

The Case for a Tax Cut

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1. Tax Increases Have Created the Surplus

Any discussion of tax policy should begin by recognizing the current and prospective future U.S. fiscal situation.

Fact #1: The United States currently has a record-high level of federal taxes. The share of federal tax payments in GDP is at a record-high for peacetime, reaching 20.7% in fiscal year 2001. Although the government predicts that share will fall to 20.2% over the next decade, even that 20.2% figure would exceed *any* year before 2000 except the final two years of World War II.

Fact #2: The primary cause of this record-high share of taxes in GDP is a large (roughly 25%) increase in federal income taxes since 1992. Over that period, personal income tax payments rose from about 8% of GDP to about 10% of GDP. Most of this increase has fallen on taxpayers in the highest brackets.

Fact #3: This increase in federal income taxes since 1992 accounts for most of the federal government budget surplus. With GDP at \$10,000 billion, this two-percentage point rise in the ratio of personal income tax payments to GDP accounts for an increase in federal income-tax payments of \$200 billion per year, or more than two-thirds of the \$281 billion (total) federal budget surplus in FY 2001. *Most of the federal government budget surplus has resulted from a \$200 billion increase in personal income taxes.*

Over the second half of the 20th century, overall payments of federal taxes as a share of GDP were fairly stable at around 18%.¹ Consequently, the increase in overall tax payments in recent years, from 18% of GDP to 20.7% of GDP, accounts for \$270 billion, or nearly all, of the \$281 billion surplus.

Fact #4: The federal government budget surplus consists of a so-called *on-budget* surplus that reached \$125 billion in fiscal-year 2001, and an *off-budget* surplus – mainly revenues for the so-called Social Security Trust Fund. The government on-budget surplus is expected to rise annually to \$558 billion in 2011. The CBO projects the (undiscounted) ten-year total of those surpluses for 2002-2011 to be \$3,122 billion. (It projects that the total, undiscounted, *off-budget* surplus will reach \$2488 billion over this ten-year period, bringing the overall ten-year government budget surplus to \$5610 billion.)

Projected surpluses imply a rapid reduction in the government's debt: the government projects that, under current policies, privately-held federal debt will fall from \$3148 billion in FY 2001 to \$818 billion in FY 2011. And that figure *understates* the decline in debt because some federal debt is not available for redemption. When the debt falls to that level in 2006, the government is

¹ Tax payments to the federal government, as a share of GDP, averaged 17.2% in the 1950s, 17.8% in the 1960s and 1970s, and 18.2% in the 1980s. After World War II, and until 1997, they reached as high as 19% only in four years: 1952, 1969-70, and 1982. Since 1992, however, this share has grown every year, rising above 19% in 1997 and 1998, and exceeding 20% in 1999, 2000, and 2001.

projected to begin accumulating assets that rise to over \$3,000 billion by 2011. On *net*, under current policies, the federal government's debt vanishes around 2008, and the government becomes a net creditor by 2009. By 2011, this net position reflects a projected gross debt of \$818 billion that is more than offset by the government's accumulation of \$3,100 billion in private assets.

Fact #5: Bringing tax payments back to their 18% historical share of GDP would require a tax cut of more than \$200 billion per year (\$270 billion in FY 2001), essentially reversing the tax increase of the last nine years.

2. What Should Fiscal Policy Try to Accomplish?

Public debate on fiscal policy is remarkable for the *absence* of clear statements about its objectives, the methods by which policies might achieve those objectives, and their costs and benefits. The two fundamental questions, "What *can* fiscal policy achieve, and what *should* it try to achieve," far from being philosophical, academic queries, are essential to provide practical guidance for policy actions.

Most analysts would agree on some key issues. First, the overall level of taxes should be chosen to fund the appropriate level of government programs, either based on their benefits and costs, or the programs that our society collectively chooses through its democratic institutions.

Because this principle applies to the expected discounted *present value* of government spending and taxes, it does not require a balanced budget each year. It permits the government to run deficits in some years and surpluses in other years. Deficits and surpluses can, in principle, contribute to various policy objectives. For example, economists often argue that the economic distortions which inevitably accompany taxes can be reduced by a policy of running deficits during periods of temporarily high government spending (such as during wars), rather than temporarily raising tax *rates* during such periods. Constant or slowly-changing tax rates, rather than highly-variable tax rates, tend to create a more efficient allocation of resources.

