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THE IMPACT OF LOOMING TAX INCREASES

23 September 2010

With a huge tax increase scheduled to begin in January, the debate has been turned upside down, distorting the picture of what is at stake – especially in light of the unprecedented deficits burdening the Federal budget. The way the subject is framed has created a bias toward higher taxes, and has clouded the critical issue of how to maintain a climate favoring needed economic and job growth.

To understand the subject properly, the following points are critical:

- *Higher Taxes Stifle Growth.* Higher tax rates will further damage a weak economy. Tax increases not only drain economic resources, but also stifle incentives to greater productivity and investment. The scheduled January tax increases could reduce employment growth by as many as 1.2 million jobs, based on Congressional Budget Office estimates.

- *Tax Hikes Cannot Catch the President's Spending.* Spending in the President's budget surges to record levels, and by decade's end will consume more than one-fourth of total U.S. economic resources. The pace of spending is so rapid that even raising taxes nearly $4 trillion over the next 10 years would not catch up.

- *Tax Relief Did Not Cause Today's Deficits.* With the full 2001/2003 tax relief provisions implemented, Federal revenue rose to 18.5 percent of gross domestic product in fiscal year 2007, well above the 50-year historical average of 18 percent. Revenue plunged after that because of a financial crisis and a deep recession, *not because of tax relief.*

- *The Tax Debate Is Upside-Down.* Baseline budgeting gives the false impression that simply *keeping tax rates the same as they are today* is somehow a *new tax cut* that will increase deficits and must be "paid for." It is nonsensical to make taxpayers "pay for" simply avoiding a tax increase.

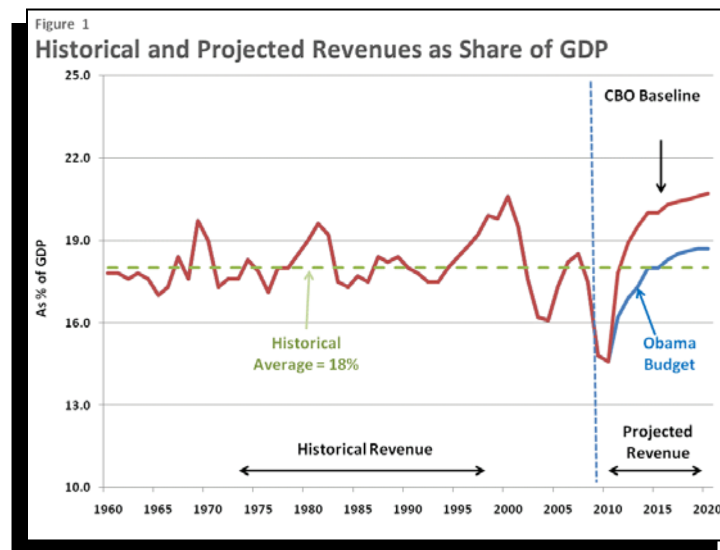
- *Tax Burdens Already Are Skewed Toward Upper Incomes.* Limiting tax increases to "the rich," as the President and the Democratic Leadership in Congress propose, will create additional barriers to job-creating investments, and will further distort the distribution of U.S. tax burdens, in which those earning in the top 10 percent of income pay more than 70 percent of Federal income taxes. In addition, complaints about current tax laws providing "tax cuts for the rich" ignore the impact raising the top tax rates will have on small businesses, the most vigorous job producers in the country.

TAX HIKES AND THE ECONOMY

Heavy government borrowing and debt due to large chronic budget deficits stifle the economy by draining resources that would otherwise be available for growth-producing private-sector investments. But raising taxes and tax rates poses economic burdens of its own, in at least three ways: by directly absorbing resources from the economy; by creating disincentives for greater productivity; and by causing taxpayers to divert resources to less productive uses.

Higher Tax Burdens

Under the tax policies in the baseline projections of the Congressional Budget Office [CBO] – which assume, among other things, that all the tax provisions enacted in 2001 and 2003 expire at the end of this year, and the alternative minimum tax [AMT] is no longer indexed – Federal taxes will reach 20.1 percent of gross domestic product [GDP] in 2014, and will continue growing from there, hitting 21 percent of GDP in 2020[1] (see Figure 1). In the President's budget, which raises the top two income tax rates, tax revenue reaches 19 percent of GDP in 2014 and rises to 19.6 percent in 2020.[2] (When other tax increases proposed by the President are included, effective tax rates on incomes, dividends, and capital gains rise significantly. See Appendix 2.)



