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Obama Budget's Tax Proposals: Wrong and Risky

J. D. Foster, Ph.D.

President Obama's budget outlines sweeping changes for federal tax policy. A few of these changes are good policy that ought to be accepted by Congress. However, the net effect of these radical tax policies would be devastating tax increases and a permanently weaker economy.

These policy proposals would be wrong-headed under any conditions, but to suggest them as the domestic economy is contracting as part of the Global Great Recession at best signals an extraordinary indifference to current conditions.

In total, over 10 years President Obama proposes $593 billion in tax relief and $1,961 billion in gross tax increases for a net tax increase of $1,368 billion.[1]

Raising Taxes, Manipulating the Economy. The budget envisions the enactment of a cap-and-trade policy effective by 2012 to address climate concerns. As portrayed in the budget, this policy raises about $80 billion a year through 2019. However, the footnote to the table indicates that significant additional amounts are expected to be raised as the policy is further defined.[2]

While raising income taxes generally, the Obama budget would also significantly shift the distribution of the tax burden. It proposes to raise taxes very significantly on upper-income families and small businesses by raising income tax rates, increasing tax rates on dividends and capital gains, preserving the death tax at onerous levels, restoring the previous phase-outs of the itemized deduction and personal exemptions, and creating a new cap on the rate at which individuals could deduct itemized deductions.

While raising taxes at one end of the income scale—where the great preponderance of the tax burden already falls—the Obama budget suggests a number of provisions to further reduce the modest levels of tax paid by individuals and families at the other end of the scale. In addition, the Obama budget proposes to increase the amount of welfare payments directed to low-income individuals and families through the tax code by over $326 billion over 10 years.[3]

The Obama budget includes few beneficial tax provisions among its many harmful proposals. For example, it includes a small but notable proposal to eliminate entirely the capital gains tax on small businesses. This provision would make it easier for prospering small businesses to raise equity capital to hire more workers and reach more markets. It also reflects an encouraging understanding of the role of equity capital in business investment—and, by so doing, also offers self-criticism for the proposal to raise the capital gains tax generally. The budget also includes an important proposal to adopt automatic enrollment in IRAs and 401(k)s to expand private saving.[4]

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214 Massachusetts Avenue, NE
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(202) 546-4400 • heritage.org

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However, the Obama budget proposes to reinstate the now-long-lapsed excises on manufacturers to finance the Superfund toxic waste cleanup program. This trust fund already has sufficient resources to finance its operations for many years, so a reinstatement of the tax largely on manufacturing concerns is unnecessary. Another bad policy recommendation is to repeal an inventory accounting rule known as "last in, first out," which would raise taxes on businesses that need to carry significant amounts of inventory. There is no policy justification for this proposal other than as a convenient means of raising taxes on businesses. These are two of the more notable of the many miscellaneous proposed tax hikes.

No Time to Threaten Radical Restructuring and Tax Hikes. The U.S. economy slid from a mild recession from December 2007 through August 2008 into a deep and rapid contraction that threatens to persist through 2009. Asia and Europe have also fallen into deep recessions expected to continue into 2010.

Matters are sufficiently dire that President Obama and the Democratic Congress responded to news of a trillion-dollar-plus budget deficit in 2009 and added to it massively through an ill-labeled stimulus bill. In addition, the Treasury and the Federal Reserve are employing a multitude of programs to restore financial markets to normal operations and begin to lay a foundation for economic recovery. This is the economic background against which President Obama has proposed to jack up tax rates on small businesses.

Higher taxes on small businesses, higher taxes on investment capital, and a massive new tax regime to finance a risky new program to drive up energy costs and restructure much of the economy according to federal government designs are all policies that would weaken the economy under any circumstances. It is extraordinarily harmful and ill-advised to propose such policies at this time.

Getting the Revenue Baseline Right. For all its problems, the Obama budget included one very important improvement in regards to tax policy: The revenue baseline presented in this budget is more reasonable, more accurate than that presented by President George W. Bush in his last budget, and far more reasonable than the baseline from which the Congressional Budget Office (CBO) continues to operate.