Second, the government should choose the menu of tax rates on various sources of income, expenditures, and other actions, to minimize the overall harm to the economy from the distorting effects of taxes on incentives, and to allocate the tax burden in a manner that serves the interests of equity and fairness. This has two key implications for tax policy.

First, tax policy should keep *marginal* tax rates as low as possible. Costly economic distortions caused by taxes are diminished, and economic efficiency enhanced, if tax *deductions* and *credits* are reduced to finance a reduction in marginal tax *rates*. Cutting taxes by reducing marginal tax rates offers benefits of greater work effort, savings, investment, fewer distortions in production decisions, savings decisions, investment decisions, and portfolio allocations, with a more efficient allocation of resources in the economy as a whole. In contrast, cutting taxes by raising individual deductions or by issuing a fixed-sum transfer payment to all taxpayers, as some have proposed, offers no such benefits. Any such deduction must be justified by some alternative social benefits, such as equity, and should exceed the social costs of those deductions (resulting from the higher marginal tax rates they require).

Second, the tax system should be structured to tax consumption spending rather than income. Taxation of income, without deductions for savings, creates economic inefficiency, reduces overall national savings and investment, decreases the economy's capital stock and productive capacity, and may reduce the rate of economic growth. Given our present income-tax system, reform should eliminate taxation of income from investment, particularly the double taxation of corporate income. There is widespread agreement among economists on these issues.

Participants in public debates over government policies often advocate changes in taxes to achieve other objectives. The Bush administration has advertised the need for a tax cut mainly on the grounds of its short-run effects in fighting the current economic slowdown and a potential recession. That argument has a long history, and plays a key role in standard macroeconomic thinking. The argument may also be politically expedient in the sense that it may win additional support in Congress. Nevertheless, this is not the most important reason for a tax cut. *The government should cut taxes to reap the long-run benefits of a more efficient allocation of resources, higher GDP, and increased economic growth.*²

3. Tax Policy for *Short-Run* Benefits

Although the strongest reasons for tax cuts reflect long-run considerations, it is nevertheless important to consider the likely *short-run* effects. The administration's argument for a tax cut, based on standard Keynesian macroeconomics, asserts that a tax cut will raise aggregate demand as families spend the tax-cut money.³ This increase in aggregate demand would help offset other factors, such as a fall in investment in information-technology equipment, that is contributing to the current economic slowdown.

According to this view, the government could use tax policy to stabilize real GDP in the face of other shocks to the economy. However, such a policy would face severe problems, including lags in both the implementation and effects of tax changes, and uncertainty about both the state of the economy (e.g. is a recession on the horizon or merely a slowdown?) and the effects of policy changes (e.g. will families spend or save the money from tax cuts?). Even if the government could overcome these problems, a policy intended to raise *consumer* spending does not prevent the fall in *investment* that reduced aggregate demand in the first place. Even if the policy were to stabilize real GDP, it would not stabilize its composition. In any case, stabilization of GDP is at best a minor objective for tax policy, which should focus on promoting an efficient allocation of resources subject to the constraints of funding government programs.

Note that any short-run benefits of a tax cut, stemming from an induced increase in aggregate demand, would be *reduced* by a policy that *links* tax cuts to the size of the government surplus or a reduction in government debt. Policies that allow tax cuts only if the surplus (or debt reduction) exceeds some critical value are *backwards* from the standpoint of standard macroeconomic stabilization theory: they allow tax cuts only if the economy is already strong (and tax revenue high) – when economic stimulus is not necessary – and prevent tax cuts when the economy is weak and a stimulus to aggregate demand may help. Therefore, to the extent that a tax cut has short-run benefits in fighting the slowdown, those cuts should *not* be linked to the level of tax revenue or reductions in government debt.

Two main arguments have been advanced in the public debate against a tax cut. One argument asserts that a tax cut will provide little help in fighting the economic slowdown because people will *save* rather than spend most of the money from a tax cut. Consequently, the benefits of a tax cut are unlikely to exceed its "costs."

² I believe it should also cut taxes to help tame the growth of government, and to allow families to keep more of *their own* money.

³ While this is a standard macroeconomic argument, there are good reasons to be skeptical of it. The argument ignores, of course, the fact that the money that *could* be used to reduce taxes could *otherwise* be used to pay down debt, which transfers that money to the government's creditors, and that *they* can spend that money. Standard Keynesian macroeconomics relies on a subtle difference between the two cases: tax cuts raise aggregate demand by more than paying down the debt because interest rates respond differently to the two policies.

