

Taxes Are a Real Drag

By BURTON G. MALKIEL

In the wake of George W. Bush's impassioned plea to return \$1.6 trillion to the American people, I want to lay out the macroeconomic case for tax-cutting. My argument is straightforward: The ability of our economy to produce continued gains in real income depends on removing the "fiscal drag" with which big government surpluses burden the economy.

There has been broad criticism of the president's proposed tax cut on macroeconomic grounds. Indeed, Robert Rubin, the former secretary of the Treasury, has gone so far as to suggest that a substantial tax cut is fiscally irresponsible and will jeopardize our economic prosperity.

Nonrecurring Factors

Critics of the tax cut argue the following: The policy of fiscal restraint that we have followed over the past several years has produced big budget surpluses that have benefited the economy in important ways. As the government has been taking in more in tax revenues than it has been spending, it has been buying Treasury bonds and reducing the supply of government debt. More funds are therefore made available for private bonds and other financial instruments. Interest rates tend to decline and private investment is stimulated, boosting the economy and increasing the prospects for long-run economic growth.

Those opposed to Mr. Bush's plan go on to argue that a big tax cut will reverse these virtuous effects. Smaller surpluses risk increasing interest rates. Private buyers will then be crowded out of the financial markets, putting investment spending



John F. Kennedy
Cut taxes

and future economic growth at risk.

Yet a substantial tax cut is essential if we are to keep the economy on a path of long-run growth. Increasing fiscal restraint worked well during the past decade, but for nonrecurring reasons. Because these factors aren't likely to continue over the next several years, the increasing fiscal drag that comes when government overtaxes citizens and siphons money out of the spending stream will

The exuberant stock market powered the economy even as taxes increased in the 1990s. But with stocks falling, we can no longer sustain a big fiscal drag.

have a depressing effect on economic activity. Unless corrected, it could lead to considerable slack in the economy.

Among those nonrecurring factors was consumer spending (two-thirds of total economic activity), which was especially strong in the 1990s as savings rates declined sharply. Consumers saved almost 9% of their personal income in 1992. Today, the savings rate is negative as consumers spend more than they earn. Private debt has increased dramatically, and a continuation of these consumer-spending trends is clearly unsustainable in the years ahead.

Investment spending has also been unusually strong, and in some areas of the economy there is evidence of overinvestment. Telecom companies, wireless providers, local exchange carriers, and builders of fiber-optic networks have all operated on the "if you build it they will come" principle. But the massive buildup of fiber-optic networks today is uncomfortably similar to the overbuilding of track at the dawn of the railroad age. Retail Internet companies and business-to-business exchanges have also overbuilt capacity. The growth rate of high-tech investment spend-

ing over the past decade isn't likely to be sustainable.

The recent high levels of consumption and investment have both been influenced by another factor that is likely to be nonrecurring—the exuberance of the stock market. From 1982 to early 2000, the stock market produced returns of 18% a year—far above the 9% to 11% returns more typical of our long-run history. The wealth effect of sharply increasing stock (and real es-

tate) prices has been an important factor behind the fall in savings rates. The unprecedented extent of the public's stake in the stock market has made rising stock prices a major determinant of consumption. Consumers have felt able to spend all of their income as long as their wealth has been increasing.

The buoyant stock market has also been an important influence supporting real investment—particularly in technology equipment. As long as entrepreneurs with a good idea could go to the stock market to raise money, even if future earnings were only a dream, financing was no problem. But what the Nasdaq stock market giveth, so can it take away. Today the financing window for new high-tech ventures without earnings is shut. With normal rather than excessively exuberant stock markets, neither consumption nor investment can grow at their recent pace.

Much has been made of the unreliability of future surplus forecasts and the imprudence of spending a surplus that may not materialize. But, in fact, it is the fiscal drag from big high-employment surpluses that may stop even the moderate forecast of 3% real economic growth from being

realized. The Congressional Budget Office currently projects budget surpluses that more than double over the forecast period (2001-2011). The projections assume that the nation remains at reasonably full employment and on a sustainable growth path. But without removing at least part of this increasing drag on the economy, we are highly unlikely to realize even moderate growth in the years ahead, and it is very doubtful that surpluses of that magnitude can be achieved.

Critics worry about the crowding-out effect of a big tax cut on economic activity. But fiscal drag suppressing the economy is the far greater danger. The worst outcome would be to squander the projected surplus by letting it evaporate through years of inadequate economic growth. A big tax cut today (front-loaded and passed as soon as possible) will not only strengthen our defenses against recession but will help us meet our long-run economic challenges by crowding in capacity-creating investments.

What Kennedy Did

In 1963, John F. Kennedy proposed a tax cut that was 2% of gross domestic product—far larger in percentage than the cut today proposed by Mr. Bush. The Kennedy proposal eliminated the high-employment surplus; the Bush proposal spends only a fraction of it. In support of his proposal, Kennedy argued that a tax cut was needed to remove "the heavy drag our fiscal system now exerts on personal and business purchasing power" and to lessen "the tax deterrents to private initiative." That same argument is equally appropriate today.

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