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Tax Cuts, Not the Clinton Tax Hike, Produced the 1990s Boom

J. D. Foster, Ph.D.

When pressed about the harmful effects on the economy, proponents of higher taxes often fall back on what can be called the "Clinton defense." President Bill Clinton pushed a major tax increase through Congress in 1993, and, so the story goes, the economy boomed. How, then, can tax increases be so bad for the economy? The inference is even stronger: that higher taxes actually strengthened the economy.

The Clinton defense is superficially plausible, but it fails under closer scrutiny. Economic growth was solid but hardly spectacular in the years immediately following the 1993 tax increase. The real economic boom occurred in the latter half of the decade, after the 1997 tax cut. Low taxes are still a key to a strong economy.

The Clinton Tax Defense. A growing body of literature and experience indicates that higher taxes are associated with a smaller economy.[1] It is generally axiomatic that the more one taxes something, the less there is of the item taxed.

There is surely no reluctance among proponents to argue that higher taxes on tobacco materially reduce tobacco consumption or that higher taxes on energy would appreciably reduce energy consumption. Yet, somehow, the argument persists that raising taxes on labor does not diminish the supply of labor or that raising taxes on capital does not appreciably reduce the amount of capital in the economy. In both cases, tax hikes weaken the economy and reduce the amount of income earned by American families.

The Clinton defense of higher taxes rests largely on a cursory review of the economic history of the 1990s. Whatever the theoretical debates, the proof, as they say, is in the pudding: President Clinton raised taxes, yet the economy grew, and grew smartly in the latter half of the 1990s. Economists have occasionally been accused of seeing something work in practice and then proving that it cannot work in theory. However, this is not the case here.

History suggests that the economy performed reasonably well in the years immediately following the tax hike, but history is not causality, and history sometimes needs a more careful examination to tell its story faithfully. Following the tax hike, the economy performed reasonably well, but not as well as one would expect given the conditions at the time. The real economic boom came later in the decade, just when the economy should have slowed as it made the transition from a period of recovery to normal expansion. Further, this acceleration coincided to a remarkable degree with the 1997 tax cut.

Contrasting the period immediately after the tax *hike* and the period immediately after the tax *cut*, the evidence strongly suggests that the tax hike likely slowed the economy as traditional theory suggests

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214 Massachusetts Avenue, NE
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(202) 546-4400 • heritage.org

and that it was the tax cut that gave the economy renewed vigor—and gave history the real 1990s boom. In other words, the Clinton defense of higher taxes does not hold up.

The Clinton Tax Hike. In 1993, President Clinton ushered through Congress a large package of tax increases, which included the following:[2]

- An increase in the individual income tax rate to 36 percent and a 10 percent surcharge for the highest earners, thereby effectively creating a top rate of 39.6 percent.
- Repeal of the income cap on Medicare taxes. This provision made the 2.9 percent Medicare payroll tax apply to all wage income. Like the Social Security payroll tax base today, the Medicare tax base was capped at a certain level of wage income prior to 1993.
- A 4.3 cent per gallon increase in transportation fuel taxes.
- An increase in the taxable portion of Social Security benefits.
- A permanent extension of the phase-out of personal exemptions and the phase-down of the deduction for itemized expenses.
- Raising the corporate income tax rate to 35 percent.

According to the original Treasury Department estimates, the Clinton tax hike was to raise federal revenues by 0.36 percent of gross domestic product (GDP) in its first year and by 0.83 percent of GDP in its fourth year, when all provisions were in effect and timing differences associated with near-term taxpayer behaviors had sorted themselves out. In 2007, the fourth-year effect would be roughly equivalent to an increase in the federal tax burden of about $114 billion.

Background. The economic environment at the time of the tax hike is important in assessing its consequences. In January 1993, the economy was entering its eighth quarter of expansion after the 1990–1991 recession. The recession had been relatively mild by historical standards, with a net drop in output of 1.3 percent. Yet even at the start of 1993, the economy was operating below capacity. Capacity utilization in the nation's factories, mines, and utilities was running at about 81 percent, whereas it had been around 84 percent through much of 1988 and 1989. The unemployment rate in January 1993 was 7.3 percent but had averaged 5.3 percent as recently as 1989. At the time of the tax hikes, the economy was recovering but still far from healthy.

Tax policy aside, much in the context of the 1990s was conducive to prosperity. The end of the Cold War brought a new sense of hope and greater certainty to the global economy. The price of energy was astoundingly low, with oil prices dropping to about $11 per barrel and averaging under $20 per barrel compared to prices above $90 per barrel today. The Federal Reserve had finally succeeded in establishing a significant degree of price stability, with inflation averaging less than 2 percent during the Clinton Administration. And, of course, a tremendous set of new productivity-enhancing technologies involving information technologies and the World Wide Web burst on the scene.