Both trajectories are markedly above historical revenue levels. Over the past 50 years, Federal revenue has averaged 18 percent of GDP[3] (Figure 1). Since World War II, revenue has exceeded 20 percent of GDP only once, in 2000. It has reached or exceeded 19 percent of GDP only four times: in 1952, 1969-70, 1980-82, and 1997 through 2001 (following the tax rate reductions

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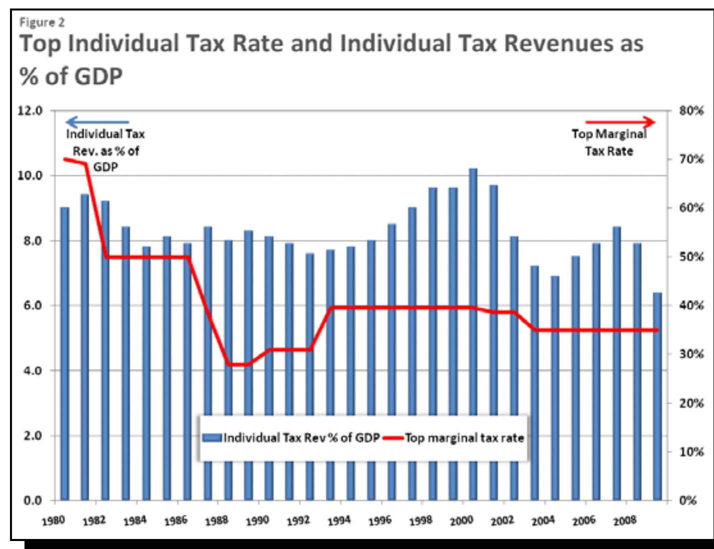
[1] Congressional Budget Office: *The Budget and Economic Outlook: An Update*, August 2010.

[2] Congressional Budget Office: *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011*, March 2010.

[3] Office of Management and Budget: *The Budget of the U.S. Government – Fiscal Year 2011*, Historical Tables.

enacted as part of the 1997 balanced budget agreement).[4] There is no way to predict the effect on the economy of sustained Federal tax burdens at those levels.

The administration wants to raise the top two individual tax rates to capture more tax revenue for the government's coffers. Yet the historical data clearly show that tax revenue is not necessarily correlated with tax *rates*. Instead, government tax revenue is highly correlated with economic growth. Over the past 50 years, the top individual tax rate in the U.S. has ranged from a high of 91 percent to a low of 28 percent, but individual tax revenue has remained remarkably steady, moving more in tandem with economic growth than these tax rate shifts. For instance, during the 1980s, while the top marginal tax rate was reduced from roughly 70 percent to 30 percent, individual tax revenues remained fairly constant as a share of the economy. In the latter part of the 1990s, the top marginal tax rate stayed constant, yet individual tax revenue reached a record high in response to robust rates of GDP growth. Revenue as a percent of GDP has tended to fall as a result of recessions. (See Figure 2.)



The lesson is that the path to higher revenue levels is through robust economic growth, not by raising tax rates. Strong economic growth is predicated on a moderate tax burden, with tax rates that support, rather than discourage, work, saving, and investment. The plan to raise the top two income tax rates would dampen incentives for individuals to work more, or for small businesses to invest and expand. This, in turn, would lower economic growth relative to what it would otherwise be, thereby partially offsetting the increase in revenues which is presumed to result from higher rates.

Stifling Job Creation

The tax rate increases scheduled to take effect in 2011, along with the expansion of the AMT, would undoubtedly slow the economy and impede job growth.

[4] Office of Management and Budget: *Historical Tables: Budget of the U.S. Government – Fiscal Year 2011*, February 2010.

According to CBO, the tax hikes will trim GDP growth by roughly 1 percentage point next year. In an economy of more than $14 trillion, that translates into $237 billion in lost income to American families, workers, and businesses. Without those tax increases, CBO estimates the unemployment rate would be as much as 0.8 percentage points lower by late 2011.[5] Given that the U.S. labor force is more than 153 million, the difference between a 9.0-percent unemployment rate (as CBO projects for 2011) and an 8.2-percent rate is roughly 1.2 million jobs.

