The Tax-Cut Debate
By R. Glenn Hubbard
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The debate over tax cuts has focused on their size. House and Senate committees have approved bills cutting taxes by $800 billion to $900 billion over 10 years, while President Clinton has called for a cut of just $250 billion. Now House members are wrangling to produce a compromise.

This is all a bit silly. The most important element is all but ignored in the debate: What is being done with the money? To realize the greatest economic benefits, tax cuts should focus on reducing marginal income tax rates -- the tax on each additional dollar of income.

High marginal rates have simple-to-understand costs. They reduce incentives to find a better job, save for the future or start a new business. Entrepreneurial activity is particularly susceptible to high marginal tax rates because they act as a "success" tax, claiming a large share of new income from successful enterprises, while the government shares little of the risk of loss. High marginal rates on saving -- directly through sometimes multiple layers of income taxation and indirectly through the estate tax -- discourage saving and thus reduce funds for capital formation. Finally, high marginal tax rates offer a potent stimulus to less efficient uses of fringe benefits and tax planning.

Aren't high marginal tax rates just a problem for very high-income households? No. It is true that the 1993 Clinton tax increases generated very high marginal income tax rates -- up to 39.6% -- for high-income taxpayers; reducing those rates should be an important component of a major tax bill. But many low-income individuals face high marginal tax rates as well, as their progress in the work force brings both income tax burdens and a phasing out of the earned-income tax credit. And many middle-income taxpayers face high marginal rates as various targeted tax credits -- a favorite social-policy tool of the Clinton administration -- are phased out. It is also worth remembering that flattening marginal tax rates would help diminish the marriage penalty, a favorite conservative cause.

The House and Senate tax bills offer a chance to consider options for reducing marginal tax rates in the context of a large overall tax cut. Both plans would reduce tax burdens broadly -- and offer cuts in marginal tax rates. The House's 10% across-the-board cut in all marginal rates is better than the Senate's reduction of the 15% rate to 14%, though the Senate plan offers additional reductions in marginal rates on saving by broadening saving incentives. Combining elements of the plans would put us on the path toward a more efficient tax system that encourages work, enterprise and saving.

What about Mr. Clinton's suggestion that the Republican tax bills are too expensive? Would a large tax cut put the nation's fiscal house and economic expansion out of order? The simple answer is no. Referring to the "cost" of a tax cut in the present circumstances is a bit like the management of a public company referring to dividends to shareholders as a cost. Just as we expect mature firms with large positive free cash flows to return those surpluses to shareholders, taxpayers have a claim on projected budget surpluses.

If a firm finds profitable new investment opportunities in the future, it can return to the capital market to raise the funds to pursue those opportunities -- with the discipline that process entails. Likewise, future new government spending initiatives should face the discipline of the tax-raising process as well as the appropriations process.

Now consider the arithmetic. We are having a national discussion about what to do with the federal budget surplus because there is a surplus. Economic growth increases federal revenue both because national income is higher and because real growth in income pushes taxpayers into higher brackets.

As a result, projected budget surpluses are large. To put things into perspective, just the most recent revision of the 15-year budget surplus is an eye-popping $1 trillion, and the nonpartisan Congressional Budget Office estimates that as much as $900 billion could be returned to taxpayers over the next decade without touching the Social Security surplus.

Assigning surpluses to taxpayers via reductions in marginal tax rates does not imply a fiscally irresponsible path of locking ourselves into large changes in taxes irrespective of whatever budget consequences actually materialize. Because economic forecasting is not an exact science, phased-in reductions in taxes are sensible. This strategy is used in the congressional tax bills, sponsored by Rep. Bill Archer (R., Texas) and Sen. William Roth (R., Del.). The administration, by contrast, wants to increase spending by more than $1 trillion -- which would be much more difficult to modify or reverse in future years.

Cuts in marginal tax rates are our most potent tax tools for raising the standard of living for all Americans. The present budget surpluses offer a rate opportunity to reduce marginal tax rates while reducing tax burdens for all taxpayers. The House and Senate tax bills offer a place to start the debate. The administration's proposal of a major expansion in government spending does not.

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