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The 28% Solution

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Abstract (Document Summary)

Economic and political conditions are now very different. The Congressional Budget Office projects \$5.6 trillion of budget surpluses over the next 10 years. President George W. Bush's tax plan uses a portion of those surpluses to improve the tax system and strengthen the economy by reversing much of the previous tax-rate increases and by cutting taxes for middle- and low-income taxpayers. Even after setting aside the projected Social Security surpluses, the officially estimated \$1.6 trillion cost of the Bush tax plan is only about half of the remaining \$3 trillion surplus. In other words, the Bush tax plan is compatible with protecting Social Security, increasing the outlays for Medicare and defense, and still having substantial money left for further debt reduction.

Economists call this the deadweight loss of a tax. Together with Daniel Feenberg, a colleague at the National Bureau of Economic Research, I have used a large publicly available sample of anonymous tax returns provided by the Treasury Department to estimate the effect of the Bush tax plan in this area. Our calculations show that the Bush plan would cut the deadweight loss of the income tax by more than \$600 billion over 10 years. That \$600 billion reduction of the deadweight loss makes taxpayers better off by just as much as an additional \$600 billion of spendable cash.

The Bush tax plan was designed to give an approximately equal percentage cut in taxes at each income level, but with relatively larger tax cuts at the bottom of the income distribution and somewhat smaller proportional cuts at the top. Those calculations ignore the taxpayer behavior that would increase taxable income and therefore tax payments substantially more in the top income brackets than in lower brackets. When that taxpayer behavior is taken into account, the fully phased-in income tax cuts significantly raise the share of taxes paid by taxpayers with incomes over \$400,000 (to 28.8% of the total, from 27.2% today) while cutting the share of taxes paid by those with incomes between \$20,000 and \$50,000 to 10.7% of total taxes, from 11.6% today.

Full Text (1385 words)

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Less than 15 years ago, President Reagan and a Democratic Congress agreed on a fundamental tax reform that cut personal income tax rates across the board, bringing the top rate down to 28%. Since the intent was to pay for those rate cuts without increasing the deficit or changing the distribution among income brackets, the Tax Reform Act of 1986 expanded the income subject to tax by eliminating many deductions and special tax rules used primarily by high-income taxpayers. That legislation was widely acclaimed, although some skeptics rightly worried that a future administration would rescind the deal for high-income individuals by increasing tax rates.

Three years later, in order to get a budget deal to limit future spending, President Bush Sr. agreed to raise the top rate to 31%. And two years after that, President Clinton used the budget deficit as a rationale for pushing the top income tax rate to 39.6%, including a 3.6% "temporary" surcharge that has never been removed. Eliminating the \$125,000 ceiling on the income subject to the 2.9% Medicare payroll tax raised the top tax rate to more than 42%, a 50% increase from the 28% rate that Congress had promised five years earlier.

Economic and political conditions are now very different. The Congressional Budget Office projects \$5.6 trillion of budget surpluses over the next 10 years. President George W. Bush's tax plan uses a portion of those surpluses to improve the tax system and strengthen the economy by reversing much of the previous tax-rate increases and by cutting taxes for middle- and low-income taxpayers. Even after setting aside the projected Social Security surpluses, the officially estimated \$1.6 trillion cost of the Bush tax plan is only about half of the remaining \$3 trillion surplus. In other words, the Bush tax plan is compatible with protecting Social Security, increasing the outlays for Medicare and defense, and still having substantial money left for further debt reduction.

Cutting marginal tax rates has a double advantage. It not only allows people to keep more of the money that they have earned but also reduces the distorting and disincentive effects of high marginal rates. Someone who earns \$50,000 now faces a 50% overall marginal tax rate -- a 28% federal income tax rate, a 15% payroll tax rate, and additional state and city taxes. Each extra dollar of taxable earnings produces only 50 cents of extra money to spend. Anyone who considers whether to take a higher-paying but more demanding and more productive job must balance the extra income against the extra effort, stress, and risk that the job entails. A 50% marginal tax rate cuts the extra reward in half and discourages doing the more productive thing. When that happens, the individual and the nation both lose.

