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## THE WALL STREET JOURNAL.

### Board of Contributors: A Case for Cutting Marginal Rates

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#### Abstract (Document Summary)

Bob Dole has proposed major tax cuts and promised to offset the resulting revenue losses with additional spending cuts. Without such spending cuts, the advantages of lower tax rates would be undermined by higher deficits that absorb savings and reduce investment. Dole budget analysts calculate that annual spending must be cut by an additional \$60 billion by 2002 -- about 3% of projected government spending -- to offset the proposed tax cuts and achieve budget balance.

Lower tax rates can cause higher growth by raising the rate of saving and investment, increasing entrepreneurial activity, and encouraging more education and training. But when economists quantify the economic gains from lowering marginal tax rates, we focus on the shorter-term benefit of reducing tax-induced distortions in behavior. Consider the potential impact of the Dole plan on a married couple with \$50,000 of taxable income. An additional dollar of taxable earnings now means 28 cents more in federal personal income taxes, 15 cents more in employer-employee payroll tax payments, and about five cents more in state personal income taxes, a remarkable combined marginal tax rate of 48%. Each extra dollar of pretax earnings only adds 52 cents of spendable income.

Taxpayer behavior after the 1986 tax rate cuts provides some very useful evidence. In a study based on a large sample of anonymous tax returns provided by the Treasury Department, I compared the taxable incomes of high-income individuals in the years before the tax rate cuts with their taxable incomes after the rate cuts. Each 1% increase in the net tax rate increased taxable income by about 1%, an estimate later confirmed in a related study by economists at the Treasury.

#### Full Text (1367 words)

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Bob Dole has proposed major tax cuts and promised to offset the resulting revenue losses with additional spending cuts. Without such spending cuts, the advantages of lower tax rates would be undermined by higher deficits that absorb savings and reduce investment. Dole budget analysts calculate that annual spending must be cut by an additional \$60 billion by 2002 -- about 3% of projected government spending -- to offset the proposed tax cuts and achieve budget balance.

Critics of the Dole plan argue both that this \$60 billion is based on an underestimate of the likely revenue loss, and that the needed spending cuts cannot be justified by the gains that would result from lower tax rates. I disagree with both criticisms. I'll focus my comments on the 15% rate cut since that's three-fourths of the total and the subject of almost all of the public debate.

Lower tax rates can cause higher growth by raising the rate of saving and investment, increasing entrepreneurial activity, and encouraging more education and training. But when economists quantify the economic gains from lowering marginal tax rates, we focus on the shorter-term benefit of reducing tax-induced distortions in behavior.

Consider the potential impact of the Dole plan on a married couple with \$50,000 of taxable income. An additional dollar of taxable earnings now means 28 cents more in federal personal income taxes, 15 cents more in employer-employee payroll tax payments, and about five cents more in state personal income taxes, a remarkable combined marginal tax rate of 48%. Each extra dollar of pretax earnings only adds 52 cents of spendable income.

The couple's high marginal tax rate induces them to substitute fringe benefits and nicer working conditions for taxable cash. Even if it costs the company a dollar to provide some benefit that the employee values at only 60 cents, that will be a better deal than paying the dollar in wages that shrinks to 52 cents before it can be spent. The logical implication of this is clear: Companies will spend money on fringe benefits and nicer working conditions until the last dollar of such spending is worth just 52 cents to the employee. What a waste!

High marginal tax rates also affect how much and how hard individuals work. When extra work means \$100 of pretax earnings but only \$52 of additional spendable income, the individual will substitute more leisure and less demanding work for the cash income that he would otherwise prefer. The logical implication of this is clear: The employee will pass up the chance to earn an additional \$100 if doing so means giving up leisure that he values at as little as \$52. What a wasted opportunity!

The Dole proposal would cut the couple's marginal federal income tax rate from 28% to about 24%. An extra dollar of taxable earnings would therefore mean 56 cents of spendable cash instead of the current 52 cents. There would be less incentive to substitute low-valued fringe benefits and leisure for spendable income. The amount of waste would decline. Although an 8% increase seems small, experience shows its effect would be substantial.

