Greenspan and the Economists' Mantra on Tax Cuts

C. Eugene Steuerle

Document date: August 16, 1999
Released online: August 16, 1999

Should we have a tax cut or shouldn't we? In deciding that issue, it would be nice to turn to a sage and simply rely on his or her wisdom. One potential sage—certainly an economist in high standing given the length and breadth of the recent economic expansion—is Alan Greenspan, chair of the Federal Reserve System. Over the past few months, Dr. Greenspan has given advice from which both sides can take heart. In essence, he argues for maintaining a surplus, but that a tax cut is still superior to spending the surplus. One example was at a Senate Budget Committee meeting earlier this year, when the conversation went as follows:

> Sen. Bob Smith, R-N.H.: I have noticed...that Republicans and Democrats both love to spend money; we just do it in different ways. The Democrats generally like to spend it on government programs to help people. Republicans generally like to give it back to people so they can help themselves. That, I think, is a political reality, and it puts in jeopardy your objective of saving. And if, in fact, in the real world we're going to be spending a lot of money here, one way or the other, what's the best way to spend it?
>
> Greenspan: Well, as I've said many a time—and some of your colleagues have repeated my mantra—that is, *I would, one, prefer that we keep the surplus in place*. If that proves politically infeasible, *cutting taxes is far superior to spending*, as far as the long-term stability of the fiscal system and the economy is concerned. [Emphasis added.] (Transcript of Senate Budget Committee, January 28, 1999.)

With Solomonic wisdom, Dr. Greenspan tells us he would not like to cut up the surplus baby, but, hey, if we are going to cut it up, let's give most of it to the tax-cutting matrons who know better what to do with it. Although Dr. Greenspan indicates that some members of Congress have "repeated [his] mantra," it would be equally correct for him to state that he is reflecting the conventional wisdom among most economists. While this advice is generally sound, it must come with a warning: it really gives no clues as to how to govern in general. Government does not exist to run surpluses or to raise taxes so that it can then return them to the public.

When economists set up models examining the economy as a whole, they usually deal with "big" variables like the money supply, or total saving in the economy, or the tax rates that apply to additional work or saving. Most of these models accept the estimate of a very high marginal return to saving and investment. Accordingly, the more saving that takes place, the higher the growth rate over the long-run. When it comes to budget policy, saving and investment effects tend to dominate most models; hence they will typically imply that the best thing to do with the surplus is to save it.

But models are just that—models. They are grand simplifications with a number of glitches that are known to most model builders. First, many start out with an assumption that government-mandated saving—either through higher surpluses or mandated saving accounts in lieu of direct spending—are converted into net national saving of an equal amount. In fact, the empirical and theoretical literature tells a very mixed story. As only one piece of evidence, it is likely that the very recent decline in the personal saving rate to less than zero was related to the additional borrowing for consumption made possible by recent declines in federal deficits.

Even if net national saving does respond fairly positively to new saving by one sector in one type of account or trust fund, moreover, offsetting declines in other saving and increased borrowing for consumption are likely to occur over time as individuals adjust to this higher level of saving and the income it generates.

Of course, Dr. Greenspan never claimed that a larger surplus translated dollar for dollar into net national saving or investment. He merely indicated that saving would be a positive factor for the economy. Moreover, he is concerned as a matter of retirement policy about the lack of saving to meet government promises to the future elderly. In the pay-as-you-go social security and Medicare systems, we have built up ever-increasing obligations for the future without the saving to go along with them. Net government saving would be good for budgetary and social security policy even if additional net national saving were modest.

The nation, moreover, has a fairly high level of national debt relative to the size of the economy. Just a few years ago that debt was accumulating at an unsustainable rate. If periods of debt accumulation occur, then it is only reasonable to assert that there must be periods in which some of that debt is paid off. Technically, one could still run modest deficits and have declines in debt relative to gross domestic product (GDP). The main requirement is that debt grow more slowly than GDP, but for our purposes here that is a technicality. A debt cycle needs to have a down, as well as an up, side.

Common sense also tells us that we might have to borrow when times are bad. When times are good, therefore, money should be set aside. Even if the net impact over time does not increase saving one iota, there are gains from this type of cyclical spending: it orients government spending toward citizens when they need it the most. While many economists give these budgetary considerations short shrift—they would emphasize mainly the impact on saving as it flows through their explicit or implicit models—I would hazard that Dr. Greenspan also had such longer-term budget cycles in the back of his mind.

What then leads to his next conclusion—that tax cuts are better than government spending? Here, once again, one needs to be aware of the models run by economists and what they do and do not tell us. Many of the models—and they are of many types, both theoretical and empirical—count the value of a dollar of spending as less than a dollar. That is, for the most part they do not distinguish between necessary educational or defense spending and wasteful pork-barrel spending.

When a dollar is taken from one person and given to another, either in the form of a transfer or some more general public benefit, the initial effect on their combined incomes is equal to zero (plus one for the transferee, minus one for the transferor). But then some models also note that the recipient of the benefit often has his or her behavior distorted—as when a transfer system discourages work for the transferee. Meanwhile, a larger tax system distorts the saving and investment behavior of the transferor as well. These distortions then add a negative value to what was already valued at most as zero. Guess what? The models then predict that smaller government is better than bigger government.

Dr. Greenspan is doing nothing more than taking this conventional wisdom and applying it to the question of what to do with the surplus. If one spends more, then taxes have to be higher to maintain the same level of debt. Or, what is the same thing, if one taxes less, then to maintain the same level of debt spending will necessarily be less. Therefore, reducing taxes is more likely than increasing spending to reduce economic distortions and help the economy in the long-term.

That government spending and taxing distort behavior and add additional costs to the economy cannot be denied—although there is considerable dispute over the size of the costs. What is left out at this point is whether or not the spending itself accomplishes some extra good—for example, that additional investment in education has an even better effect on the economy than additional saving, or that maintaining minimum consumption standards improves well-being by more than the costs imposed through the extra distortions.

If pushed, Dr. Greenspan would not deny these addendums, but he could also claim that given the size of government at all levels, the probability of additional social gains is lessened and the distortionary cost of additional taxes and spending is much more likely to be higher today than when government was smaller. He would also recognize that some of the tax cuts proposed are nothing more than spending hidden in the tax code, and these would not qualify for his designation as "tax cuts," at least in any way that would be supported by the economic models.

In sum, saving the surplus is good, but it is not always better than tax cuts. And while smaller government avoids some of the distortions associated with larger government, it is not always superior to a government that better meets important societal needs.

What really gives the Greenspan argument its force is that the choices today are being made following a period of high debt accumulation, preceding a period for which much has been promised to baby boomers and their children on retirement, and during a period when federal, state, and local governments together have already moved toward historically high levels of domestic spending and taxation as a proportion of the economy.

Other Publications by the Authors

- C. Eugene Steuerle