The high marginal tax rate also induces individuals to take more of their compensation in the form of fringe benefits and other untaxed perks. The employee might prefer to have \$100 in cash to spend on whatever he likes rather than the extra benefits, such as nicer working conditions or first-class travel, that an employer can buy for \$100. But since the \$100 in cash would shrink to just \$50 after tax, the employee's choice is shifted to fringe benefits and perks. When that happens, the individual and the nation lose again.

Economists call this the deadweight loss of a tax. Together with Daniel Feenberg, a colleague at the National Bureau of Economic Research, I have used a large publicly available sample of anonymous tax returns provided by the Treasury Department to estimate the effect of the Bush tax plan in this area. Our calculations show that the Bush plan would cut the deadweight loss of the income tax by more than \$600 billion over 10 years. That \$600 billion reduction of the deadweight loss makes taxpayers better off by just as much as an additional \$600 billion of spendable cash.

Taxpayers' responses to the lower marginal tax rates also make the true cost of reducing the marginal rate substantially smaller than the official estimates. Using the tax return data at the National Bureau of Economic Research, we estimate that, when the Bush tax cuts are fully phased in, the net revenue loss would be only about 65% of the officially estimated revenue loss, which does not allow for such changes in taxpayer behavior.

Our estimate implies that the revenue loss in 2010 that the Joint Committee on Taxation estimated as \$233 billion would actually be only about \$150 billion. The total revenue loss would be cut from the official estimate of \$1.6 trillion to only about \$1 trillion. Because of the timing of the tax cut and taxpayers' lags in responding to it, I think a safer estimate of the total 10-year revenue loss would be about \$1.2 trillion.

The Bush tax plan was designed to give an approximately equal percentage cut in taxes at each income level, but with relatively larger tax cuts at the bottom of the income distribution and somewhat smaller proportional cuts at the top. Those calculations ignore the taxpayer behavior that would increase taxable income and therefore tax payments substantially more in the top income brackets than in lower brackets. When that taxpayer behavior is taken into account, the fully phased-in income tax cuts significantly raise the share of taxes paid by taxpayers with incomes over \$400,000 (to 28.8% of the total, from 27.2% today) while cutting the share of taxes paid by those with incomes between \$20,000 and \$50,000 to 10.7% of total taxes, from 11.6% today.

In short, the Bush tax plan would strengthen incentives, reduce waste, and fit easily within the available budget surplus. It cannot be opposed with the argument that it favors the rich since high-income taxpayers would end up paying a larger share of total taxes.

But these virtues of the Bush plan and the more than \$400 billion increase in the projected budget surpluses since

the plan was first presented during the presidential campaign raise an obvious question: Why leave the top personal income tax rate at 33%? When that 33% is combined with the 2.9% Medicare payroll tax and the phase-out rules for itemized deductions, the total marginal tax rate would still be more than 36%, a major increase from the 28% top rate agreed to in 1986.

Why not cut the top personal rate back to the 28% that was set in bipartisan legislation back in 1986? Doing so would still leave a combined marginal tax rate of 32% (including the Medicare tax and the phase-out rules for itemized deductions), just short of the 33% that President Bush has said is the maximum acceptable amount for the government to take from taxpayers.

Cutting the top personal income tax rate to 28% from 33% would cut total revenue by very little. Even if changes in taxpayer behavior are ignored, the estimated cost of the tax plan would increase by only about 5%. The behavioral responses of taxpayers to the lower marginal tax rates would offset two-thirds of that estimated additional revenue loss. The net revenue cost of this significant rate cut would be only about \$4 billion in 2010 and less than \$30 billion over 10 years. One reason for this low cost is that many of those whose marginal tax rates are reduced would then face the alternative minimum tax, shrinking their tax savings but still leaving them with the 28% marginal rate of the alternative minimum tax. The top income groups would still pay a significantly increased share of total taxes.

The changes in behavior that would follow the lowering the top rate to 28% from 33% would cut the deadweight loss by about \$2 for every extra dollar of net revenue loss, \$60 billion in extra waste reduction over 10 years. Cutting the top marginal tax rate to 28% is a way of improving incentives and reducing waste with very little additional revenue loss. It is a small but important improvement in the Bush plan that would strengthen the tax system and the economy. And returning to the top rate agreed in the Tax Reform Act of 1986 might even renew taxpayers' faith in the credibility of congressional promises.

Mr. Feldstein is a professor of economics at Harvard. He was chairman of President Reagan's Council of Economic Advisers.

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