Absent a major negative shock, one should have expected a period of unusually strong growth from 1993 onward as the economy more fully employed its available capital and labor resources. In the four years following the Clinton tax hike (from 1993 through 1996):

- The economy grew at an average annual rate of 3.2 percent in inflation-adjusted terms;
- Employment rose by 11.6 million jobs;[3]
- Average real hourly wages rose a total of five cents per hour;[4] and
- Total market capitalization of the S&P 500 rose 78 percent in inflation-adjusted terms.

1. For a discussion of recent research on the economic effects of tax changes, see J. D. Foster, "Tax Hikes, Economic Clouds, and Silver Linings: A Review of Deficits and the Economy," Heritage Foundation *Backgrounder* No. 2095, February 25, 2008, at *www.heritage.org/Research/Taxes/upload/bg_2095.pdf*.
2. U.S. Department of the Treasury, Office of Tax Analysis, "Revenue Effects of Major Tax Bills," September 2006.
3. Bureau of Labor Statistics, total non-farm payroll, payroll survey.

These statistics indicate a solid but not spectacular performance in the overall economy. Job growth was strong, as one would expect coming out of recession. Real wage growth remained almost nonexistent, and the stock market performed well. But the real question is this: Altogether, did the economy perform better or worse because of the tax hike? The data from the period do not provide a clear answer.

The year 1997 was a watershed for both tax policy and the economy. By 1997, the economy had entered into a sustained expansion. The unemployment rate was 5.3 percent, a level thought at the time to be roughly consistent with full employment. Similarly, capacity utilization rates hovered around 82.5 percent: again, roughly consistent with full employment of the nation's industrial capacity. With a mature expansion and the economy running at what was believed to be about full capacity, growth would normally be expected to ease back as the economy make the transition from recovery to normal growth. It was not a moment when one would expect growth to accelerate.

The 1997 Tax Cut: The Economy Unleashed. In 1997, the Republican-led Congress passed a tax-relief and deficit-reduction bill that was resisted but ultimately signed by President Clinton. The 2007 bill:

- Lowered the top capital gains tax rate from 28 percent to 20 percent;
- Created a new $500 child tax credit;
- Established the new Hope and Lifetime Learning tax credits to reduce the after-tax costs of higher education;
- Extended the air transportation excise taxes;
- Phased in an increase in the estate tax exemption from $600,000 to $1 million;
- Established Roth IRAs and increased the income limits for deductible IRAs;
- Established education IRAs;
- Conformed AMT depreciation lives to regular tax lives; and
- Phased in a 15 cent-per-pack increase in the cigarette tax.

According to Treasury's original estimates, the 1997 tax cut was relatively modest, amounting to just 0.11 percent of GDP in its first year and 0.22 percent of GDP by its fourth year. In 2007, the fourth-year effect would be roughly equivalent to a reduction in the overall tax burden of about $30 billion.

Despite its modest size, tax cut advocates had high expectations for the tax cut's effects on the economy because the reduction in the capital gains tax rate was expected to unleash a torrent of entrepreneurial and venture capital activity. They were not disappointed.

In 1995, the first year for which these data are available, just over $8 billion in venture capital was invested.[5] Venture capital is especially critical to a vibrant economy because high-risk/high-return investment permits promising new businesses to blossom, rapidly spreading new technologies and new ideas into the marketplace and across the economy. Such investments, when successful, generate returns to investors that are subject primarily to the tax on capital gains. By 1998, the first full year in which the lower capital gains rates were in effect, venture capital activity reached almost $28 billion, more than a threefold increase over 1995 levels, and by 1999, it had doubled yet again.

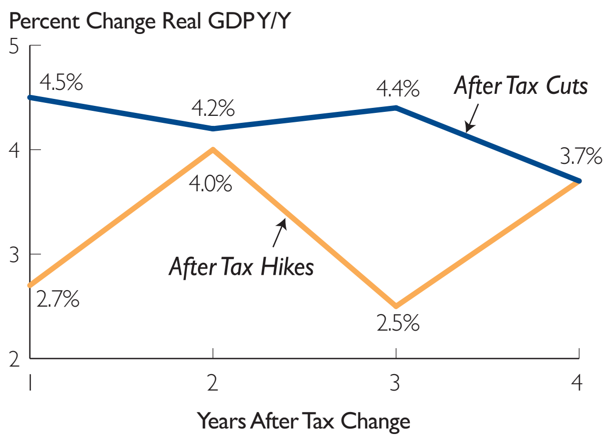
The explosion in venture capital activity cannot be credited entirely to the cut in capital gains tax rates, as the cut fortuitously coincided with technological developments that gave rise to the Internet-based "New Economy." However, the rapid development and application of these new technologies could not have occurred at such a rapid clip absent the enormous investment flows made possible largely by the reduction in the capital gains tax rate. This experience demonstrated yet again the truth of the axiom: The less you tax of something—in this case, venture capital investment—the more you get of it.