Taxpayer behavior after the 1986 tax rate cuts provides some very useful evidence. In a study based on a large sample of anonymous tax returns provided by the Treasury Department, I compared the taxable incomes of high-income individuals in the years before the tax rate cuts with their taxable incomes after the rate cuts. Each 1% increase in the net tax rate increased taxable income by about 1%, an estimate later confirmed in a related study by economists at the Treasury.

Since middle-income taxpayers might be less responsive than those high-income taxpayers, I'll cut the earlier estimated response in half and assume that the 8% increase in the net tax rate causes the couple to increase its taxable income by just 4%, from \$50,000 to \$52,000. Such an increase in taxable income could occur because the husband or wife worked more or because they substitute bigger cash wages for some fringe benefits.

The \$2,000 of extra consumption and tax revenue would otherwise have been fringe benefits and leisure valued at about 52 cents per dollar, or \$1,040. The \$960 difference between the \$2,000 and that \$1,040 value measures the reduction in waste that results from the 15% rate cut. Economists refer to this \$960 waste as the deadweight loss of the higher tax rates.

What happens to the tax revenue? A couple with \$50,000 of taxable income would pay \$1,340 less in tax if their income were unchanged. In the language of the Washington tax analysts, that's the "static" revenue loss.

But the increase in taxable income induced by the tax cut substantially reduces this revenue loss. The rise in taxable income reflects both the higher net tax rate and the effect of the \$1,340 static tax cut on the demand for leisure and fringe benefits. Statistical evidence suggests that the net effect would increase taxable income by about \$1,500. Taxing this at the reduced marginal tax rate of 24% plus the employer-employee payroll tax rate of 15% produces \$585 of extra tax revenue. Instead of a static revenue loss of \$1,340, the "dynamic" estimate of the revenue loss is only \$755. The "feedback" effect of increased taxable earnings cuts the loss of income tax revenue in this case by 44%.

In summary, for this couple the 15% rate cut would reduce tax revenue by \$755 and would cut the deadweight loss by \$960, implying a total gain of \$1,675 to these taxpayers. The taxpayers gain more than two dollars for every dollar of revenue loss.

The story is similar for high-income taxpayers except that we can expect them to be more responsive to tax rate changes. It's appropriate to assume that they would respond to the 15% rate cut with the same responsiveness as in 1986 -- a 1% increase in taxable income for each 1% rise in the net of tax share.

Consider a couple with \$300,000 of taxable income who now face a federal marginal tax rate of 39.6%. A 15% cut

in all tax rates would imply a static tax cut of \$14,173 and a reduction in the marginal tax rate to 33.7%. The rate cut would thus raise the net-tax share from 52.5% (assuming a 5% effective state tax rate and the 2.9% Medicare payroll tax) to 58.4%, an increase of 11.2%. Their taxable income would rise by about \$28,000. Taxing this at 33.7% plus the 2.9% Medicare tax implies additional income tax revenue of \$10,240. This revenue feedback reduces the static revenue loss by 72% to \$3,933.

Cutting tax rates by 15% reduces this couple's deadweight loss by more than \$18,000. The couple save \$14,173 of their initial tax bill and responds to the lower marginal tax rate by willingly increasing their taxable income enough to pay \$10,240 more in taxes because the goods and services that they can buy with the extra net cash exceeds the value of the foregone leisure and fringe benefits.

With these calculations in mind, let's look at the criticisms of the Dole tax cut. First, are the Dole assumptions about revenue feedback really too optimistic? The Dole budget analysis assumes a revenue feedback equal to about one-third of the static revenue loss. As my examples show, the experience after the 1986 tax cuts would actually imply substantially greater revenue feedback and therefore less net revenue loss.

Second, can the spending cuts needed to pay for the tax cuts be economically justified? Government spending is justified only if the benefit that it produces exceeds the total cost of paying for those benefits, including the deadweight loss of raising the revenue. With today's very high marginal tax rates, the total cost now exceeds more than two dollars for every extra dollar of government spending. If Congress can use that as the criterion for judging existing spending programs, it shouldn't be difficult to identify the \$60 billion of additional desirable spending cuts. But getting those cuts enacted will require a Congress and a president committed to deficit reduction and budget balance.

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