Backgrounder

Published by The Heritage Foundation

No. 2454
August 26, 2010

Obama Tax Hikes Defended by Myths and Straw Men

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Abstract: *President Obama has called for a huge tax increase to take effect on January 1, 2011. Instead of reducing spending, he proposes to raise taxes on a wide swath of taxpayers—including small businesses—despite the weak economic recovery. Congressional Democrats stand poised (immediately following the November elections) to endorse the President's request and threaten to go much further. Proponents of letting the tax cuts expire—which would indeed be a tax hike—have offered a wide array of justifications for this wrongheaded policy. Heritage Foundation fiscal policy expert J. D. Foster wades through the myths and straw arguments to set the record straight.*

President Barack Obama has called for a huge, $921 billion tax increase beginning on January 1, 2011, and congressional Democrats have signaled their intent to meet his request and more—after the mid-term elections.[1] To achieve the bulk of this increase, the Democratic leadership need merely do nothing: The tax relief enacted a decade ago during a mild recession is scheduled to expire and Congress apparently intends to let this tax relief lapse in 2011 coming out of a severe recession.

In the big picture raising taxes is not about the size of the deficit but about a vision for America and the appropriate size of government. Federal spending has exploded under President Obama. It now consumes around 25 percent of the economy, producing dangerous and unsustainable deficits. Either Congress and the President return spending to historically normal

Talking Points

- Proponents of allowing long-established tax provisions to expire in 2011—a tax hike—offer an array of creative myths and straw man arguments to defend it.
- The facts are that raising taxes would weaken the economy in the short-term and long-term. Higher tax rates would target especially those small businesses most likely to create new jobs.
- Suggestions that avoiding a tax hike must be "paid for" by raising taxes elsewhere are nonsensical. The most recent argument—that in 2001, President Bush intended the tax cuts to be temporary—is flat-out false.
- The recent explosion in projected federal budget deficits is due to an explosion of federal spending. The correct policy course is to reduce budget deficits by returning spending to previous levels—about 20 percent of the economy.

This paper, in its entirety, can be found at:
http://report.heritage.org/bg2454

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
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levels of about 20 percent of the economy, or taxes must go up dramatically. While the long-run budget picture remains the greater threat, current deficits are a severe and immediate threat that must be addressed very soon.

The state of the economy today plays an especially critical role in how Congress should respond. The unemployment rate hovers near 10 percent and is likely to remain highly elevated for years according to the Administration's own economic forecast. The American economy seemed poised to recover earlier in the year, but is restrained by a number of factors internal to the economy such as ongoing weakness in the real estate market, factors external to the economy such as a potential slowing of export markets abroad, and especially by the broad erosion of business and consumer confidence due to policy threats from Washington. For all the talk of jobs, jobs, jobs, Washington policymakers appear singularly intent on *inhibiting* job creation. The Obama tax hike arising from the expiration of long-standing tax relief is but one example of many.

The Obama tax increase proposal should be denied. The arguments for defeating the tax increase and preserving current law are sound. Arguments for allowing any or all of the relief to lapse are flimsy or false. The sole substantive argument offered by proponents for the Obama tax hike is that it supports a vastly and permanently larger government presence in the lives of Americans, American communities, American state governments, and the economy. This, however, is a vision of a less prosperous America, a less free America. In short, it is the wrong vision for America.

Tax Relief Erased Excessive Tax Burdens

Contrary to claims by big-government advocates, the 2001 and 2003 tax relief did not strip the government of its normal tax revenues. In 2000, federal receipts breeched $2 trillion and set a post-war high of 20.6 percent of the U.S. economy, just as the economy began to slide into recession. Having campaigned on tax relief to restore the level of taxation to its historical share of between 18 and 19 percent, President Bush was well prepared and the Congress enacted his program of sweeping tax relief mid-year 2001. Unwisely, Congress chose to phase in the tax relief, so the economic recovery remained anemic. Correcting its error two years later, Congress made the 2001 relief immediately effective and added important new pro-growth elements of dividend and capital gains rate relief. It worked. Over the next 12 months the economy surged by 4 percent and the recovery was well underway.

