CENTER ON BUDGET AND POLICY PRIORITIES

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Tax Cuts Vs. Spending Increases: Is There a Basis for Chairman Greenspan's Preference for Tax Cuts?

On March 26, the Center on Budget and Policy Priorities issued *Tax Cuts Vs. Spending Increases: Is There a Basis for Chairman Greenspan's Preference for Tax Cuts?* The analysis, prepared for the Center by economists Jason Furman and Peter Orszag, examines Federal Reserve Board Chairman Alan Greenspan's statement to the Senate Budget Committee on January 25 that tax cuts are preferable to spending increases as a means of avoiding "excessive" surpluses. Other Center reports have examined Chairman Greenspan's premise that projected surpluses are excessive and need to be reduced. This new analysis evaluates Mr. Greenspan's seemingly automatic preference for tax cuts over spending increases as a means of disposing of surpluses. The report analyzes the costs and benefits of tax cuts and program expansions using three criteria: short-run impacts on the economy, long-run economic and social benefits, and the political viability of scaling back tax cuts or program increases in the future if this should become necessary. The analysis finds little evidence to justify an automatic preference for tax cuts on other than ideological grounds.

Short-Term Impacts on the Economy

Tax cuts and spending increases have similar short-run impacts on inflation, unemployment, and growth, as well as on national savings and government debt. On the basis of macroeconomic criteria, there is little reason to prefer tax cuts to increases in programs.

In addition, neither tax cuts nor spending increases are significantly more effective than the other in stimulating the economy. On the one hand, tax cuts may, if anything, have a smaller impact on the economy in the short run than spending increases because a modest portion of a tax cut would be saved rather than spent (and hence would not be injected into the economy quickly). On the other hand, tax cuts can be implemented relatively quickly after being enacted; for some types of program increases, it may take more time for money to flow into the economy.

Chairman Greenspan has said his preference for tax cuts is *not* related to their short-run impact on the economy.

Long-Run Economic and Social Benefits

Advocates of lower marginal tax rates often state that lower rates increase work incentives, encourage more saving, and reward entrepreneurship. The evidence for each of these effects, however, is mixed. Overall, the evidence is not consistent with the belief that the level of taxes or government spending has a large effect on economic growth.

The strongest period of growth in U.S. history was the 1960s, when the top marginal rate was 70 percent or higher. More recently, economic growth was very strong in the 1990s. Yet there were increases in the top marginal tax rates in 1990 and 1993. Furthermore, the most rigorous and comprehensive recent study of the effects of marginal tax rate reductions on the economy finds that reductions in tax rates lead to only small increases in economic activity.

In addition, some possible uses of the surplus for program initiatives would have significant economic and social benefits. Increased government expenditures devoted to reducing class size, expanding Head Start and pre-school programs, and increasing research and development, for example, could lead to future increases in the productivity of the workforce and, in some cases, might reduce the need for costlier government spending later. In short, there is not a basis on economic grounds for automatically preferring tax cuts to program increases; the relative economic effects depend significantly on the *types* of tax cuts and program increases. In addition, as the *Washington Post* editorial page recently noted, decisions on how to use projected surpluses should not be based simply on economic criteria but also should reflect the nation's basic values and priorities.

Political Prospects for Scaling Back Initiatives if Fiscal Conditions Deteriorate

Chairman Greenspan's main arguments for preferring tax cuts are based less on economic grounds than on his political judgments. He has said government programs tend to grow while tax cuts are limited, and that if fiscal conditions worsen, it is easier to reverse a tax cut than a program increase. Neither of these propositions is supported by empirical evidence, however, and they are of dubious validity. In particular, these propositions ignore important distinctions among various types of programs, such as the difference between discretionary programs — for which funding levels are set a year at a time and a program's expenditures may not exceed its annual appropriation — and mandatory (or entitlement) programs, where changes in law are generally permanent.

- Some mandatory programs have proven significantly more costly than initially envisioned. But others have cost less than expected; the Children's Health Insurance Program is one recent example. Furthermore, a number of entitlement programs can — and have — been pared back at various times. Medicare reductions were enacted in 1990, 1993, and 1997; reductions in food stamps, the Supplemental Security Income program, and child nutrition programs were enacted in 1981 and 1996. The unemployment insurance program and even the school lunch program were reduced substantially in 1981. Legislation enacted in 1983 is now gradually raising the age that must be attained before an individual can receive full Social Security benefits. Discretionary spending is still more flexible; there have been numerous cases in which discretionary programs have been frozen or reduced. Spending programs do not necessarily explode.

- Indeed, federal spending has *fallen* — not increased — in recent years when measured as a share of the economy. The Congressional Budget Office estimates that in fiscal year 2001, federal spending will equal 18 percent of the economy (i.e., of the Gross Domestic Product), the lowest level since 1966. Under

President Bush's budget, federal spending would decline by 2011 to 15.9 percent of GDP, which would be the lowest level since 1951. (Despite some spending increases included last fall in the appropriations bills for fiscal year 2001, total federal spending declined slightly as a share of the economy again this year.)

- Just as the cost of spending programs does not grow inexorably, the revenue loss from tax cuts does not always remain limited. New tax breaks may be used increasingly over time as more taxpayers learn about them, resulting in higher costs than initially estimated. Also, once some tax cuts — such as Roth IRAs — are enacted, they cannot be scaled back or eliminated if fiscal conditions worsen, because people have made lifetime financial decisions based on them.

- Most important, Chairman Greenspan's assumption that tax cuts are easier to reverse than spending increases is highly questionable. The first President Bush paid a substantial political price for the tax increases enacted in 1990, and many political observers believe the 1993 tax increases contributed to the Democratic loss of Congress in 1994. In the aftermath of these two events, enacting tax increases appears to have become much more difficult politically. Increases in various discretionary programs and a number of means-tested entitlement programs may well be easier to reverse now than broad-based tax cuts.

In short, there is no reason to believe tax cuts are automatically preferable to spending increases. Chairman Greenspan's principal arguments were not economic but rather were based on his own personal values and political prognostications. History provides little support for the hypothesis that program initiatives are inherently more difficult to reverse than tax reductions. If a substantial fraction of the surplus is committed this year, policymakers should debate the best ways to address the major challenges the nation faces, rather than being guided by an ideological preference for either tax cuts or program initiatives.