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USE BUDGET SURPLUSES FOR TAX REFORM

Although the Clinton Administration projects enormous federal budget surpluses—$4.5 *trillion* over the next 15 years—it opposes using even one cent of that for a net tax cut. Instead, the Administration's budget plan calls for using some of the projected surpluses to expand the size of government, while reserving the majority for debt repayment. Its proposed budget actually seeks, according to the Administration's numbers, $78 billion of tax *increases* and $26 billion of user fee *increases* (higher taxes by another name, essentially) over the next five years. The Administration would also provide $33 billion of targeted tax cuts, mostly for politically favored groups and causes.

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This tax-and-spend budget strategy would squander the surpluses. What should be done is to use the funds to begin repairing some of the worst failings of the current tax system. The tax system is virulently biased against saving and investment. One source of the bias is a basic defect in the income tax: it taxes earnings used for consumption once but earnings that are saved twice. The tax system then aggravates the basic anti-saving distortion by piling additional layers of tax (for instance, the corporate income tax and the estate and gift tax) on saving and investment and their returns. The differentially heavy taxation of saving and investment naturally discourages those activities. Because saving and investment largely determine the quality and quantity of the capital stock and because the capital stock powerfully influences people's ability to produce goods and services, the sorry result of the tax biases is a smaller, less productive economy.

The tax system also penalizes working and earning taxable income because of its high and graduated marginal rate structure. Again, the result is a smaller, weaker economy.

An additional problem with the tax system is its complexity. According to some estimates, tax paperwork takes away from productive activities the equivalent of several million full-time workers, at an economic cost of hundreds of billions of dollars.

The key to easing tax biases is to lower tax rates at the margin on the activities being overtaxed. Tax rates at the margin are what matter because they determine how strongly taxes push people to alter their behavior. People may choose to work a few more hours a week or weeks a year, or to retire sooner or later. They may choose to save and invest a bit more or a bit less. It is the tax on the incremental, "marginal" income that affects their decisions.

Taxes at the margin can be brought down by lowering marginal tax rate schedules. They can also be reduced by correcting flaws in the tax code that raise effective marginal tax rates because they overstate income (by either undercounting legitimate expenses or overcounting revenues). A tax base that measured income correctly would also result in a much simpler tax code with far lower paperwork costs.

There are many ways to improve the tax system. Consider three current proposals. One plan being discussed on Capital Hill is to enact a 10% across-the-board cut in marginal income tax rates. This would not simplify the tax system or eliminate the structural biases, but it would ease the damage, and raise after-tax rewards, which would encourage people to supply additional work, saving, and investment. Another idea put forward by several members of Congress is to abolish the estate tax. This would have the twin virtues of reducing marginal tax rates on saving and investment while simplifying the tax code. The very complicated estate tax has marginal rates as high as 55% and that comes on top of all other taxes previously collected on saving and investment. Another worthwhile reform would be to shorten depreciation periods. Present-law depreciation schedules often make businesses delay writing off investment costs until years after they have made the expenditures. Those delays depress the discounted values of the write-offs to below actual investment costs, cause net income to be overstated, raise effective marginal tax rates, and thereby block many valuable investment projects.

The most dramatic change would be to scrap the individual and corporate income taxes and replace them with a consumption-based income tax that is not biased against saving and investment. One of the concerns with fundamental tax reform is that, if it had to be revenue neutral, there would be winners and losers. If the budget surpluses were used to provide a net tax cut at the same time that the tax code were restructured, however, the tax load on almost everyone could be reduced.

Regrettably, the tax increases recommended in the Administration's budget would generally raise marginal tax rates and heighten tax complexity. Many would apply to business income, increasing existing biases against saving and investing. As for the highly publicized but comparatively smaller tax cuts in the Administration's package, they would generally not lower tax rates at the margin. Also, because of their targeted eligibility rules, they would add new complexities to the tax code.

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The main objection to tax relief is the view espoused by the Clinton Administration and others that higher taxes supposedly increase national saving while lower taxes supposedly decrease national saving. The kernel of truth in this proposition is that higher taxes will add to government saving if they are not spent on higher government outlays. But higher taxes and government saving add to total national saving only insofar as they do not diminish private saving, which requires the public to pay for the higher taxes by cutting consumption. If, instead, the government boosts taxes by $1, government spending rises by $0.50, and private saving falls by $1, then national saving will fall by $0.50.

Bringing these hidden assumptions into the open immediately reveals the shakiness of the taxes-lift-saving argument. Taxes that fall primarily on saving and investment and the returns to those activities are likely to cut saving dollar for dollar, if not more. The tax increases enacted in recent years and the proposals the Administration has submitted this year are disproportionately of the anti-saving type.

Nor is it plausible that the government can be trusted to run budget surpluses year after year without quickly diverting the funds into larger government. When budget surpluses began last year, for instance, the Administration publicly insisted that all of the surpluses should go into debt repayment, with none used to cut taxes or hike government spending. Within a few months, however, the Administration and the Congress had pushed through an "emergency" spending package that the Congressional Budget Office estimates will cost $51 billion during the period 1999-2009. And in its budget requests this year the Administration has dropped any pretense that spending increases should be resisted. For example, its discretionary spending request would break previously agreed to budget caps by $212 billion over five years.

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Even deficit hawks need not be alarmed by tax relief. When beginning with huge projected surpluses, tax relief is fully compatible with balanced budgets. Balanced budgets are sufficient to stabilize the dollar amount of the national debt. Consequently, tax relief is consistent with a national debt that is rapidly shrinking as a percent of the growing economy. In 1997, the publicly held national debt was close to half the size of gross domestic product (GDP). Using the CBO's budget projections with the modification that the surpluses are converted into tax cuts, the debt would fall to about one quarter of GDP by 2009. And if the tax cuts spur economic growth beyond what the CBO is projecting, the relative size of the national debt would fall still faster.

The Administration's talk of using most of the federal budget surpluses for government debt repayment may be an effort to avoid cutting taxes so a high revenue stream will remain available for the government to spend in later years. Its proposed tax increases would give it even more dollars to spend. A superior budget strategy would be providing tax relief to combat tax biases and complexities. That would prolong the economic expansion and enhance long-term economic opportunities for everyone.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.