Two Bad Tax Cuts

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Contrary to what many conservatives will tell you, there is such a thing as a bad tax cut. Consider these: one from Republican Senator John Ashcroft of Missouri, the other from Democratic President Bill Clinton.

Ashcroft recently proposed that the federal government make Social Security taxes deductible from taxable income. Such a tax cut, he argues, would disproportionately benefit those earning $65,400 or less because Social Security taxes are levied on only the first $65,400 of a taxpayer's labor income. Furthermore, Ashcroft says the change 'would have absolutely no effect on the Social Security trust fund.' He's right, of course: Social Security taxes would be unchanged, and income tax payments would fall.

If that's all it did, Ashcroft's proposal would be okay because at least it would reduce the government's total tax take. But making Social Security taxes deductible would also lessen taxpayers' resistance to increases in payroll taxes. Over the past 30 years or so, Social Security taxes have climbed steadily, rising from 3.5% of GDP in 1964 to 6.7% in 1995. Over that same period, the total share of GDP grabbed by the federal government has been remarkably stable, varying between 18% and 20%. In short, Social Security has taken a rising share of federal tax revenues. Implementing Ashcroft's proposal would increase Social Security's share further.

There's a simpler idea that would give taxpayers close to the same tax cut: Reduce the Social Security tax rate by one percentage point. For all but the highest-income taxpayers, the marginal tax rate would fall by one percentage point, giving them a slightly higher incentive to earn income. More important, such an across-the-board cut in tax rates would not give the Social Security trust fund a favored position.

Clinton's bad idea is a $1,500 tax credit on tuition for the first two years of college--for every dollar in college tuition you paid up to $1,500, you would get a tax refund of one dollar. An unintended consequence of Clinton's plan is that it would make college students paying less than $1,500 in tuition unconcerned about tuition increases. (In 1994 the average tuition at community colleges was only $1,114.) The reason is that for every dollar of tuition increase, the student's or her family's tax liability would fall by one dollar; the federal government would bear the entire cost.

A more defensible approach would be to offer a tax deduction for college tuition (Clinton's proposal would offer this after the first two years), on the theory that college attendance is an investment and that, just as corporations can write off purchases of machinery against income, students should be allowed to do the same with their tuition.

The worst thing about bad tax cuts is that they crowd out the chance for implementing good ones. The big lesson tax economists learned from the tax changes of the 1980s is that high marginal tax rates affect behavior perversely and should therefore be avoided. Although most of the evidence that has led to this consensus is from the 1980s, the theoretical work showing the dangers of high marginal tax rates is from the early 1970s. Interestingly, a main contributor to this research was an adviser to the British Labour Party, Nobel laureate James A. Mirrlees. The top marginal tax rate, concluded Mirrlees, should be no more than about 20%. Moreover, he found the marginal tax rate should be that same 20% for everyone. In short, the optimal tax structure, said this left-wing economist, is a proportional tax, what we now call a flat tax.

While we may not get all the way to a flat tax, we certainly shouldn't move further away from it than we already are--which is what both the Ashcroft and Clinton tax credit proposals would do.