There’s a Lot to Like About Bush’s Tax Plan

By Robert J. Barro

Frankly, I have not been a fan of all of the economic policies of the Bush Administration. But the tax plan is excellent, the best proposal we’ve seen since 1986. At that time, President Ronald Reagan continued the work of the 1981 tax cuts by implementing a major reduction in marginal income-tax rates. This tax policy helped to sustain a 17-year economic boom from 1983 to 2000 (aside from the mild recession of 1990-91). Given the current economy, it makes sense to repeat Reagan’s success by making our tax system friendlier toward investment and work, which the Bush proposal does.

The two key elements are the dividend tax exclusion and the acceleration of the cuts in marginal rates. The first will lessen the double taxation of income on capital and will, thereby, spur investment. The second will encourage work and productivity. It will also eliminate the adverse effects from the promised phase-in of the income-tax rate cuts, which encourages people to defer income until the lower rates occur.

The Administration has also proposed two new forms of tax-favored savings accounts, a lifetime account and a retirement account. Fact is, the current law is a confusion of tax-favored plans, involving an array of limitations on contributions, incomes, and withdrawals. The new plans add to the jumble. What we need is a simple system that leaves income on assets fully untaxed. I appreciate that the new savings proposals are intended to simplify and to move toward that goal. But I would have preferred that the Administration articulated this to the public and then proposed a straightforward plan for achieving this objective.

One common complaint is that the tax cuts will create federal deficits that will raise interest rates and impose other economic costs. It’s hard to understand these arguments either from economic theory or history. According to theory, the predicted effects on interest rates would be small and of uncertain direction. That seems right empirically. In the 1980s, when deficits soared, nominal interest rates came down sharply along with inflation. Real interest rates fluctuated in a way unrelated to deficits and debt levels. The best measures of real rates come from the Treasury’s inflation-protected bonds. The rates on 10-year bonds were above 4% when the budget surplus was at its peak in 2000, then fell sharply to 2.1% today, as the surplus turned into deficit. There’s no evidence that budget gaps raise interest rates.

One attraction of tax cuts and deficits is that they starve the government of revenue and thereby promote spending restraint. This worked particularly well in the 1980s. The Reagan tax reductions were a proclamation that the growth in the government had to stop—and, with something of a lag, that happened from the mid-1980s through the 1990s. Only recently, when the high-tech boom led to soaring revenues and a budget surplus, did the restraint disappear and spending resume its upward trend. So, this gives us another reason to like deficits.

Whereas the main point of the Bush plan is to make the tax system more efficient and spur economic growth, the main complaints have been that it gives too much to the rich. Since the rich pay most of the income taxes, it is hard to see how we can have a substantial tax reduction that does not go mostly to the rich. For instance, in 2000, the top 5% of adjusted gross income accounted for 56% of the income taxes, whereas the bottom 50% paid only 4%. One reason the poor pay so little is the vast expansion of the earned-income tax credit, which lowered the taxes of the working poor.

The difference in tax payments between the rich and the poor is much more than one would expect from the differences in their income. According to U.S. Census Bureau figures on family income in 2000, vs. 13% for the bottom 50%. Internal Revenue Service figures on adjusted gross incomes (which differ from the Census numbers by including capital gains and excluding cash transfers) show more of a spread—the top 5% got 35% of the total in 2000, and the bottom 50% got 13%. An accurate picture would be somewhere between the two sets of figures. Still, both sources demonstrate to us that the income tax is proportionately a much greater burden on the wealthy.

I do not see massive redistribution of income as a reasonable part of the government’s business. Despite the financial practices of Enron Corp., most people’s income comes from their skill and effort (or, through inheritance, from the skill and effort of their parents). People deserve to keep most of what they have produced and earned, after sharing reasonably in the tax burden for financing a limited government. I find nothing fair in people paying income-tax rates above 40% (which is the true number today at high incomes). Thus, for me, fairness complements efficiency in arguing for the wisdom of the Bush tax plan.

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28 BusinessWeek / February 24, 2003