4. Bureau of Labor Statistics, average hourly earnings, non-supervisory employees.
5. PriceWaterhouseCoopers, National Venture Capital Association "MoneyTree" Report, at *www.pwcmoneytree.com/moneytree/nav.jsp?page=historical.*

Comparing the Periods. The Clinton years present two consecutive periods as experiments of the effects of tax policy. The first period, from 1993 to 1996, began with a significant tax increase as the economy was accelerating out of recession. The second period, from 1997 to 2000, began with a modest tax cut as the economy should have settled into a normal growth period. The economy was decidedly stronger following the tax cut than it was following the tax increase.

Chart 1 WM 1835

Economy Stronger After Tax Cuts

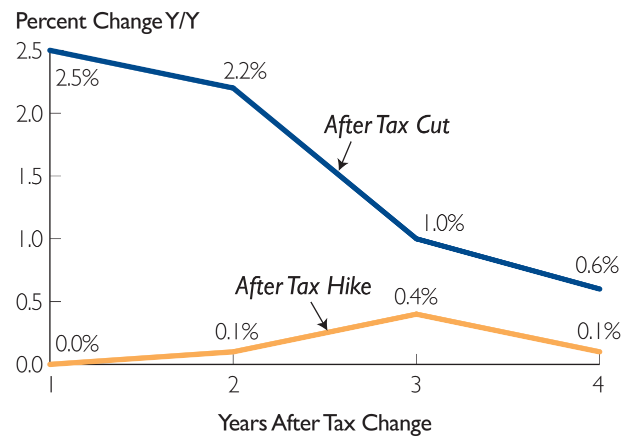


The economy averaged 4.2 percent real growth per year from 1997 to 2000—a full percentage point higher than during the expansion following the 1993 tax hike (illustrated in Chart 1). Employment increased by another 11.5 million jobs, which is roughly comparable to the job growth in the preceding four-year period. Real wages, however, grew at 6.5 percent, which is much stronger than the 0.8 percent growth of the preceding period (illustrated in Chart 2). Finally, total market capitalization of the S&P 500 rose an astounding 95 percent. The period from 1997 to 2000 forms the memory of the booming 1990s, and it followed the passage of tax relief that was originally opposed by President Clinton.

In summary, coming out of a recession into a period when the economy should grow relatively rapidly, President Clinton signed a major tax increase. The average growth rate over his first term was a solid 3.2 percent. In 1997, at a time when the expansion was well along and economic growth should have slowed, Congress passed a modest net tax cut. The economy grew by a full percentage point-per-year faster over Clinton's second term than over his first term.

Chart 2 WM 1835

Real Wages Grow Faster After Tax Changes



The evidence is fairly clear: The tax cuts, especially the reduction in the capital gains tax rate, made a major contribution to a strong economy. Given this observation, it seems likely, though admittedly less certain, that the tax increases in 1993, while not derailing the economy as many had forecast at the time, did indeed slow the recovery compared to what the economy could have achieved.

Table 1 WM 1835

Comparison of Various Economic Measures Before and After Tax Cuts

	Average Real GDP Growth Rate *(% per annum)*	Job Growth *(millions)*	Real Wage Growth	S&P 500 Capitalization *(% change, constant$)*
1993–1996	3.2	11.6	5 cents	78
1997–2000	4.2	11.5	49 cents	101

Conclusion. Proponents of tax increases often reference the Clinton 1993 tax increase and the subsequent period of economic growth as evidence that deficit reduction through tax hikes is a pro-growth policy. What these proponents ignore, however, is that the tax increases occurred at a time when the economy was recovering from recession and strong growth was to be expected. They also ignore that the real acceleration in the economy began in 1997, when economic growth should have cooled. This acceleration in growth coincided with a powerful pro-growth tax cut.

The evidence is persuasive that the tax increase probably slowed the economy compared to the growth it would have achieved and that the subsequent tax cuts of 1997, not the tax increases, were the source of the acceleration in real growth in the latter half of the decade. As taxes are now above their historical average as a share of the economy and are rising, Congress should look to enact additional tax relief to keep the economy strong.

—J.D. Foster, Ph.D., is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy for the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.