In the rhetoric of public debate, tax cuts have *costs* because the government loses revenue. Even the Bush administration speaks of the “cost” of tax cuts. However, this represents a one-sided and inappropriate focus on the *government’s* budget and the *government’s* debt. The public debate has virtually ignored the effects of taxes on *family* budgets and the potential of tax cuts to help pay *family* debts. Tax cuts have a cost only to the government; they have *benefits* for taxpayers. A cut in marginal tax rates *benefits* the economy as a whole by reducing distortions, leading to a more efficient allocation of resources, a likely increase in the level of GDP, and in long-run economic growth. The true *cost* of a tax cut consists of the other policy changes required for intertemporal budget balance: an offsetting increase in future tax revenue or a reduction in the discounted present value of government spending. Any discussion of the costs and benefits of a tax cut cannot escape addressing those issues.

Even the impact of tax cuts on the government’s budget is overstated in most of the debate, which ignores the likely behavioral responses to lower marginal tax rates, implicitly assuming *no* responses of labor supply, savings, investment, and production, and no benefits from more efficient allocation of resources. However, the likely behavioral responses will reduce the government’s revenue losses (below what standard calculations predict) and raise family revenue gains *above* what standard calculations predict. Studies of the effects of the Kennedy tax cuts in the 1960s and of the Reagan tax cuts in the 1980s indicate that tax cuts raise aggregate supply as well as aggregate demand, raising long-run real GDP. The resulting increase in the tax base raised government tax revenue to offset partly the effects of lower tax *rates*.

This does not imply that cutting tax rates will raise government tax revenue (though evidence suggests that past cuts in certain taxes have indeed increased revenue from those taxes). However, the important point is *not* that a tax cut will raise GDP enough that total tax payments will rise. They won’t. The important point is that a tax cut *will* increase GDP. And families can take the benefits of that increase either in the form of private consumption, or private savings, or to fund whatever government programs they collectively choose.

4. Tax Policy for *Long-Run* Benefits

A second argument against tax cuts asserts that the government should attempt to raise national savings, investment, and long-run economic growth, and that the best way to achieve this goal is to reduce the government’s debt rather than cut taxes. Tax cuts, they argue, might raise private saving (to the extent that people save money from a tax cut), but could nevertheless reduce overall national saving.

Most economists agree that a reduction in the government debt would increase overall national savings and investment. However, reductions in marginal tax rates have other, related, benefits that debt reduction does not (or postpones). Lower tax rates affect incentives and increase economic efficiency. Moreover, the public debate ignores the set of fundamental tax reforms that the government could, and should, undertake to improve distortions that currently reduce national savings and investment. Tax reforms that would enhance economic efficiency and raise national saving, investment, and long-run economic growth include:

- reducing taxes on saving and shifting the tax base from income to consumption spending;
- reducing taxes on income from investments, including interest income and capital gains;
- eliminating the corporate income tax.

These fundamental tax reforms would likely have a vastly greater effect on national savings and long-run growth than even a complete elimination of the government’s debt. Consider, for example, the great fiscal experiment that the United States has experienced over the past two decades. Over that time, large government budget deficits have changed to government budget

surpluses. While standard Keynesian macroeconomic models predict that this change reduces aggregate demand, leading to economic slowdown, the U.S. economy continued its rapid expansion (except for the 1990-91 recession). The experiment of replacing deficits with surpluses appears to have had virtually *no* effect on aggregate demand. Moreover, the reduction in the (privately-held) government debt as a share of GDP from almost 50% in 1993 to less than 35% in FY 2000 did *not* raise either private saving or overall national saving. Instead, private savings (as measured by GDP accounts) *fell* rapidly from almost 9% of GDP in 1992 to *negative* numbers recently.⁴ *National* savings remained virtually unchanged. This experience should temper our confidence in assertions that further reductions in the government's debt would raise national savings and investment, thereby contributing to long-run economic growth.

The public debate obscures other key issues by framing the policy choice as "tax cuts versus debt reduction." First, political realities suggest that the real policy choice is *not* between tax cuts and debt reduction. It is between tax cuts and some *combination* of debt reduction and increases in government spending. Even if overall national savings were to respond more strongly to a dollar of debt reduction than to a dollar in tax relief, the increased government spending that is almost certain to accompany debt reduction reduces after-tax real family income and is likely to reduce national savings. For this reason, tax cuts are likely to raise national savings by *more* than a combination of debt reduction and increased government spending. Tax cuts also have the benefit of providing a (partial) constraint that helps limit *future* increases in government spending, helping to maintain higher national saving in the future.