Revenue baselines are part of the infrastructure of the budgetary side of tax policymaking. All tax policies are scored for budget purposes relative to a baseline projection of current and future revenue streams. However, because Congress has long been in the bad habit of passing temporary tax provisions, their expiration raises important questions about how to treat these provisions in the baseline, questions the CBO has consistently answered incorrectly.

Describing the consequences of maintaining current policy is an underlying principle of revenue and spending baseline projections. To an extent, autopilot is the default. When spending programs like the highway program expire, the CBO and the Administration assume that current policy will be preserved

1. These figures are measured against a current policy baseline, which projects revenues over the budget window assuming all current tax policies are continued. Thus, a tax provision like the R&D tax credit that typically expires each year and is extended each year is carried in the baseline forecast as though it were permanent. This baseline issue is discussed below.
2. U.S. Office of Management and Budget, A New Era of Responsibility: Renewing America's Promise (Washington, D.C.: U.S. Government Printing Office, 2009), footnote 5, table S-6, at *http://www.gpoaccess.gov/USbudget/fy10/pdf/fy10-newera.pdf* (March 24, 2009).
3. The tax system ought to be used to raise revenue to finance federal spending. Unfortunately, it is also used to provide cash payments to millions of individuals through refundable tax credits. The amount of cash payments goes up in this budget because existing credits are increased, new refundable tax credits are created, and other tax relief provisions eliminate tax liability for certain tax filers so that tax credits for which they qualify generate cash payments. Cash payments to individuals with zero income tax liability are treated as outlays, or spending.
4. For a discussion of auto IRAs, see J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security through Universal IRAs," Retirement Security Project, at *http://www.retirementsecurityproject.org/pubs/File/RSPAutoIRALongpaperFINAL7.10.2007.pdf* (March 24, 2009).

and so continue the highway spending in the spending baseline. In contrast, when a tax provision like the R&D tax credit or the Alternative Minimum Tax "patch" expires, the CBO ignores current policy and constructs the revenue baseline assuming the tax provision will expire. This difference is illustrated by comparing the CBO and Obama baselines and the scoring of Obama's policies.

In constructing its revenue baseline for 2009 and beyond, the Obama baseline reflects the revenue effects of expiring tax provisions as though they were permanent, while other tax provisions that Obama would allow to expire are properly shown as tax hikes.

For example, the 15 percent and the top 35 percent income tax rates were both enacted in 2001, and both expire at the end of 2010. President Obama has called for extending the 15 percent rate and raising the top tax rate to 39.6 percent. President Obama's revenue baseline correctly assumes the extension of the 15 percent rate, and it shows the revenue increase from raising the top tax rate.

In contrast, the CBO shows the revenue losses from extending the 15 percent tax rate and subsumes the revenue gains from raising the top tax rate into the baseline. Whereas the CBO baseline is its negative image, the Obama revenue baseline is true to the intent and meaning of the baseline and is consistent with how the spending baseline is constructed. Congress should direct the CBO to correct its methodologies to be correct with the Obama Administration's approach.[5]

A Better Change in Course on Tax Policy. President Obama has presented a full slate of tax policy proposals in his budget. The net effect of these proposals would be much higher levels of taxation and much weaker economy. A wiser course would be to jettison the tax hikes, including the jobs-destroying climate change initiative, and focus on policies that strengthen the economy such as cutting spending and cutting tax rates.

—J. D. Foster, Ph.D., is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

5. For further discussion of this tax baseline issue, see J. D. Foster, "Obama to CBO Revenue Baseline: Nuts—and He's Right!," by Heritage Foundation *WebMemo* No. 2019, August 11, 2008, at *http://www.heritage.org/Research/Budget/wm2019.cfm*; "Fair Tax Policy Requires a Fair Revenue Baseline," Heritage Foundation *WebMemo* No. 1848, March 13, 2008, at *http://www.heritage.org/Research/Budget/wm1848.cfm*.