The Bush Tax-Cut Rewards Ambition
By **R. Glenn Hubbard**
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WASHINGTON -- U.S. President George W. Bush's proposals to enhance near-term growth have focused attention on the benefits of cutting marginal tax rates. While all U.S. taxpayers will face lower tax rates as a result of his 2001 tax cut, this week's proposal will allow tax relief to take effect immediately rather than over several years. In the long term, lower marginal rates will pay off through increased labor supply, saving, and entrepreneurship, and thus ultimately higher growth and stronger job creation. In the near term, the president's proposal will also provide important support for demand.

Opposition to the tax cuts has come mainly from those who claim a tax cut for all Americans means the wealthy will benefit disproportionately. But this is a straw man that has been used for years to prevent Americans from keeping more of the money they earn. Those who object to marginal tax cuts assume that once rich, Americans stay rich, and once poor, they stay poor. The view is wrong because it ignores the large amount of economic mobility in the U.S.

That fluidity has real implications for marginal tax rates which penalize the last dollar of income earned. In the first year after rates are cut, roughly 28% of U.S. taxpayers face a lower marginal tax rate -- that is, benefit from a reduced tax rate on their last dollar of income. But in the next 10 years -- the "window" used for the federal budget -- about half of taxpayers benefit from lower marginal tax rates. Even at the highest incomes, where the top 1% of filers pay more than one-third of individual income taxes, four times as many individuals benefit over 10 years than in a single year.

These numbers reflect the fact that Americans move up and down the income and tax bracket ladder, depending on their stage in life. A college student gains only modestly from tax cuts, but benefits greatly in the future when he or she finishes school and enters the labor force. The same applies to a new small-business owner who becomes successful and benefits from tax relief as profits grow. Everyone's tax rate changes with decisions they make about jobs, marriage, children, whether to own a home, and when to retire. Over time, those changes mean more than is apparent from a snapshot of a single point in time.

Consider a two-earner couple with two children with a joint income of $65,000 at age 30. Over the years, this couple works, pays taxes, buys a home, and puts away money to be spent on children, education, and retirement. The tax rate this couple pays on the last dollar of earnings changes greatly over time with income, tax preferences such as the child credit, and the taxation of Social Security benefits.

Many American taxpayers also have short-term fluctuations in their incomes and thus their tax bracket as they move in and out of the labor force, or as their business and investment income move with the ebbs and flows of the business cycle. Having children, marriage and divorce, saving for retirement, giving to charity, unusually high medical expenses, and home mortgage interest -- all these things can affect the tax bracket in which a taxpayer falls.

More than half of U.S. taxpayers changed tax brackets -- both up and down -- within a 10 year period (the calculations are performed by following the same taxpayers for 10 years and assuming that the president's tax cut was in place over the entire period). More than one-fourth of taxpayers moved to a higher bracket and about two-thirds of taxpayers in the bottom bracket moved up after 10 years. More than one-fourth also moved to a lower tax bracket and more than half of the taxpayers facing the top rate in the first year were in a lower tax bracket after 10 years.

This is part of the reason that nearly 6% of taxpayers faced one of the top two rates at some point over the 10-year period, even though less than 2% pay the top rate at any one time.

To properly assess the "fairness" of a tax cut then, lifetime income is a better measure, and one that resonates with a certain American spirit. A great majority of Americans believe -- and rightly so -- that their fortunes will improve over time. A marginal tax rate cut rewards that ambition.

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