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# What to do with Budget Surpluses? Here's a Clue

*Taxes as a Share of GDP are at Highest Level Since World War II*

The latest economic news coming out of Washington tells us that what was once thought impossible may soon become a reality: Not only may the federal budget balance as soon as next year, but the federal government may soon be running budget *surpluses.*

Specifically, there was an unexpected increase in tax receipts of $75.2 billion (5%) over forecast. This added revenue, combined with $30.5 billion (1.9%) in lower-than- expected government spending, resulted in a forecast fiscal year 1997 federal budget deficit of just $22.6 billion.

Politicians of all stripes in Washington are congratulating themselves, and are giddy with the anticipation of new sources of money and with visions of administering these new found surpluses.

There are three ways to use these potential surplus revenues: Tax cuts, added spending, or debt reduction. But before deciding how to use these potential surpluses, policy makers should remember a few things.

## Federal Taxes are at a Post-WWII High

A large increase in federal revenue sounds like a good thing, at least to government-types. But remember that taxes are not just *received* by government—they are *paid* by taxpayers, and are extracted from the private economy.

In fiscal year 1997, this increase in federal revenue means that ***federal taxes bite captured 20% of GDP—the highest level since 1945***, when federal revenues claimed 20.8% of GDP. The previous postwar high of 19.7% occurred both in 1969 and 1981, years that were followed by recessions.

## High Taxes Stymie Economic Growth

This high level of taxation imposes a burden on our economy. High taxes increase the costs of operation for businesses, and high taxes on individuals reduce the amount of discretionary income available for savings or spending.

Harvard economist Dale Jorgenson calculates a very large loss of potential economic output due to high taxes. He finds that every dollar of taxes raised by the federal government through 1994 cost the economy about 18 cents, but warns that increases in taxes since 1994 levels now cost the economy as much as 40 cents per dollar raised.

## Surpluses Could be Used to Cut Taxes

Potential surplus revenue could be used to lower this historically-high tax burden. And tax cuts have the greatest potential payoff depending upon how taxes are cut. For example, reducing only average tax rates, say through raising exemptions or tax credits, produces only negligible economic benefits.

Lowering marginal tax rates on labor income, say through cutting payroll tax rates, would have a more positive effect. But the greatest benefit would come from lowering marginal tax rates on saving and investment through capital gains tax cuts, reductions in or the elimination of the estate tax, or changes in depreciation rules for businesses.

## Don't Count on Surpluses

It is dangerous to start counting budget surpluses before they appear. For one thing, this is an economic *forecast* by a government forecasting agency, and such forecasts are USUALLY wrong. In fact, the latest good news about the budget deficit reflects a Congressional Budget Office forecast revision of $2.2 *trillion* over the next ten years. That's right—it's an admission by the CBO that their *last* forecast was off by $2.2 trillion. And all it would take this time to trip up the CBO's latest forecast is a recession or other economic shock.

If only six months ago forecasters predicted this year's budget deficit would be over five times higher than it turned out to be, how can anyone place confidence in forecasts one, two, or ten years out?

## Beware the Temptation to Spend

But even if CBO is right this time, there is a strong bias in Washington toward spending that will likely preclude budget surpluses. Few Congresses and Presidents have been able to withstand the pressure to spend "found money." Consider what has happened to the so-called "Peace Dividends" we were *supposed* to realize at the end of the wars of the 20th Century:

- After the Vietnam War, Congress spent $1.09 of every dollar of military savings.
- After the Cold War, Congress has spent $2.30 of every peace dividend dollar.

From 1987 to 1994, real defense spending was cut by $75 billion, but non-defense spending rose by over $200 billion. Congress spent the money more than twice over that was made available by the end of the Cold War.

## More Government Spending?

Government spending is the least productive (and most potentially *counter*productive) way to use surpluses. For one thing, government already spends too much money, and as nightly news features like the "Fleecing of America" point out, much of government spending yields questionable benefits to society and may actually do harm.

Before designing new ways to spend money, government should first root out obsolete, wasteful or counterproductive programs.

## Paying Down the National Debt

Using surpluses to pay down the national debt is appealing to responsible citizens and to politicians who wish to appear responsible. One such plan has already been proposed in Congress, and has been widely praised.

But reducing the national debt while maintaining high tax rates could have little pay off. Unless the return to capital in the United States becomes more attractive than it currently is, there will be no incentive for businesses to expand domestic investment in productive assets like plant, machinery or computers. Money freed up by buying back Treasury bonds would more likely end up financing capital abroad. While U.S. investors would receive some reward, the vast majority (95%) would remain in the country where the capital physically sits.

Also, policy makers should remember that similarly well-intended but misplaced debt-reduction through high taxes during the Eisenhower administration helped lead to the election of John F. Kennedy, who promised tax cuts.

## Conclusion

Although common wisdom counts death and taxes as the only two sure things in life, a close third would be that a government budget forecast would missed the mark. The nation would be far better served if its political leaders concentrated on devising and enacting sound tax and spending policies, and let surpluses or deficits take care of themselves.

For fifty years, the American people have been burdened with high tax rates to pay the costs of international tumult and domestic folly. Today taxes are at a post-war high.

It's time to return the overall tax burden to a reasonable level. Tax cuts are the appropriate use of any budget surpluses.