By 2007, total federal receipts had recovered along with the economy. As the unemployment rate fell from its recession high of 6.3 percent in June 2003 to 4.6 percent in June 2007, receipts hit $2.6 trillion, far above the previous highs, while the tax share returned to a more normal 18.5 percent. The 2008–2009 recession reduced tax receipts dramatically once again, yet Obama Administration figures indicate that even absent any tax hikes federal receipts would reach $3.7 trillion by 2016, more than a trillion dollars above their previous highs. Perhaps more telling, the federal tax share would soon return to the 18.5 percent of the economy last attained in 2007, while rising further as the decade progresses.

In nominal terms, economic growth will again push federal tax receipts to yearly highs as soon as 2012 according to Administration figures. Yet despite this rapid growth in receipts, the federal government is projected to run massive deficits of more than $1.4 trillion in 2009, 2010, and 2011, and deficits are projected to remain at about a trillion dollars a year through the end of the decade. The reason deficit projections are so high is that spending growth has and is projected to continue to outstrip revenue growth by a wide margin. As the problem begins and ends with excessive spending, solutions to the budget deficit should likewise begin, and end, with spending reductions.

1. Obama has proposed allowing all of the 2001 and 2003 tax cuts applicable to taxpayers with annual incomes above $200,000 ($250,000 for married filers) to expire, which would raise taxes by $629 billion between 2011 and 2020. He also proposed limiting the tax rate applicable for itemized deductions for these same taxpayers, which would raise an additional $292 billion. See Office of Management and Budget, "Mid-Session Review: Budget of the U.S. Government, Fiscal year 2011," at *http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/11msr.pdf* (August 13, 2010).

Proponents of raising taxes have offered many straw man arguments and myths to support their case. While sometimes clever and well-presented, they remain myths just the same.

STRAW MAN: Extending current tax policy will not stimulate the economy.

REALITY: While extending current tax policy will provide at most a modest boost to the economy, raising taxes will slow down recovery.

Will extending current tax policy (and therefore abstaining from raising taxes) stimulate the economy? Not significantly, and no serious proponent of lower taxes and a smaller government would argue the contrary.

This is a straw man argument because continuing current policy cannot add much stimulus. To stimulate the economy substantially there must be some new and effective policy, such as a reduction in the corporate tax rate or further increases in the amount of investment a small business can deduct immediately. The admittedly modest stimulus from extending current tax policy would stem from erasing the debilitating threat hanging over all business decisions that their taxes will jump. The real issue is not whether extending current policy would be a powerful stimulus—it would not—but how much damage a massive tax hike would inflict on a weak economy. It's not whether tax policy presses harder on the accelerator, but whether Washington will slam on the brakes.

MYTH: Preventing a tax hike is a tax cut.

FACT: Extending the 2001–2003 tax provisions is not a tax cut; the failure to extend any of these provisions as Obama proposes is a tax hike.

It is absurd to suggest that extending current policy is a tax cut. The facts are plain: The failure to extend current tax policy would impose massive tax hikes on millions of Americans. Preserving current tax policy cannot, therefore, be a tax cut. The confusion is perpetuated by a long-standing, distorted, and misleading Congressional Budget Office (CBO) scoring convention.

The Obama Administration and outgoing Office of Management and Budget director Peter Orszag deserve credit for instituting a balanced and accurate presentation of the facts in its very first budget submission and more recently in the "Mid-Session Review."[2] In its current policy baseline the Obama Administration assumes expiring spending provisions like the highway program and appropriations programs will be extended. Thus spending levels are presented assuming the current level of services will be maintained. New spending proposals are treated as additions or subtractions to current policy. This is a sensible approach.

In like manner, the Obama Administration's current policy revenue baseline assumes that expiring tax provisions will be extended. In other words, current policy is extended, while new proposals are shown as deviations from the current policy baseline. His proposal to raise the individual income tax rate, for example, is shown as raising revenue.

CBO, in contrast, persists in presenting an asymmetric treatment, assuming expiring spending provisions will be extended while expiring tax provisions will be allowed to lapse. Consequently, the revenue baseline fails to reflect an assumption that the 2001 and 2003 tax relief would be extended. Therefore, proposals to extend the relief appear in the CBO and Joint Tax Committee revenue tables as reductions in revenue. This sort of scoring perversity is indefensible, yet CBO has refused to correct its conventions, leaving policymakers with a very distorted picture of the budget and a distorted interpretation of policy.