But even the President's more limited tax increases will create barriers to investments in business expansion and job creation – because they will reach successful, job-producing small businesses, which pay their taxes at the top individual tax rates. "Obama's proposal to increase taxes on personal incomes exceeding $250,000 ($200,000 for singles) is the latest example of his delusional approach," writes columnist Robert J. Samuelson. "It satisfies the liberal itch to 'get the rich.'"[6]

Those tax hikes on the supposedly wealthy will hit directly at the most vigorous job-creators in the country. More than half of all private-sector jobs (50 million to 60 million people) are provided by companies with fewer than 500 employees each, which also generate about two-thirds of the net new jobs over time. Roughly 75 percent of these small businesses are organized as so-called "pass-through entities" – limited partnerships, S corporations, and the like – whose income and expenses are passed through to their principal owners and shareholders.

Treasury Secretary Geithner has sought to dismiss the effects on business expansion and job creation, saying that raising only the top two income tax rates would "only impact 2 to 3 percent of small-business owners across the country" and hence would not have "a negative impact on growth."[7]

But those businesses generate the lion's share of small-business profits and hire the most workers. "Some of these are partnerships of doctors, lawyers, and accountants," writes Samuelson. "Others are contractors, restaurant owners, florists, and plumbers."[8] The most economically meaningful questions are: 1) what share of pass-through business income will be affected by raising the top two income tax rates; and 2) how many jobs are actually supported by those entities.

On the first point, pass-through business income is heavily concentrated in the top two tax rates. According to the Joint Committee on Taxation, these tax increases will affect roughly 50 percent of all pass-through business income.[9] More important, estimates suggest that these successful small businesses in turn support roughly 20 million to 30 million American jobs. In other words, the planned tax increase next year will negatively affect the economy in general and job growth in particular.

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[5] Congressional Budget Office: *The Budget and Economic Outlook: An Update*, August 2010.

[6] Robert J. Samuelson: "The Ritual of Sound-Bite Economics," *The Washington Post*, 20 September 2010.

[7] Interview on ABC's *This Week*, 25 July 2010:
http://abcnews.go.com/ThisWeek/week-transcript-geithner/story?id=11245464.

[8] Samuelson, op. cit.

[9] Senate Finance Committee, Republican Staff: "Questions and answers on the effect of tax increases on small businesses proposed by the President and Congressional Democratic Leadership," 26 July 2010.

That is why roughly 300 economists have signed a letter to the Democratic Leadership in Congress urging them not to raise any taxes next year. The letter notes that small businesses would be affected by the plan to increase the top two income tax rates, which would "threaten to undermine an economy still suffering from 9.6 percent unemployment and anemic growth." The letter goes on to say that "if Congress allows heavier taxes on work and investment, we will undoubtedly see less of both at a time they are needed most."[10]

The President's tax policies are especially misguided now, when the recovery is still fragile and not yet self-sustaining. Most economists agree the economy needs to transition from growth based on debt-financed consumption to growth led by investment. Indeed, earlier this year Treasury Secretary Geithner joined the chorus of private economists emphasizing the need to shift "to a recovery led by private investment."[11] Yet the administration is pursuing policies that will dampen this much-needed private investment.

The Treasury's own 2007 study on taxes and competitiveness says: "[T]he [empirical] evidence consistently indicates that higher marginal tax rates on individual income discourage small business from expanding." The Treasury report goes on to cite a number of academic studies showing that higher individual tax rates discourage small businesses from hiring workers and making investments.[12]

Higher tax rates also cause people to divert resources to less productive uses, attempting to shelter some income from taxes. This results in what is known as *excess burden* or *deadweight loss* of taxes. "Taxes distort choices and steer resources away from their best and highest use based purely on economic merit. When decisions are, in part, made for tax reasons, economic resources are wasted."[13] This also causes the tax base to shrink, meaning the government collects less in tax revenue than anticipated.

TAX HIKES CANNOT CATCH THE PRESIDENT'S SPENDING

The tax debate is driven by Federal spending. Spending is the principal means by which government implements its policies. It is the reason government taxes and borrows, and hence is the root of fiscal policy. Spending also is the best measure of the size and scope of government, because all government spending gets paid for, through either taxes or borrowing – and both are burdens on the economy.

