Two Good Reasons for a Tax Cut

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President Bush's proposed tax cut, though small, is a step in the right direction. To put the tax cut in perspective, over ten years it amounts to a cut of only about 1 percent of GDP. Compare that to Reagan's 1981 tax cut that cut taxes by almost 3 percent of GDP. And Reagan did so starting from a budget deficit rather than a surplus.

Unfortunately, Bush and some of his advisers are using a bad argument for a good policy. The reason to cut taxes early, they say, is that the economy is slowing and tax cuts will cause people to spend more. That's a pure "demand-side" argument, the kind that former President Reagan and his advisers rightly dismissed when they advocated the 1981 tax cut. Decades of evidence have shown that the main factor that increases spending is growth in the money supply. If any policy should be used to affect the growth rate of spending, it should be monetary policy.

But we should cut taxes and even more than Bush advocates. Moreover, taxes should be cut independent of the current growth of the economy.

There are two main reasons for cutting taxes. First, the current tax system badly mauls incentives. Take people in the top (39.6 percent) tax bracket. In 1997, these people were only 0.7 percent of taxpayers, but they paid 26 percent of all income taxes. High tax rates cause them to earn less taxable income, not just by working fewer hours but also by taking more pay in fringe benefits and investing in tax-free municipal bonds. The across-the-board cuts in tax rates that Bush proposes would increase everyone's incentive to earn taxable income. When the tax cut is fully implemented, high-bracket taxpayers, for example, will be in the 33 percent bracket. Thus, their after-tax gain from an additional dollar of income rises from 60.4 cents to 67 cents, an 11 percent increase. This was the "supply-side" case made by Ronald Reagan and his advisers when they cut tax rates.

Similarly, cuts in the 15 percent and 28 percent tax rates would increase incentives of lower- and middle-income earners to earn taxable income. This boosts the economy long term and makes tax revenue higher than otherwise. With this feedback effect of the Bush tax cut added in, estimates Harvard University's Martin Feldstein, the feds would lose, not the oft-cited $1.6 trillion but, rather, $1.2 trillion, or less than 25 percent of the anticipated budget surplus.

Some critics of the Bush tax cut claim that it does nothing for lower-income people. But it does cut taxes of everyone who pays federal income taxes. Simple truth: you can't reduce taxes for people paying no taxes.

Which brings me to the more important reason to cut taxes: those taxes are our money, meaning the money of the people who paid them. If the government keeps the revenue, it will pay down some debt but spend the rest, as it did in the last Congress. We the people need to restrain Congress and the president from spending our money.