The Real Reason We Need a Tax Cut

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Some of the arguments advanced to justify President George W. Bush's proposed $1.6 trillion tax cut are weak. But I do believe there is an excellent case for large cuts as long as big surpluses appear likely during the next decade.

During the latter stages of Bush's campaign, he and other Republicans claimed that tax cuts would combat the current economic downturn and help prevent a serious recession from developing. However, it is unlikely that reduced taxes would have much effect on the slowdown even if they were adopted soon and made retroactive to the beginning of the year. Most households would not raise their spending by much simply because a tax cut has been substituted for a paring down of the federal debt, the option favored by former Vice-President Al Gore and many Democrats. Economists usually argue that reducing debt mainly involves substituting future tax reductions for present ones. It doesn't change consumer behavior much.

More important to the long-run growth of the economy is the proposed cut of all marginal income tax rates, including lowering the top rate from 39% to 33%. The President also wants to abolish the estate tax. This tax will probably remain, albeit with a widened exemption from about $700,000 to the $4 million-$5 million range. I believe both of these tax reductions would stimulate investment and entrepreneurial activities. However, studies by many economists of investment responses to changes in personal income tax rates reach conflicting conclusions about their importance.

GRABBY INTEREST GROUPS. But even if the most negative of these findings were correct, the case for a large tax cut is still strong. I have argued in previous columns in this magazine and elsewhere that the most important effect of a tax reduction is to curtail government spending, not to stimulate private spending. In his address to the House of Representatives, President Bush did claim that tax cuts help to keep a lid on government spending by reducing the fiscal surplus.

In this view, the government is similar to spending-addicted individuals who tend to squander whatever resources they can lay their hands on. Hundreds of powerful political interest groups clamor for greater subsidies and other government help. The subsidies benefit these groups but reduce efficiency and harm the country as a whole. Apparently, the most effective way to restrain these pressures is to reduce the revenue that legislators and government officials have to spend.

What happened to federal government spending during the 1990s supports this analysis. Federal spending was held down during the early years of this decade by the agreement between President Bill Clinton and Congress that the then-large fiscal deficit had to be reduced. But both branches of the government agreed to loosen the spigot after the booming economy greatly expanded tax revenues. Subsequent government spending then

grew rapidly: The average rate of increase in discretionary spending during the past three years exceeded 5%, and it grew by more than 8% during the past year.

The addiction to spending whatever revenue is available is bipartisan and almost as strong among Republicans as among Democrats. Indeed, on many programs, the Republican-dominated Congress voted to increase spending well beyond the already generous amounts requested by President Clinton. Congressional Republicans and Democrats differ largely on how to increase spending rather than on whether or not to spend more. Republicans favor much greater spending on the military, and President Bush has also proposed sizable increases in spending on Social Security, Medicare, and education, along with ``only'' a 4% overall increase in other discretionary programs.

OIL EXPERIMENT. Like federal spending, outlays by state and local governments also expanded rapidly during the past few years as their tax revenues boomed. Changes in the world price of oil provide a clear-cut ``experiment'' that tests the effects of government revenue on spending in other countries. When prices are high, oil-producing nations have tended to spend about two-thirds of their increase in oil revenue on weapons, schooling, infrastructure, and higher personal wealth of those in power. Only the remaining one-third goes to tax cuts, reduced government debt, and the accumulation of government assets.

If large tax cuts get enacted in order to restrain government spending when sizable fiscal surpluses are expected, then subsequent tax increases would be appropriate if these surpluses failed to materialize. Since forecasting tax revenue is a highly imperfect art, the durability of tax cuts might be tied to what happens to actual surpluses during the next 5 to 10 years.

The government's Leviathan appetite for spending has to be controlled. One of the best weapons presently available is to take away the temptation to spend more by using large tax cuts to reduce revenue and budget surpluses.