Spending in the President's budget remains well above the historical average (about 20.3 percent of GDP), and by decade's end will consume more than one-fourth of total U.S. economic resources (see Appendix 1).

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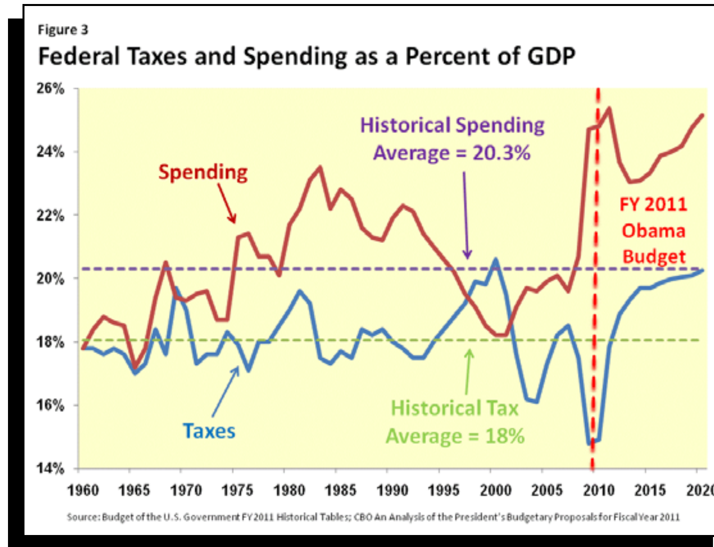
[10] "GOP, economists to urge continuation of all Bush tax cuts," *The Hill*, 22 September 2010: http://thehill.com/blogs/on-the-money/domestic-taxes/120197-gop-economists-to-urge-continuation-of-all-bush-tax-cuts

[11] "Private sector must drive economy: Geithner," *Market Watch*, 25 July 2010: http://www.marketwatch.com/story/us-economy-seeing-gradual-recovery-geithner-2010-07-24.

[12] Department of the Treasury: *Treasury Conference on Business Taxation and Global Competitiveness*, July 2007.

[13] Robert J. Carroll, *Towards Understanding the Full Burden of High Tax Rates*, the Tax Foundation Fiscal Fact No. 186, August 2009.

His budget chases this rapid spending growth with tax increases totaling $1.1 trillion over the next 10 years – including roughly $700 billion from raising the top two income tax rates.[14] But the President's spending continues to outrun even these hefty tax hikes, producing unsustainable deficits that never fall below $724 billion, or 4.1 percent of GDP (see Figure 3). In 2020, the deficit under the President's budget is nearly $1.3 trillion, 5.6 percent of GDP, and debt held by the public will have risen to 90 percent of GDP.[15]



Even much larger tax increases would not keep pace with the President's spending. CBO's projections, which reflect a range of tax hikes scheduled to take effect under current law, incorporate tax increases of about $3.9 trillion over the next 10 years. Starting in 2014, total Federal tax revenue would permanently exceed 20 percent of GDP – a level it has never held for more than 1 year at a time since World War II. Yet revenue would still fall short of the President's spending proposals by a total of about $7 trillion over the next 10 years.[16]

TAX RELIEF DID NOT CAUSE TODAY'S DEFICITS

Proponents of tax increases have encouraged the fallacy that tax relief punched a huge hole in the Federal budget, and therefore taxes should be raised to help "correct" the resulting deficits. The facts dispute this view.

With full tax relief implemented, revenue rose to 18.5 percent of GDP in fiscal year 2007, well above the 50-year historical average of 18 percent. That year, the Federal Government ran a "primary" budget surplus (based on spending excluding interest) and a unified deficit of $161

