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Budget Update Shows No Need for Tax Hikes

Curtis S. Dubay

The White House Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) both released updates of their budget estimates for the next 10 years this week. Both reports show staggering deficits for each year during that period. The cumulative deficit between 2010 and 2019, or the total amount added to the national debt, as a result of President Obama's budget will be over \$9 trillion—\$2 trillion more than estimates earlier this year.[1]

These alarming figures are sure to bring calls by some for higher taxes to close the growing deficit. A close look at the figures, however, shows that spending is the main driver of these deficits. According to President Obama's own assumptions, he and Congress can control the deficit if they limit spending to historical levels.

Tax Revenue Grows Sharply Under Current Policy. Deficits over the next 10 years will average close to \$1 trillion a year. But contrary to claims that tax cuts created these burgeoning deficits, close scrutiny of future tax revenue (as estimated by OMB under current policy) shows that tax revenue will increase significantly over the next decade.

If the 2001 and 2003 tax cuts are extended permanently (and all income tax rates, including those on capital gains and dividends, remain at their current levels), the death tax retains its 2009 rates and exemptions, and the Alternative Minimum Tax adjusts annually for inflation, total tax revenue will increase from \$2.3 trillion in 2010 to \$4.3 trillion in 2019.[2] This 85 percent growth rate means that Congress would have \$200 billion more tax revenue to spend each year on average.

Tax Hikes Unnecessary. Tax revenues under current policy are sufficient to keep deficits under control if President Obama and Congress spend in accordance with historical averages. Total tax revenue as a percentage of gross domestic product (GDP)—the measure of all productivity in the economy—averaged 17.9 percent since World War II. If current policy remains law, according to OMB, total tax revenue will also average 17.9 percent of GDP between 2010 and 2019. Similar CBO estimates reach the same conclusion.

Since World War II, spending has averaged 20 percent of GDP. If President Obama and Congress limit spending to 20 percent of GDP, the deficit would equal the postwar average deficit of 1.8 percent of GDP by 2015 and fall below that level in succeeding years.

Progressive Income Tax Increases Deficit. The current deficit would be substantial even without the stimulus and the financial bailouts, because tax revenues decreased sharply because of the recession. A large factor contributing to the decrease is the steeply progressive income tax.[3]

During periods of economic growth, receipts from the progressive income tax surge, but during periods of contraction, receipts decline rapidly. This occurs mostly because much of high earners' income stems from volatile sources, such as capital

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(202) 546-4400 • heritage.org

gains, dividends, business income, and bonuses, and their incomes fall just as sharply during economic downturns as they rose during good economic times and they have less income to tax.[4]

The income tax accounts for about 45 percent of all tax collections, so fluctuations in the revenue it raises are a large factor determining the size of the deficit from year to year. When Congress sets a budget for future years, it relies on estimates of the revenue the income tax will raise in those years. If the economy contracts in the interim, the revenue raised by the income tax falls and larger-than-anticipated deficits result.

For example, in January 2009, the CBO estimated that the income tax would raise $1.2 trillion in 2010.[5] Congress set its 2010 spending levels based on that assumption. However, in the period since January, the economy continued to deteriorate. As a result, the CBO now estimates that the income tax will raise $984 billion in 2010—a decrease of $216 billion in just eight months. In that eight-month span, the CBO raised its projection for the 2010 deficit by $678 billion.[6] A good portion of that increase is attributable to the projected fall in income tax receipts.

While rapidly increasing spending is the main culprit of record-setting deficits, the volatility of income tax receipts is also a large factor. Even if Congress stopped its out-of-control spending, deficits would be considerable because of this volatility.

President Obama's plan to raise the top two income tax rates to their levels prior to the 2001 and 2003 tax cuts would increase the progressivity of the tax code and increase revenue volatility. Congressional plans to slap a 6 percent surtax on top earners to partially fund government-run health care would increase progressivity and revenue volatility even more.

Instead of increasing the progressivity of the income tax with these rate increases, President Obama and Congress should work to make the income tax more like a flat tax. A flat tax would tax all income at one rate, instead of multiple rates for higher levels of income like the current tax code. While not a cure-all for deficits, a flatter income tax would significantly decrease the volatility in revenue and provide a more stable budgeting base for Congress. As an added bonus, it would also not be a disincentive to work, save, and invest like the current progressive income tax.

No Tax Hikes. The recently updated budget figures make clear that a lack of revenue is not causing record deficits, so no tax hikes are necessary to close future budget gaps. Instead, Congress and President Obama can do so by limiting spending to the historical average of 20 percent of GDP by:

- Reforming current entitlement programs like Social Security, Medicare, and Medicaid to make them more efficient and affordable;
- Dropping plans for an expensive takeover of the health care system; and
- Eliminating wasteful and lower-priority programs.

To get further control over future deficits that result from tax revenue volatility, Congress and President Obama should also reduce the progressivity of the income tax by moving to a flatter income tax code.

—Curtis S. Dubay is a Senior Analyst in Tax Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

1. Brian M. Riedl, "New Budget Estimates Show Unsustainable Spending and Debt," Heritage Foundation *WebMemo* No. 2595, August 25, 2009, at *http://www.heritage.org/Research/Budget/wm2595.cfm.*
2. White House Office of Management and Budget, "The President's 2010 Budget: Mid-Session Review," August 2009, Table S-3, at *http://www.whitehouse.gov/omb/assets/fy2010_msr/10msr.pdf* (August 26, 2009).
3. Curtis S. Dubay, "Income Tax Will Become More Progressive Under Obama Tax Plan," Heritage Foundation *Backgrounder* No. 2280, June 1, 2009, at *http://www.heritage.org/Research/Taxes/bg2280.cfm.*
4. Curtis S. Dubay, "Seven Myths About Taxing the Rich," Heritage Foundation *Backgrounder* No. 2306, August 3, 2009, at *http://www.heritage.org/Research/Taxes/bg2306.cfm.*
5. Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2009 to 2019," January 2009, Table 5, at *http://www.cbo.gov/ftpdocs/99xx/doc9957/01-07-Outlook.pdf* (August 26, 2009).
6. Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2009, Table 1.2, at *http://www.cbo.gov/ftpdocs/105xx/doc10521/08-25-BudgetUpdate.pdf* (August 26, 2009).