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Reducing Tax Rates Across the Board: A Cornerstone of Pro-Growth Tax Relief

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The Federal Reserve Board's recent decision to put downward pressure on interest rates has temporarily quieted those who claimed George W. Bush was exaggerating the possibility of an economic downturn solely to boost his tax cut plan. Many critics, however, continue to believe that tinkering with monetary policy is all that is needed to boost the economy. This is misguided. The Federal Reserve's actions may or may not be warranted, but its job is to preserve a stable price level, not to fine tune the economy. Lowering marginal tax rates for individual taxpayers represents good tax policy, good economic policy, and good leadership—particularly if there are fears that the economy is performing below its potential.

Specifically, the plan proposed by President-elect Bush would reduce personal income tax rates. A new 10 percent tax bracket would be created that would apply to a substantial portion of the income that is currently taxed at 15 percent. The 28 percent and 31 percent tax brackets would be reduced to 25 percent, and the 36 percent and 39.6 percent tax brackets would be lowered to 33 percent. This is good policy for several reasons:

- **The current tax rate on work, savings, and investment penalizes productive behavior and impedes economic growth.** Because of steep personal income tax rates, highly productive entrepreneurs and investors can take home only about 60 cents of every dollar they earn, not including state and local taxes or other federal taxes. This reduces the incentive to be productive. Lower tax rates will reduce this "tax wedge" and encourage additional work, savings, investment, risk-taking, and entrepreneurship.

- **The budget surplus is growing.** According to the latest Congressional Budget Office (CBO) projections, the aggregate budget surplus for the 10-year period of 2001 to 2010 will be at least $4.6 trillion, and the CBO is expected to revise this projection upward. The Clinton White House reportedly projects surplus tax revenues between 2002 and 2011 of $5 trillion. President-elect Bush's proposed tax relief package is expected to save taxpayers $1.3 trillion to $1.6 trillion over the next 10 years—not including revenue feedback from the additional economic growth that will follow.

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- **Reducing the tax burden will help control federal spending.** Without the specter of deficits, lawmakers lose the will to say no to special interests and pork-barrel projects. In the three years since the surplus materialized in 1998, inflation-adjusted federal spending has grown twice as fast as it did during the three prior years when the government was running a deficit.
- **Lower tax rates are an important step toward fundamental tax reform.** When tax rates are high, deductions, credits, and exemptions provide large tax savings to some taxpayers; but roughly 70 percent of all taxpayers receive no benefits since they claim the standard deduction. A simple and fair tax code would treat everyone equally, without creating winners and losers, by taxing all income only once and at one low rate. Reducing marginal tax rates will move the nation toward a low tax rate system and reduce the value of special-interest tax breaks (which are more valuable when rates are high), the economic distortions they cause, and the political pressure to add new preferences to the code.
- **Tax increases did not cause the surplus, and tax cuts will not cause a deficit.** Opponents of tax cuts often claim that the 1993 tax increase is responsible for today's budget surpluses. This is contradicted by Clinton Administration budget documents: In early 1995, *nearly 18 months after enactment of the 1993 tax increase*, the Office of Management and Budget projected budget deficits of more than $200 billion for the next 10 years. Clearly, events after that date—including the 1997 capital gains tax cut and a temporary reduction in the growth of federal spending—caused the economy to expand and the budget deficit to vanish.
- **Tax rate reductions and entitlement reforms are not mutually exclusive actions.** Critics argue that a big tax cut would make it harder to reform Medicare or modernize Social Security by allowing younger workers to shift some of their payroll taxes into personal retirement accounts. Given the magnitude of the projected budget surpluses, there is no conflict between these goals. Moreover, entitlement reform would be desirable even without a budget surplus because it would significantly reduce the long-run unfunded liability of both programs. Large projected surpluses simply make it easier for legislators to implement the necessary policies.

Opponents once argued that tax cuts were unwarranted because the federal government was running a budget deficit. Now they argue that tax cuts are unwarranted because there is a surplus. Their real agenda is to block any reduction in tax rates and increase the dollars they have available to spend.

Some critics claim that the economy may need help right away, not six months down the road. Believing that aggregate demand drives the economy and enamored with short-term economic tinkering, such advocates of Keynesian economics prefer an "easy money" Federal Reserve policy to reducing tax rates and reforming the code. But the economic damage caused by high marginal tax rates cannot be "fixed" by making changes in monetary policy.

The extent to which people are concerned about the timing of a tax cut suggests that lawmakers should act now, making a tax reduction retroactive to January 1, 2001. The President-elect should not be swayed by those who fundamentally disagree with his vision for the nation. Rather than reduce his proposed tax relief package—which includes eliminating the death tax, reducing the marriage penalty, and expanding educational savings accounts—President Bush should *expand* it to include a reduction in the capital gains tax. Under no circumstances should he compromise on personal income tax rate reductions. An across-the-board reduction in marginal tax rates should be the cornerstone of the tax relief package.

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