MYTH: An extension of the tax cuts must be paid for.

FACT: It is neither necessary nor logical to raise taxes to avoid a tax hike elsewhere.

The expression of the "fact" in this case may seem so obvious as to be perplexing. But that is the point here: The argument the tax hike proponents are making is so nonsensical that when expressed simply, its absurdity is inescapable. If true tax relief were under consideration, in the context of the current outsized budget deficits one could argue the tax

2. Office of Management and Budget, "Mid-Session Review: Budget of the United States Government, Fiscal Year 2011."

relief should be offset within the budget, preferably with suitable spending reductions. But, as noted, extending current tax policy is not a tax cut. It is the prevention of a tax hike, and therefore there is no basis for arguing that extending current policy needs to be offset with other budgetary savings.

Many commentators demonstrate a noteworthy inconsistency in this area. A wide range of tax provisions expire at the end of 2010. These include, for example, a doubling of the child tax credit to $1,000, marriage penalty relief, and the 10 percent tax bracket, in addition to the higher rates on individual income and the higher rates on capital gains and dividends. If one argues that extending the higher income tax rates and capital gains and dividend tax rates must be paid for, then the same must apply to the lower-income and middle-income tax provisions, such as the higher child tax credit. To put these figures into context: Whereas the Obama tax hikes total some $628 billion over 10 years, the balance of the tax provisions that would then have to be paid for would require about $2.4 trillion in offsets over 10 years.

MYTH: Higher tax rates would not weaken the economy in the short run.

FACT: Higher tax rates would sap the recovery.

Proponents of the Obama tax hikes argue they would do little damage to the economy in the short run. It is important not to overstate the matter—the Obama tax hikes would not by themselves cause a depression, nor would they tip a strong economy into a recession. But raising taxes on work and investment will mean less work and less investment—which, in the context of an unemployment rate hovering around 10 percent and monetary authorities exploring new ways to prop up a faltering economy—can only be regarded as an overtly hostile anti-jobs policy.

When it comes to incentives, proponents of big government can never seem to keep their story straight. They understand raising taxes on tobacco inhibits cigarette sales. They argue for various penalties in the areas of labor law and the environment, as well as for consumer protections, to encourage good behavior on the part of employers, manufacturers, and service providers. They support subsidies for alternative energies to encourage the production of otherwise wholly uneconomic fuels. More generally they adamantly support a wide range of incentive carrots and sticks to shift the economy away from fossil fuels, going so far as to advocate the creation of an artificial market via a cap-and-trade scheme so producers can see and respond to the incentives presented by a market price charged to emit pollutants. But the proponents of all these behavior-distorting policies inexplicably lapse into programmed denial when it comes to the most basic of economic incentives—the after-tax earnings incentives to work, to save, to invest, to take risks, to start a new business—and the obvious influence marginal tax rates have on those incentives.

MYTH: Small businesses would be only marginally affected by higher taxes rates.

FACT: Successful, growing, hiring small businesses are especially targeted by higher tax rates.

Another popular myth offered to sustain the Obama tax hikes is that higher tax rates would fall on too few small businesses to matter. While less than 2 percent of tax returns reporting small-business income would be subject to the higher tax rates Obama proposes, there is much more to the story.

Millions of American taxpayers earn a few bucks on the side. Sometimes the extra income is from a lucrative hobby; sometimes the work is more serious. Millions of these sideliners are honest enough to report their earnings as small-business income. But they are not small businesses in the traditional sense. They have no employees. They have no fixed place of business. They do not offer services widely.

True small businesses have employees. They invest in machinery. They offer goods and services widely. And the successful ones earn significant sums to compensate for the risks of running the business and to earn a return on capital invested, typically plowing those earnings back into the business so it can expand further by investing more money and hiring more workers. And because they earn significant sums, successful small businesses earn the bulk of small business income. So, while only a small portion of taxpayers reporting small-business income would face Obama's higher rates,

those facing the higher rates are the successful and expanding small businesses that create new jobs the economy needs to grow. According to a survey by the National Association of Independent Business, the businesses most likely to face Obama's higher rates are those employing between 20 and 250 workers. Raising rates on successful small businesses is a big part of the reason why the Obama tax hikes would hurt the economy.