Second, policymakers are not limited to a choice between tax cuts and debt reduction: they can *also* choose between government spending and debt reduction. The fact that many opponents of tax cuts have not proposed cuts in government spending to reduce the government debt naturally raises suspicions about whether their position reflects great concern about the level of that debt, or a belief that the government should use the higher level of revenue to increase its spending.

Finally, a tax cut does not imply abandonment of debt-reduction as a long-run policy. Debt reduction can continue slowly over time (until the aging of the baby-boom reverses it). Most long-run projections indicate that the aging and retirement of the baby-boom generation will lead to an increase in federal spending in the second quarter of the 21st century, requiring either higher tax rates, increased government debt, or spending reductions at that time. The baby-boom problems for government spending include not only social security, spending for which is projected to rise from about 4% of GDP today to about 6% in 2040, but also Medicaid and Medicare, for which the government projects even greater spending increases. Consequently, the CBO projects that privately-held federal debt will begin rising starting in around 2020 or 2030, reaching 50% of GDP (the same as the 1990 level) by around 2030 to 2060.

The problems that our economy will face due to the aging of the baby-boom generation should not obscure that issue. The best way to prepare for that future is to follow policies that maximize economic efficiency and enhance growth. By raising the rate of economic growth, cuts in marginal tax rates today can help provide greater resources for the middle of the century.

It is instructive to look behind the veil of finance to the real-resource issues that the economy will face in the coming decades. When the year 2030 arrives, the key Social-Security-Medicare-Medicaid problem will reduce to the *division* of the economy's *available resources* between the aging baby-boomers and the younger members of society. Political forces will strongly affect the outcome of that division. The most important effect that *current* policies can have on the economic situation in 2030, and the well-being of all generations alive at that point, operates through economic growth. The higher the rate of economic growth over the next several decades, the more resources available to divide in 2030, and the less severe the "problem."

⁴ While that statistic excludes savings in the form of capital gains on assets, recent capital losses on stocks have not led to increases in conventionally-measured private savings, either.

Perhaps you are not convinced. Then you can fix *your* share the problem on your own: Anyone who remains concerned about future taxes or social security payments can *fix the problem for himself* by saving more today. Any family can, *in essence*, pay off *its* share of the government debt by saving money and treating itself as the government's agent (in managing its investment). Any family can do this, without using the political system to force that solution on other families.⁵

5. Conclusions

The case for a tax cut does *not* rest on any short-run benefits of fighting an economic slowdown. Nor does it depend on whether families save or spend the money from a tax cut. Instead, it rests on long-run considerations. Reductions in marginal tax rates, along with more fundamental tax reforms to reduce penalties on savings and investment, would improve resource allocation, enhance economic efficiency, raise real GDP, and enhance economic growth.

The Bush administration's proposed tax cut is too small and does not sufficiently reduce taxes on savings and investment income. A strong case can be made for tax cuts that are large enough to bring the ratio of federal tax payments to GDP back to its recent level of about 18%. That requires an immediate tax cut of more than \$200 billion per year (2% of GDP), and that number will grow each year as GDP rises. A tax cut of that magnitude would roughly *undo* the income-tax increase of the last nine years that raised income-tax payments from 8% to 10% of GDP.

The government should continue to seek a slow reduction in the ratio of the government debt to GDP. More rapid economic growth will make that task easier. It should also seek ways to reduce government spending to provide additional revenues for debt reduction without foregoing the benefits of reduced marginal tax rates.

Finally, the government should vigorously pursue fundamental changes in the tax system. It should completely overhaul the system seeking both vast simplification and elimination of the large distortions that currently reduce saving, investment, and long-run economic growth. The likely economic consequences of the aging baby-boom generation underscore the importance of pursuing these fundamental reforms in conjunction with reductions in marginal tax rates.

⁵ Of course, some people are concerned not for themselves but for others: the Rodriguez family will face higher future taxes and lower social-security payments in the future, but, some people believe, the family is too shortsighted and is failing to save enough money today. Tax cuts create the danger that each family can make its *own* decisions, rather than the "best" decisions.