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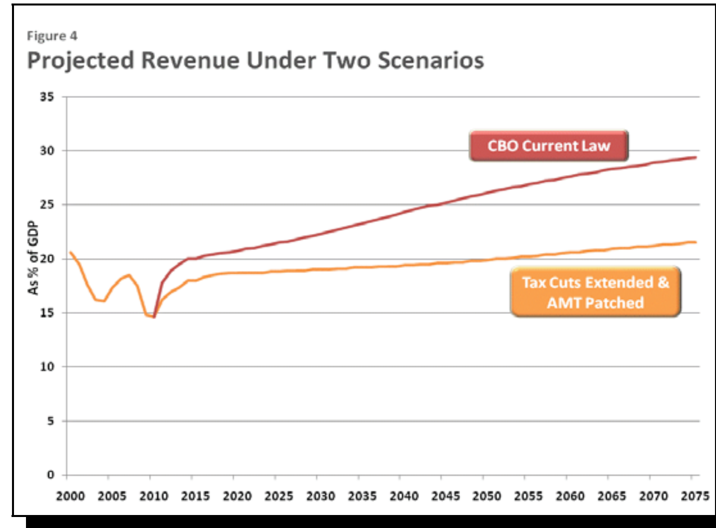
[14] Calculations based on Office of Management and Budget: *The Budget of the U.S. Government – Fiscal Year 2011*, Table S-8.

[15] Congressional Budget Office: *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011*, March 2010.

[16] Congressional Budget Office: *The Budget and Economic Outlook: An Update*, August 2010.

billion, or 1.2 percent of GDP. Revenue plunged after 2007 due to a financial crisis and a deep recession, not because of the 2001/2003 tax relief. By comparison, today's deficit is estimated at $1.3 trillion, or 9.1 percent of GDP, and the President has called on the Fiscal Commission to make recommendations yielding a primary surplus by 2015; and the President's tax increases, which drives revenue above 19 percent of GDP, still leaves deficits exceeding 4 percent of GDP every year.



Nor would extending today's rates lose revenue and starve the government. If current tax rates were maintained for the next decade, and the AMT were indexed for inflation, tax revenue as a share of the economy would grow consistently, reaching 18.7 percent of GDP by 2019 (see Figure 4). That too is greater than the past 50 year's average; and tax revenue will continue drifting upward thereafter, reaching 20 percent of GDP by mid-century, well above the U.S. historical average.

'PAYING FOR' FALSELY LABELED 'TAX CUTS'

The current tax debate has been muddled by the eccentricities of congressional budgeting, giving the false impression that simply keeping tax rates the same as they are today is somehow a *new tax cut* that increases deficits. The President and Democratic Leadership in Congress have exploited the confusion to argue that these "tax cuts" must be "paid for" to prevent them from increasing deficits – and then have applied this reasoning only where convenient. There are two basic problems with this argument.

First, the entire notion of taxpayers having to pay simply *for avoiding a tax increase* is flawed. All government spending is paid for, either by tax collections today or through additional debt, which represents a claim on future tax collections. As noted earlier, it is government *spending* that must be paid for, and the financing will come from taxpayers one way or the other.

Second, the President and Democratic Leadership rigorously apply their pay-as-you-go [pay-go] discipline only where it serves their interest. The President's budget and the pay-go rules apply only to the top two income tax rates – supporting his "soak the rich" rhetoric – dismissing more than 80 percent of the impact of extending all the 2001 and 2003 provisions. Put another way, the President wants to contend that extending the top two rates increases deficits by $700 billion, but

at the same time ignore the $3.2-trillion deficit increase that – by his own logic – results from extending the “middle-class” provisions he favors. He cannot have it both ways.

In fact, projecting revenue based on simply maintaining today’s tax rates shows a more important truth: *spending will grow $10.6 trillion faster over the next 10 years than the revenue that would be generated from keeping today’s tax policies in place.*[17]

UNBALANCED TAX BURDENS

In any case, the frequent charge that current laws provide “tax breaks for the rich” rests on a faulty view of how taxes work.[18] Rate reductions create a strong incentive for taxpayers to *earn income* – and the more they earn, the more they benefit.

But U.S. tax burdens already are heavily skewed toward higher incomes, and became more so after enactment of the 2001 and 2003 tax laws. Cross-country data show that upper-income individuals in the U.S. pay the highest share of total taxes among all countries in the Organisation for Economic Co-operation and Development.

A 2009 CBO analysis showed that in 2006 (the latest year for which data were available) nearly 70 percent of total Federal tax burdens were borne by those with incomes in the highest 20 percent of the income range (termed the highest “quintile”), compared with just 16.5 percent for the second-highest quintile, and 9.1 percent for those in the middle quintile (see Table 1). More than half the total tax burden fell to the top 10 percent of income earners, and more than a fourth to just the top 1 percent of earners.