MYTH: Tax rates matter little in the long run.

FACT: Tax rates have their most powerful effects on long-run growth and wages.

Additional tax rate reduction would benefit the economy as it struggles to recover, in contrast to the ineffectual profusion of debt adopted by President Obama and his congressional allies. However, lower tax rates on productive activity have their greatest effects on productivity and wage gains in the long run as workers and businesses respond to and plan on the improved returns to economic effort.

For example, allowing the tax relief to lapse, especially the higher tax rates on individual income, on dividends, and on capital gains, would drive up the hurdle rate or required pre-tax return for new investment. Businesses generally face an array of investment opportunities and levels. They determine which investments to pursue by comparing the expected pre-tax return on each investment with the firm's internal hurdle rate after accounting for risk and taxes. The higher the tax rate, the higher the hurdle rate, the fewer of the possible investments that make the cut and so the less investment a business will undertake.

These effects take time to manifest, however, because major business investments typically require extended evaluation and planning. Also, businesses already have certain levels of productive equipment in place and more on order. A hurdle rate driven higher by higher tax rates may significantly reduce the company's target level of capacity, but the company will rarely respond by unloading excess equipment. Rather, the company will shrink its operations over time as equipment becomes worn out or obsolete and not replaced. In the short run, this means a sizable drop in business investment and real economic growth; over the long run it means less capital employed in the economy, less productivity growth, less wage growth, and less competitiveness in global markets.

Similarly, while workers can and do respond quickly to changes in tax rates, a full response requires an extended period. For example, Obama's proposed higher tax rates will drive many two-earner couples with children to decide that one parent should leave the workforce and raise the children. However, the couple may hold off with this decision for a while to adjust the family's finances to reflect the reduction in after-tax family income.

MYTH: The country cannot afford not to raise taxes.

FACT: The problem is spending, not revenues. The country cannot afford to let current spending levels continue.

Supporters of the Obama tax hikes sometimes argue the nation cannot afford *not* to raise taxes. This argument perpetuates two false mindsets. The first is that the level of tax collections under present law is unusually low. As noted above, taxes as a share of the economy will soon return to, or exceed, the historical average, reaching 18.5 percent in 2012 and rising thereafter. While the level of tax collections is exceptionally depressed in 2010, this is due to the recession and its effects on taxable income.

The second false mindset runs deeper, as it reflects a point of view regarding the proper relationship between the citizen and the state. This point of view suggests that the foregone tax revenues properly belong to the government and that taxpayers are being granted a favor of some kind in being allowed to keep more of their own money. Raising taxes is not just a bookkeeping exercise: This money is the taxpayer's property and government is taking it.

The federal government is currently running, and is projected to continue to run, unsustainable near-term deficits which serve as a bridge to long-standing, unsustainable long-term deficits. The nation cannot afford these deficits, and the econ-

omy cannot afford vastly higher taxes—which means it cannot afford to continue spending at current levels. In a strict mathematical sense, unsustainable budget deficits can be met with equal effectiveness through tax increases or spending reductions. But rampant federal spending created unsustainable deficits and spending should be cut to restore a sound fiscal policy.

MYTH: The Obama tax hikes would alleviate the long-term budget crisis.

FACT: The Obama tax hikes, while enormous in their own right, are almost inconsequential compared to the size of the unfunded spending in Social Security, Medicare, and Medicaid.

Tax hike proponents sometimes suggest the nation's long-term fiscal problems are largely due to inadequate revenues. The facts say otherwise. To begin, the nation's long-term fiscal problems deriving from unaffordable benefit promises in Social Security, Medicare, and Medicaid were made long before President Obama took office. In fact, they were made long before President George W. Bush took office. True, Bush worsened Medicare's plight with the enactment of the new Medicare drug benefit, but the drug benefit's enactment occurred subsequent to and independent of the tax relief enacted in the past decade. Tax relief enacted a decade ago did not cause the long-run budget crisis arising from excessive entitlement spending.

