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Periodic Tax Cuts a Necessary Companion to a Progressive Income Tax Code

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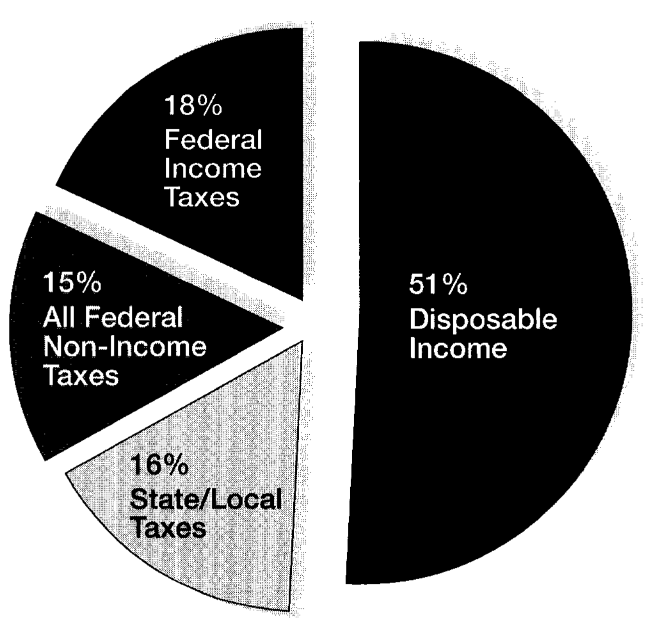
George W. Bush is currently locked in a serious debate with members of Congress over how much of the projected $5.6 trillion in budget surpluses should be given back to American taxpayers and what form those tax cuts should take. President Bush and a growing number in Congress argue that the government's ballooning budget surpluses justify an across-the-board reduction in marginal tax rates. Others in Congress, however, argue that these surpluses should be used to deliver "targeted" tax cuts to specific groups of taxpayers such as those deemed to be "middle-class."

Figure 1
Since 1992, Nearly Half of All New Personal Income Growth Has Gone To Pay Taxes



Source: Tax Foundation, Bureau of Economic Analysis

While targeted tax cuts would certainly be a boon to a select group of taxpayers, such cuts would add unnecessary complexity to an already complicated tax code. More importantly, however, targeted tax cuts would not fix a more serious problem in the tax code — real income growth is combining with the code's progressive rate structure to make tax collections grow at a faster rate than taxpayers' incomes.

This fact was not lost on Federal Reserve Chairman Alan Greenspan during his recent testimony before the Senate Budget Committee:

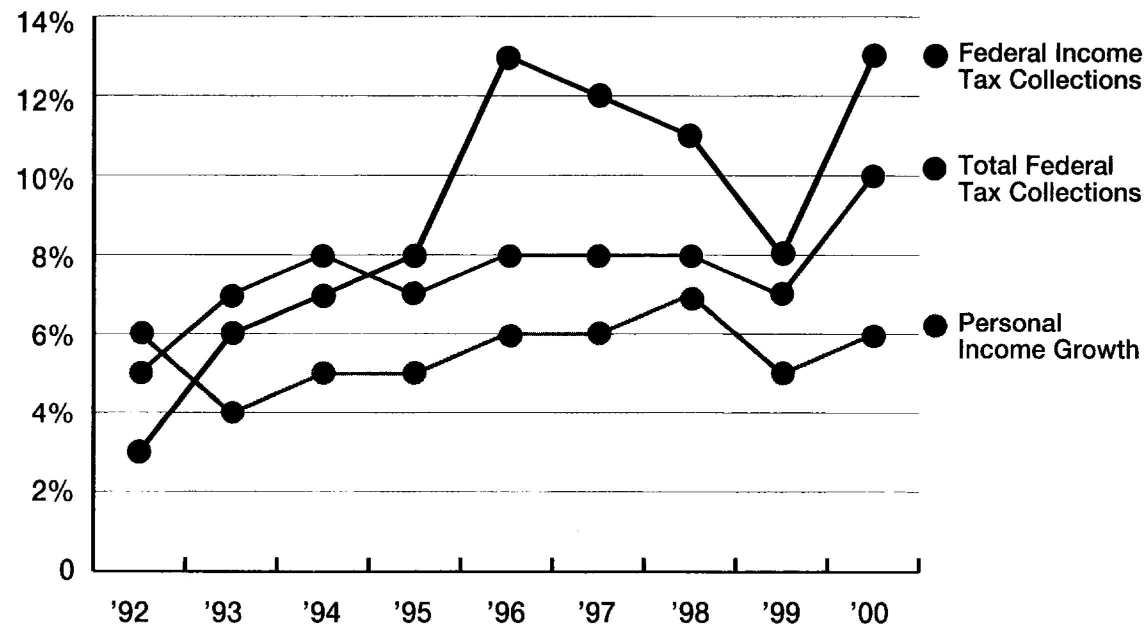
> [T]he experience of the past five to seven years has been truly without recent precedent. The doubling of the growth rate of output per hour has caused individual's real taxable income to grow nearly two and one-half times as fast as it did over the preceding ten years and resulted in the substantial surplus of receipts over outlays that we are now experiencing.

Recently released statistics from the Bureau of Economic Analysis show that while the nation's economic performance over the past eight years has been an enormous benefit to working Americans, it has been equally beneficial to government coffers. Since 1992, total personal income has grown by more than $2.8 trillion. However, as shown in Figure 1, nearly half of all of this new wealth went to taxes at the federal, state, and local levels. The largest share of this new income (18 percent) went to federal income taxes, while state and local taxes took 16 percent and all other federal taxes — including payroll taxes — took 15 percent.

The fact that income taxes took the largest share of this new income is a direct result of the progressive nature of the U.S. tax system. In short, "progressive" means that the more you earn, the higher the percentage of your income that you pay in taxes. To many Americans, this However, the progressivity in the tax code is most evident in the growth rate of income tax collections.

Over the past eight years, income tax collections have grown by an average of 9.1 percent per year, 64 percent faster than the

Figure 2
Growth Rate of Federal Tax Collections Outstrips Personal Income Growth



Source: Tax Foundation, Bureau of Economic Analysis

seems fair as a general proposition, but those same people may not consider it fair that when Americans raise their incomes, government takes the lion's share.

Our recently booming economy has proven that the federal government does exactly that. Americans' incomes are way up, but the federal government got as much of the boom as taxpayers. More and more "middle-class" taxpayers have been pushed into higher tax brackets, resulting in a flood of new tax revenue into the federal Treasury.

Figure 2 compares the growth rates of personal income and federal tax collections since 1992. Since then, total personal income has grown on average by 5.6 percent per year. By contrast, total federal tax collections have grown by an average of 7.6 percent per year, 40 percent faster than the rate of personal income growth.

growth rate of personal income. Put in dollar terms, the magnitude of tax collections above and beyond the growth of personal income is quite large. Had, for example, the growth rate of income tax collections been held to the same growth rate of personal income since 1992, taxpayers would have saved $950 billion in taxes during the period.

Targeted tax cuts can be crafted in a way that returns considerable tax relief to selected groups of taxpayers. But no amount of targeted tax relief can overcome the inevitable effect that the progressive tax code has on working Americans as they become more productive and their earnings grow. Any nation with a progressive tax code and an expanding economy must either enact periodic tax rate cuts or accept the fact that its government will collect an ever-increasing fraction of the nation's income.

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