

Don't Look for Tax Cuts from This Budget Surplus

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Several years of full employment, a booming stock market, and a growing economy have all contributed to a rapid expansion in tax revenues. During the next decade, according to the Congressional Budget Office, this could produce cumulative budget surpluses of more than \$1.5 trillion. These surpluses could make possible very desirable tax relief to the many families that have seen their taxes increase since the bipartisan tax act of 1986. Unfortunately, substantial tax cuts are unlikely because of what has been called the "flypaper effect": Governments tend to spend the revenues they receive.

Government expenditures reflect political battles between taxpayers and powerful interest groups that clamor for greater subsidies. Taxpayers always resist higher tax rates, but their resistance hardens when government accounts are in deficit, which helps slow the expansion of government spending. However, government outlays readily expand after revenues boom, since greater spending can then be financed without higher tax rates, and possibly even with some reductions.

This common-sense view that the main brake on government spending comes from tax revenues is confirmed by what happened to past budget surpluses. John F. Cogan of the Hoover Institution examined Federal responses to Social Security surpluses during the previous 50 years. His findings showed that Congress allocated these surpluses either to raise benefits, expand eligibility, or allocate funds for other purposes.

Cogan also found that Social Security benefits are often increased shortly before elections--a relevant point now, with this November's congressional battles looming. Both Republicans and Democrats have proposed that part of the budget surplus be set aside to fund future retirement benefits. Republicans tend to favor using surplus revenues to establish individual retirement accounts, whereas Democrats prefer shoring up benefits under the government's pay-as-you-go system.

This is typical of what happens to other budget surpluses. My University of Chicago colleague Casey B. Mulligan and I studied the effects of revenue windfalls in different nations during the past several decades. We found that unexpected increases in government revenue are generally devoted not to tax relief but to expanding old programs and creating new ones.

Oil-producing nations spent liberally on new construction and other programs after oil revenues boomed during the 1970s and early '80s, then reined in their plans when prices fell. The current slump in world oil prices is forcing Middle East sheikdoms, Venezuela, Mexico, and other major producers to abandon some grandiose spending plans.

We do find that sometimes, surpluses lead to lower taxes, as when income tax rates were reduced following World War II in response to the large decline in military spending.

Even then, however, income tax rates remained far above prewar levels because federal spending stayed permanently higher.

Budget surpluses generate higher spending, which often becomes permanent, even after the budget goes from surplus to deficit. It is extremely hard politically to cut back government programs once they have begun or expanded, since subsidized groups fight tooth and nail to preserve their benefits.

DISGUISED BURDEN. Some politicians are now making noise about using projected surpluses to cut taxes, but a few simple questions can expose the shallowness of their arguments. Are Republicans in Congress who want to convert the Social Security system to a system of individual accounts, which is an excellent idea, proposing to reduce the Social Security tax on employees and employers from its total of 14%? If not, their suggestion amounts to a disguised increase in an already heavy Social Security tax burden.

Are Democrats who want to improve prenatal care or expand coverage to the 40 million persons without protection against serious illnesses proposing to reduce other government-financed health expenditures, such as generous Medicare subsidies to wealthy retirees? After all, it could hardly be claimed that America is neglecting the health sector when medical spending is almost 15% of gross national product, a higher percentage than any other industrial country.

Unless taxpayers become more effective politically than they have been in the past, the anticipated Federal budget surpluses will be directed mainly toward increased spending rather than devoted to reducing taxes. But aroused and politically powerful taxpayers may yet be able to overcome the flypaper effect and force politicians to give them back some of their own money through substantial tax relief.