Table 1: Percent Distribution of Total Federal Tax Burden, by Income Group, 2006

Lowest Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Highest Quintile	Top 10 Percent	Top 5 Percent	Top 1 Percent
0.8	4.1	9.1	16.5	69.3	55.4	44.7	28.3

Source: Congressional Budget Office.

Table 2: Percent Distribution of Individual Income Tax Burden by Income Group, 2007

Bottom 50 Percent	Top 50 Percent	Top 25 Percent	Top 10 Percent	Top 5 Percent	Top 1 Percent
2.9	97.1	86.6	71.2	60.6	40.4

Source: Internal Revenue Service

The imbalance in the tax distribution is even more pronounced when only income taxes are considered (see Table 2). The top 1 percent of taxpayers in the U.S. – those with adjusted gross incomes exceeding $410,000 – paid more than 40 percent of all individual income taxes in 2007 (the latest year for which data are available). That is the “highest percentage in modern history,”

[17] Calculations based on Office of Management and Budget: *The Budget of the U.S. Government – Fiscal Year 2011*, Table S-7.

[18] Some also use this complaint to justify expanding refundable tax credits, which they then term “tax cuts.” But refundable credits are *spending*, and both the President’s budget and CBO present them as such.

according to the Tax Foundation.[19] The share of total income taxes paid by this income group has *doubled* over the past 25 years. The top 5 percent of taxpayers paid 60.6 percent of income taxes in 2007, while the other 95 percent of taxpayers paid 39.4 percent.

This means that the share of income taxes paid by the top 1 percent now exceeds the share being paid by the bottom 95 percent of all taxpayers. In other words, the 1.4 million taxpayers at the upper end of the income scale are paying a greater share of the tax burden than the bottom 134 million taxpayers, according to the Tax Foundation.[20] The top 50 percent of taxpayers now account for nearly all (i.e. more than 97 percent) of income taxes paid, while the bottom half of all taxpayers pay less than 3 percent of all income taxes.

CONCLUSION

The President and Democratic Congress have driven spending to record levels, resulting in unprecedented deficits and pressure for higher taxes. But getting deficits and debt under control will require economic growth, a focus on *spending*, a fundamental restructuring of government programs, and a *sustained* commitment to fiscal control.

The heavy borrowing advanced by the President and Democrats controlling Congress, to support a huge surge in spending, pushes deficits to unsustainable levels exceeding 4 percent of GDP every year. This will sap U.S. savings and investment, impeding sustained economic growth. But the alternative of large tax increases to catch up even part way to the President's spending levels also has damaging economic consequences. It will directly absorb resources that otherwise would be available to the private sector for growth-producing activities; it will discourage greater productivity and sap job growth; and it will cause taxpayers to divert resources to less productive uses. All these effects will burden both near- and long-term growth, threatening Americans' jobs, prosperity, and standards of living for both current and future generations.

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[19] Scott A. Hodge: "Tax Burden of Top 1% Now Exceeds That of Bottom 95%," Tax Foundation Tax Policy Blog, 29 July 2009: http://www.taxfoundation.org/blog/show/24944.html.

[20] Ibid.

This document is a product of the Republican staff of the Committee on the Budget, U.S. House of Representatives. It has not been approved by the ful committee and may not reflect the views of individual committee members.

APPENDIX 1
SPENDING COMPARISONS: THE PRESIDENT'S BUDGET AND THE CONGRESSIONAL BUDGET OFFICE BASELINE

Total Federal spending, which averaged 20.3 percent of gross domestic product [GDP] over the past 50 years,[21] will remain at record levels throughout the next decade under the President's budget. The President's spending will swell to 25.4 percent of GDP next year, then dip slightly to a low of 23 percent in 2013, and then begin rising again, reaching 25.2 percent in 2020.[22]

All these sums far exceed the annual average of the past half-century, and are greater each year than the Congressional Budget Office baseline spending projection.[23]

Table A-1: Spending in the President's Budget
(in percentages of gross domestic product)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Non-Interest Spending	23.7	21.8	20.8	20.6	20.5	20.7	20.6	20.6	20.9	21.1
Debt Service	1.6	1.9	2.2	2.5	2.8	3.1	3.4	3.6	3.8	4.1
Total Spending	25.4	23.7	23.0	23.1	23.3	23.9	24.0	24.2	24.8	25.2

Congressional Budget Office. Figures may not add due to rounding.

