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Tax-Cuts Won't Hurt the Surplus

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Today the Office of Management and Budget releases its mid-session review of the budget. If recent history is any guide, the event will trigger a media buzz. Though the federal government will take in \$158 billion more in revenue than it spends in fiscal year 2001, the focus will still be on one misplaced question: What happened to the rest of the surplus?

The short answer is: very little. Remarkably, the U.S. has chosen to maintain a substantial unified surplus at a time of slowing economic growth. In its April budget, the administration expected a surplus of \$281 billion, a figure that has diminished as a consequence of the past year of growth slowdown. The economic outlook suggests that the slowdown will slowly reverse course, gaining momentum in the latter half of this year and returning the U.S. to its growth potential in 2002. This forecast incorporates a substantial fiscal stimulus from the president's tax cut, which is likely to raise the annual rate of gross domestic product growth by as much as a percentage point during the second half of 2001.

Viewed narrowly, the tax cut "hurts" the surplus. More broadly, its fiscal stimulus will spur aggregate demand as the effects of substantial monetary easing take hold. We are likely to hear calls to reverse course, perhaps in the name of preserving the Medicare "surplus." Putting aside the fact that Medicare draws on general revenues -- and not the reverse -- a tax increase in the name of the Hospital Insurance Trust Fund surplus would amount to nearly a complete fiscal turnabout, substituting for a \$38 billion tax cut stimulus a \$32 billion tax hike. It is the wrong medicine at the wrong time, and reveals a misunderstanding of the ultimate role of surpluses in the economy.

To understand this, consider four economic lessons:

First, budget surpluses are the product of a strong underlying private economy -- not the other way around. The Clinton administration claimed surpluses caused economic growth, a suggestion that is the budget equivalent of new math.

Under the circumstances, however, it was easy to believe the new math. Between fiscal year 1998 and fiscal year 2000, the Congressional Budget Office recorded unified surpluses totaling \$430 billion. Even better, each year the surplus beat expectations -- over this period, the "surprise surplus" added up to \$152 billion. At the same time, real economic growth improved, with an average annual GDP growth rate of 4.6%, accompanied by a falling unemployment rate and low inflation.

But correlation and causation are not the same thing. In the short term, budget surpluses will vary with cyclical movements in the economy. Over the longer term, cyclical considerations fade and the resources in the economy, and thus the budget, are dependent upon productivity growth. In other words, the "standard of living" for the government comes from the same pool as the standard of living for the private economy.

 [Harvard University](#) economics professor Martin Feldstein used Congressional Budget Office data to conduct a postmortem of the Clinton administration's economic policies. He found that over 75% of the rise in the revenues was a result of the strong economy. The tax increases, such as those in 1993, contributed only one-quarter of the surprising growth in revenues. In sum, the logic that links tax increases to larger budget surpluses, and then larger surpluses to improved economic growth, is by no means clear.

Second, our ultimate ability to meet Social Security obligations will rest with the size of the U.S. economy. In its present form, Social Security has no prefunded resource to meet benefits promised to future generations. Current Social Security surpluses are not being used to acquire real assets, which would then be redeemed to finance future benefits. While the Social Security Trust Fund is accumulating special Treasury bonds, redeeming those bonds to pay for the retirement of Baby Boomers will require additional taxes or spending cuts. What is relevant for Social Security is that the economy provide sufficient resources to finance benefits when they must be paid.

In the end, the U.S. will rely on the private economy as the continued engine of growth. In the past, a strong private sector that produced surpluses also provided low unemployment, rapid gains in productivity, and an explosion of new technologies and products. Viewed from this perspective, the recently enacted tax cut fits naturally into a growth-oriented agenda. Lower taxes reduce fiscal drag on the economy in the short term. Lower marginal tax rates provide longer-term incentives for work, savings, risk-taking and innovation. In this way, the current fiscal policy helps to provide for the future of Social Security.

Third, the convention of keeping Social Security "off budget" is intended to control spending. The president has made clear his intention to maintain the Social Security surplus for Social Security. In the past, Social Security surpluses have provided a tempting source for new spending initiatives. Lowering taxes demands fiscal discipline; it limits government's claim on the resourcefulness of the private economy.

Indeed, a body of economic research shows that lower government spending is associated with higher economic growth. In an empirical study of investment and growth in industrial economies, Alberto Alesina of Harvard, Roberto Perotti of Columbia, and Silvia Ardagna and Fabio Schiantarelli of Boston College conclude that higher government spending depresses business investment, thereby reducing the economy's growth opportunities.

Fourth, fiscal discipline is better achieved through spending restraint than tax increases. From an economic growth perspective, recent research concludes that lower tax burdens are associated with stronger economic growth. For example, economists Eric Engen of the Federal Reserve and Jonathan Skinner of Dartmouth find that a permanent, across-the-board reduction by five percentage points in marginal tax rates would raise the economy's growth rate for a long period of time by about 0.3 percentage points. This is no small change: Raising the growth rate of GDP from 3.1% per year to 3.4% would raise GDP by 6% after 20 years -- the equivalent of roughly \$600 billion today.

To summarize, the present budget situation is more a success and an opportunity than a problem. It is a success because the fiscal health of the government over the next 10 years remains strong even in the presence of the current growth slowdown, and because the well-timed tax cut will provide an important lift to the economy. It is an opportunity because the tax cut -- sound economic policy in its own right -- has focused greater priority on controlling entitlements and other government spending. To frame the budget as a Medicare or Social Security "problem" is mistaken, and to pursue ill-advised tax hikes in the name of fixing it is even worse.

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