

## When is a Tax Cut Justified?

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Over the past few months, the Clinton administration has proposed that about 60 percent of the projected federal budget surplus be saved for Social Security. Many Congressional Republicans responded by proposing to accept that requirement (although in a different fashion) and then enact a tax cut with a portion of the remainder. Although the administration has proposed some targeted tax cuts of its own—in particular to promote private saving—it has opposed an across-the-board tax cut in favor of using larger percentages of the remaining surplus for objectives more closely associated with retirement policy. Arguing for more than the administration's tax cuts, Republicans responded that the public paid the price for bringing the budget back into balance, and in no small part through tax increases. Therefore, taxpayers deserved to get back some of their money. Back and forth the debate has proceeded, with tax cutting at the heart of the differences between the two parties.

This column is not intended to take sides in that debate but to try to make it a bit more rational and sensible. The heart of the issue is: "When is a tax cut warranted?"

It is as foolish to argue that a tax cut is never warranted as it is to argue that a tax cut is always justified—which sometimes seems to be the simplistic stances of the two political parties. The answer to the broad question is more complicated: A tax cut (or increase) is justified when the marginal dollars raised are of more (less) worth to society when held in private hands than when flowing through the government.

Admittedly, this is a general answer, and doesn't supply enough information for a specific answer at a point in time. But it does allow one to start from a social or economic perspective rather than jump immediately into the politics of the matter. Not that politics doesn't have its own important role; it's just that in the search for political victory, obfuscation is often considered as justified a means toward the end as is clarification.

Politicians, after all, want to be known as creating winners. Winners are those who get an additional expenditure or reduction in tax. The politician wants to be able to claim, "Look at what I gave you." The "I" in the claim, of course, requires a bit of hubris since every dollar flowing through to one individual or business almost inevitably comes from another. Any expenditure is financed out of someone's taxes. Any tax cut means that there must be a lower level of expenditures somewhere or, for the same level of revenues, that another's taxes are raised. Sometimes the persons who are forced to bear the increased burdens are members of future generations who do not yet vote.

A perfect equation of winnings and losings is required if a balance sheet is to be accurate, but it is possible that a tax or expenditure change is of such value to society that it produces additional gains in the form of growth. In that case, winnings can possibly exceed losings. Those who like educational spending usually like to claim such gains; so, in a different fashion, do Keynesians and supply-siders for their tax cuts. Often such claims are exaggerated, which makes them harder to evaluate. We should hope, nonetheless, that all legislators only vote for legislation they believe is for the net good of the nation.

By the same token, losings can exceed winnings when we stretch beyond the initial counting of who pays and who receives. For instance, economists generally argue that taxes cause distortions that rise exponentially as the rate gets higher. Therefore, the cost to the economy of most taxes is greater than the direct cost to the taxpayers. One can also conclude that costs of taxation are in excess of 100 percent simply by adding in the additional compliance and enforcement costs to society. Like it or not, taxes distort.

Returning to our general rule, however, the issue is not whether any particular tax dollar costs society more than a dollar. It does, and those marginal costs must be honestly recognized. But those costs must be arrayed against the benefits of the expenditure that is financed. Perhaps the taxes cover the cost of educating youth or removing conditions of poverty in ways that simply could not be achieved if individuals acted alone

or through non-governmental groups. Ideally there should be extra benefits flowing through the government to match or more than match the additional costs of collection and taxation. If there are, then the marginal taxes are effectively justified by the marginal expenditures they make possible. If the opposite is true—costs at the margin are in excess of benefits—then a tax cut may be justified.

The timing of taxes and expenditures adds yet further confusion to this calculus. When taxes are in excess of expenditures in any particular year, the government claims a "surplus" in its unified budget. This surplus is more a measure of cash flow than of changes in net worth. After taking into account interest receipts and payments, expenditures and taxes must match up in the long-run. Therefore, whether or not a surplus (or deficit) justifies a tax cut (or increase) requires a longer-term perspective. If expenditures are needed tomorrow, then we must also decide whether current or future taxpayers should pay for them.

A current surplus may not mean a lot if future expenditures are expected to be well in excess of expected taxes. Nor may a current deficit be much of a problem if future tax increases or spending reductions are going to be taking place. The former situation is the one we are in today, as future expenditures grow both with the aging of the population and with the growth built into many expenditure programs. The latter situation was the one we were in during the first part of the postwar era—when entitlement spending was less automatic in its growth, while inflation was constantly increasing average tax rates and future tax revenues.

Let's bring the discussion back to today's debate. A tax cut may be justified if one believes that promises of future expenditures are too high. The cut is a lot harder to justify if it merely means tax decreases for today's taxpayers and increases for future taxpayers, who already are expected to bear increasing burdens due to the aging of the population. By the same token, fighting against a tax cut cannot simply be justified by pointing to future deficits under current law; it also requires a clear assessment that the higher level of government expenditures made possible by those taxes—despite their additional distortionary costs—are in the best interests of the nation.

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