

BY ROBERT J. BARRO

## BOY, WE REALLY NEED A TAX CUT



### GOOD MOVE

It will stimulate investment and growth; increase incentives to work and save; and lower the amount of money Congress can spend

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The political winds in Washington have shifted dramatically, and the issue now concerns the size and composition of an income tax cut, not whether to have one. Talk of a tax cut is largely being driven by the projected federal surpluses, which are now large enough to make retirement of the publicly held federal debt a real possibility. The situation reminds me of a long-ago fiscal episode.

*In January, 1835, the national debt was paid off, the existence of a surplus was an assured fact...what was to be done with it? (Davis Dewey, *Financial History of the United States.*)*

When Andrew Jackson and then Martin Van Buren were the Presidents, the problem of ongoing surpluses was "solved" mostly by increasing federal spending. Part of the added expenditure went through the states, as directed by the Distribution Act of 1836. Other parts were spent on public works and fighting Indians in Florida. There was no tax cut, despite some suggestions to reduce tariffs. The recession of 1837 reduced tax revenues, which came mostly from tariffs and public land sales.

The worry about running out of public debt has not been an issue for 165 years. However, Federal Reserve Chairman Alan Greenspan revived the matter in his recent congressional testimony, in which he pleased Republicans and shocked Democrats by declaring himself a tax-cut advocate. According to Greenspan, "the emerging key policy need is to address the implications of maintaining surpluses beyond the point at which publicly held debt is effectively eliminated." He then argued that reduced taxes were better than added expenditure as a way to resolve the quandary of insufficient public debt. Of course, the depletion of the stock of publicly held government bonds could be avoided by allowing the Social Security trust fund to invest in a broad class of securities, including corporate stocks. This option would be politically less worrisome if the funds were held in personal accounts, rather than in a government-managed portfolio.

There are a number of more serious reasons for a federal tax cut. A reduction that served to lessen tax distortions would stimulate investment and long-term economic growth. Decreases in marginal tax rates are especially attractive because they increase incentives to work, save, and invest. Another good argument is that tax cuts remove revenues from Washington and thereby keep Congress from spending them. This point was understood by Ronald Reagan

when he pushed for income-tax cuts in the 1980s.

To fight a recession, the Bush plan should be changed to eliminate the gradual phase-in of tax cuts. Otherwise, the prospect of lower tax rates motivates people to postpone income. This feature of the 1981 tax reform may have contributed to the 1982 recession. A related idea, recently raised, is that any tax reduction be retroactive to Jan. 1 of this year. The exact method by which retroactivity is achieved is secondary, as long as people believe that marginal tax rates for 2001 are not higher than those in future years.

One important consideration is the likelihood of an economic downturn. As hard as that is to gauge, the last quarter's growth rate, stock-market returns, and interest-rate patterns can help to predict growth. Putting this information together yields a forecast for gross domestic product growth in 2001 that is barely positive. A reasonable "confidence range" is from -1% to +2% growth. It makes sense, then, to consider a growth slowdown and a possible recession as part of the tax-cut deliberation, assuming that a tax cut can be enacted by this summer.

**HISTORICAL MODELS.** The extent of the slowdown may depend on the Fed's interest-rate policy—and this policy can itself be predicted. The Fed responds regularly to inflation, economic activity (especially labor-market conditions), patterns of market interest rates, and the stock market. However, the Fed's recent cut in rates by a full percentage point was much larger than its experience would dictate. Even now, the historical model predicts only a one-quarter-point additional cut by the spring, whereas the futures market suggests that rates will fall another half-point by April and an additional quarter point by July. I am concerned that the Fed's aggressive stand deviates from the policy that has been so successful since the mid-1980s.

In general, I would be more confident if President Bush had installed a stronger economic team. Lawrence B. Lindsey is a reasonable economist with particular knowledge of the U.S. tax system, but where are the rest? The reliance seems to be on Greenspan, who ought to be focusing on monetary policy. Some years ago, I wrote a column in which I observed that economic outcomes bore little relation to the expertise of an Administration's economic advisers. This proposition is certainly going to be tested by the present White House.