Turning now to the data, according to the Administration's figures, the tax relief *in toto* is projected to be about 1.6 percent of the economy in 2012, rising to about 2 percent by 2020. In 2000, the level of taxation reached 20.6 percent of the economy, fell to a more normal 18.5 percent in 1997, and is projected to return to 18.5 percent by 2016. In contrast, the CBO projects that federal spending will reach 24.3 percent in 2010, and rise to 27.6 percent by 2035, whereas the normal level is around 20 percent.[3] In short, revenues will soon return to normal levels as a share of the economy, rising steadily thereafter, while spending is vastly higher than normal today due to President Obama's spending policies, and is projected to rise rapidly in coming years as entitlement spending accelerates.

MYTH: A strong economy will solve America's budget woes.

FACT: A strong economy will help, but only aggressive spending reductions will restore a sound fiscal policy.

A strong economy is necessary to begin to drive down the unemployment rate and create opportunities for America's workers and families. A strong economy would also rapidly increase the flow of revenues into federal coffers, helping to bring down the deficit. A strong economy will not, by itself, restore a sound fiscal policy.

Federal receipts are projected to be about 15 percent of the economy in 2010, whereas the normal level of receipts is between 18 percent and 19 percent. If and when the Obama Administration calls a truce to its anti-growth policies and allows the economic recovery to flourish, revenues will quickly return to normal levels as the Obama Administration projects. However, even under its rosy spending projections the Administration expects spending to remain around 23 percent of the economy. With a maximum sustainable deficit of about 2 percent of the economy, that leaves an excess budget deficit of about 3 percent of the economy, or more than $400 billion in 2010.

This also suggests the only viable solution for the budget deficit. A strong economic recovery is a necessary condition for a sustainable near-term budget. Higher taxes would weaken the recovery dramatically, and so whatever progress on deficit reduction one expected from higher taxes would be long delayed, along with the job creation the nation needs. Thus, the only practical alternative that can restore a sound fiscal policy consistent with a strong recovery is a significant reduction in spending.

MYTH: President Bush intended the tax cuts to expire.

FACT: The tax cuts were intended to be permanent and were enacted on a temporary basis solely to overcome a parliamentary hurdle.

3. See Congressional Budget Office, "The Long-Term Budget Outlook," August 2010, at *http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf* (August 13, 2010).

One of the oddest and newest myths surrounding the 2001–2003 tax relief is that President Bush and Congress conspired for the tax relief to expire 10 years after its enactment. It is impossible to construct a conspiracy to explain such a policy without quickly falling into the valley of the absurd. Nevertheless, a brief review of the record is in order.

President Bush proposed permanent tax relief. He did so during the campaign and as President, and he did so because he believed, correctly, that taxes had risen too high, because permanent tax relief would be more effective in strengthening the economy in the short run and for the long haul, and because stability is inherently good in a tax code. Many in Congress also preferred permanent tax relief. However, to overcome certain parliamentary hurdles in Congress it proved necessary to pass the legislation under what is called "reconciliation," and tax relief enacted under reconciliation automatically expires after 10 years. In every budget President Bush submitted in the following years he proposed that Congress make the tax relief permanent.

Conclusion

The nation is engaged in a profound debate over the proper size and scope of government. Under President Obama, the size and scope of government has expanded radically, along with the level of federal spending. The resulting budget deficits are unsustainable and pose a severe and immediate threat to the economy. The President and his allies are now calling for the higher taxes necessary to pay for this new spending. Allowing some or all of the 2001–2003 tax cuts to expire would be merely a small down payment on the sums necessary to sustain current spending levels.

Suggesting such a massive tax hike to underwrite current bloated spending levels is inappropriate under any circumstances, but when the economy is perilously close to recession and deflation such suggestions are grossly irresponsible. The only responsible solution to the budget deficit that would be both effective and consistent with a strong economic recovery is to cut spending significantly, returning it to historically normal levels. Spending during the Clinton Administration averaged almost 20 percent of the economy. Spending during the Bush Administration averaged about the same. Reducing federal spending from the current level of 25 percent to the levels prevalent during the Bush and Clinton Administrations would fully address the short-run budget problems.

Obama and his allies have increased spending radically. A sound, responsible budget policy absent tax hikes does not demand radically lower levels of spending. It only requires reversing Obama's radical spending. Congress should make current tax policy permanent, as President Bush originally proposed—and then get about the business of paring government spending to sustainable levels.

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