Table A-2: Congressional Budget Office Baseline Spending Projection
(in percentages of gross domestic product)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Non-Interest Spending	23.1	21.3	20.6	20.2	20.1	20.5	20.4	20.2	20.4	20.6
Debt Service	1.5	1.6	2.0	2.3	2.6	2.9	3.1	3.2	3.3	3.4
Total Spending	24.5	23.0	22.5	22.5	22.8	23.4	23.4	23.4	23.8	23.9

Congressional Budget Office. Figures may not add due to rounding.

[21] Office of Management and Budget: *The Budget of the U.S. Government – Fiscal Year 2011*, Historical Tables.

[22] Congressional Budget Office: *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011*, March 2010.

[23] Congressional Budget Office: *The Budget and Economic Outlook: An Update*, August 2010.

APPENDIX 2
EFFECTIVE TAX RATES
UNDER THE PRESIDENT'S BUDGET PROPOSALS

The President's tax proposals are more extensive than simply raising the top two income tax rates.

- The top capital gains tax rate also would rise from 15 percent to 20 percent, and dividends would lose their current 15-percent tax rate and become taxable as ordinary income, with a top rate of 39.6 percent (see Table A-3).

- In addition, the recently enacted health care legislation contains myriad tax increases that will come on line in 2013. For instance, the top income earners will pay a higher Medicare tax on their wages and salaries – effectively a boost to their marginal rate (see Table A-3) – and will be dealt an entirely new 3.8-percent tax on their investment income (Table A-4).

Taken together, administration policies will push the effective top income tax rate (and potentially the dividend tax rate as well) to roughly 45 percent, and the top capital gains rate to about 24 percent (Table A-5).

Table A-3: Effective Top Income Tax Rates Under Administration Proposals

Policy	Resulting Effective Tax Rate
Calendar Year 2010	
Top Statutory Income Tax Rate	35%
Calendar Year 2011	
Proposed Tax Rate Increase	39.6%
Reinstatement of PEP/Pease Provisions	41.6%
Net 2.3-Percent Medicare Tax on Wages and Salaries	43.9%
Calendar Year 2013	
Non-Deductible Medicare Tax of 0.9 Percent	44.8%

Table A-4: Effective Dividends Tax Rates Under Administration Proposals

Policy	Resulting Effective Tax Rate
Calendar Year 2010	
Top Statutory Rate	15%
Calendar Year 2011	
Tax Dividends at Ordinary Income Tax Rate	39.6%
Reinstatement of PEP/Pease Provisions	41.6%
Calendar Year 2013	
New 3.8-Percent Tax on Investment Income	45.4%

Table A-5: Effective Capital Gains Tax Rates Under Administration Proposals

Policy	Resulting Effective Tax Rate
Calendar Year 2010	
Top Statutory Rate	15%
Calendar Year 2011	
Proposed Tax Rate Increase	20.0%
Calendar Year 2013	
New 3.8-Percent Tax on Investment Income	23.8%

Links to Other Documents on the Tax Debate

William W. Beach, Rea S. Hederman Jr., John R. Ligon, Guinevere Nell, and Karen A. Campbell: *Obama Tax Hikes: The Economic and Fiscal Effects*, a Report of the Heritage Center for Data Analysis, the eritage Foundation, 20 September 2010: http://thf_media.s3.amazonaws.com/2010/pdf/CDA10-07.pdf.

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Committee on Ways and Means Republicans: *Democrats' Ticking Tax Bomb, Part V (Small Businesses)*, 23 August 2010: http://republicans.waysandmeans.house.gov/News/DocumentSingle.aspx?DocumentID=203752

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Brian M. Riedl: *The Three Biggest Myths About Tax Cuts and the Budget Deficit*, a Heritage Foundation Backgrounder, 21 June 2010: http://www.heritage.org/research/reports/2010/06/the-three-biggest-myths-about-tax-cuts-and-the-budget-deficit

Small Business Administration: Frequently Asked Questions, Updated September 2009: http://www.sba.gov/advo/stats/sbfaq.pdf.