8% of the total gains are reported by the three-quarters of tax filers with incomes of $50,000 or less. More than any other type of income, capital gains are concentrated at the very top of the income scale.

Mr. Dole suggests that this cut will “free up” money that is supposedly “locked into” individuals’ existing portfolios. But someone can still sell an asset only if there is someone else willing to buy it. A capital gains tax cut may lead to considerable paper shuffling as more people trade their stock, but this activity generates no new money for the economy as a whole.

The High Cost of Tax Cuts

Even if it did not help the economy, a tax cut may still seem like a good idea, since everyone can use additional money. But any reduction in tax revenue has to be matched by spending cuts or higher deficits. Since Mr. Dole insists that he will not let the deficit rise, there must be further cuts in spending. The Republican Congress has already proposed substantial cuts in Medicare, and Dole may add to these cuts or also go after Social Security to pay for his tax cuts. In addition, he may target federal spending for education, environmental cleanup, infrastructure, and other areas of public investment. Additional cuts in these areas will slow growth enough to quickly offset the lower tax burden incurred by a typical family.

Mr. Dole has also promised to curb the power of the Internal Revenue Service. However, the main impact of Dole’s proposals will be to make it easier for wealthy individuals to engage in tax-avoidance schemes. The consequence will be higher taxes for everyone else, higher deficits, or both.

Conclusion

The middle-class income squeeze is the result of what employers are putting into paychecks, not what the government is taking out. The Dole proposal offers little hope of increasing economic growth, and it does nothing to address the real problem of declining *before-tax* wages. Supply-side economics did not work before and will not work now. It has a legacy of economic failure and social injustice from which the nation is still struggling to recover.

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