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Obama Tax Hikes: Bad for All Americans

Curtis S. Dubay

Abstract: *President Obama's tax plan will, famously, end the 2001 and 2003 tax relief for Americans earning $250,000 a year or more. But, far from raising taxes only on the "rich," the widespread effects of the Obama plan will hurt Americans at every income level. If Congress adopts the President's plan, it will eliminate all the growth-promoting policies in the 2001 and 2003 tax relief packages, slowing down economic growth and job creation at a time when the economy is struggling to recover from the Great Recession. Heritage Foundation tax policy expert Curtis Dubay reminds that higher taxes have never closed budget deficits, and explains why the Obama plan is bad for all Americans.*

The 2001 and 2003 tax relief packages are set to expire at the end of this year, just a few months from now. Congress will soon make a choice: Raise taxes by letting some or all of the provisions of the relief expire, or extend all relief and keep taxes at the current level. If Congress decides to raise taxes, President Barack Obama's tax hike plan, the one he has proposed since the campaign, will set the parameters of who will pay higher taxes and whose taxes will remain the same.

If Congress adopts the President's plan, it will eliminate all the growth-promoting policies in the 2001 and 2003 tax relief packages. This will slow down economic growth and job creation while the economy struggles to recover from a steep recession. Slower economic growth will not only hurt those that will pay higher taxes under President Obama's plan—it will hurt Americans at all income levels. Instead of raising

Talking Points

- Congress will soon decide whether to keep tax rates at the level they have been for a decade, raise them for high-income earners, or raise them for all taxpayers. If Congress raises taxes on high earners it will use President Obama's tax hike plan as a guide.
- President Obama's tax plan would eliminate all pro-growth policies of the 2001 and 2003 tax relief. Despite the President's insistence that the tax hikes will only affect "the rich," all Americans will suffer—through lost jobs, lower wages, and fewer opportunities.
- Higher taxes reduce incentives for individuals and businesses to work, invest, and take risks—the basics of economic growth that are largely lacking today.
- Tax hikes will not close the deficit because people will alter their behavior to minimize their tax liability.
- Americans cannot afford a tax hike now. Congress should permanently extend the 2001 and 2003 tax relief for everyone.

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(202) 546-4400 • heritage.org

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taxes on the so-called rich, Congress should permanently extend the tax relief for all taxpayers.

Obama Tax Plan Kills Pro-Growth Policies

President Obama's tax plan extends the 2001 and 2003 tax relief for all families that earn less than $250,000 a year ($200,000 a year for singles). His plan increases taxes on families, small businesses, and investors whose income is above that threshold.

If Congress passes the President's tax plan, the following anti-growth tax hikes will occur:

- Marginal income tax rates rise for families and small businesses making more than $250,000 a year:
  - the 35 percent bracket rises to 39.6 percent, and
  - the 33 percent bracket rises to 36 percent;
- Capital gains rate rises from 15 percent to 20 percent;
- Dividends tax rate rises from 15 percent to 20 percent;[1] and
- Certain exemptions and itemized deductions for high-income taxpayers are eliminated.

The following policies will remain in place:

- Lower marginal income tax rates:
  - 28 percent bracket versus 25 percent, and
  - 31 percent bracket versus 28 percent;
  - 10 percent income tax bracket for all;
- Alternative Minimum Tax (AMT) threshold indexed for inflation;
- Marriage penalty reduction; and
- Child tax credit increased from $500 to $1,000.

President Obama regularly states that his plan extends the 2001 and 2003 tax relief for 95 percent of Americans, only calling on the top 5 percent to pay more. Such class warfare is economically misguided.

Raising taxes is more than just a matter of fiscal policy and deficits. It is not just a bookkeeping exercise. Raising taxes deprives citizens of their property. Raising taxes has important results as higher taxes discourage the forces of economic growth, thus spreading their consequences far and wide in terms of lost jobs, wages, and opportunities.

If Congress enacts the President's tax plan, it will hurt Americans at every income level, not only the so-called rich, because it will:

- Slow down economic growth as the economy continues to struggle;
- Keep people unemployed that otherwise would have found work;
- Put even more Americans out of work; and
- Slow down economic growth permanently and lower Americans' standard of living as a result.

With unemployment lingering around 10 percent and economic recovery softening, now is the worst possible time to discourage families, small businesses, and investors from engaging in the behaviors that will help lift the economy out of its long and persistent slump. Unfortunately, that is exactly what President Obama's tax hike plan will do. In fact, if Congress passes the President's tax hike plan, businesses will create an average of almost 800,000 fewer jobs per year between 2013 and 2019 than they would if tax rates remain where they are now.[2] That is, 800,000 additional Ameri-

1. According to the current budget resolution under which Congress is operating, the tax rate on dividends will rise to 39.6 percent on January 1, 2011. If Congress decides to set the dividends tax rate at any rate below this level it will need to offset the cost with other tax hikes since it did not exempt dividends from its "pay-as-you-go" budget restrictions like it did the other 2001 and 2003 tax policies it intends to extend. This greatly increases the likelihood that dividends rates will rise to 39.6 percent. See Curtis Dubay, "Obama Tax Hikes: Higher Dividend Taxes Hurt Seniors," Heritage Foundation *Backgrounder* No. 2461, September 10, 2010, at *http://www.heritage.org/Research/Reports/2010/09/Obama-Tax-Hikes-Higher-Dividend-Taxes-Hurt-Seniors*.
2. William W. Beach, Rea S. Hederman, Jr., John L. Ligon, Guinevere Nell, and Karen A. Campbell, "Obama Tax Hikes: The Economic and Fiscal Effects," Heritage Foundation *Center for Data Analysis Report* No. 10-07, September 20, 2010, at *http://www.heritage.org/Research/Reports/2010/09/Obama-Tax-Hikes-The-Economic-and-Fiscal-Effects*. (Assumes tax rate on dividends rises to 39.6 percent as called for in the budget resolution and explained in this paper.)

cans per year will not have a job because of a misguided tax increase—roughly equivalent to the total loss of jobs during the recent recession. In terms of job loss, the Obama tax hike is effectively equivalent to a deep recession, except this one would be intentional.

Even focusing on the negative employment effects does not show the true extent of the injury Americans would suffer from the tax hikes. Overwhelmingly, the jobs lost would not be those of the so-called rich who are the unfortunate subjects of the Obama tax hikes, but lower-income and middle-income workers. Not only will there be fewer jobs, but also a generally poorer economic environment in which opportunities for workers, even for college graduates, would diminish. Likewise, opportunities for advancement would be reduced. Americans of all income levels will suffer.

In pure dollar terms, Americans will see their incomes fall by more than $720 billion over the next 10 years.[3] That works out to an income reduction of $6,000 per household due to the tax increase that was only intended to hurt the rich. As a result of this decrease in incomes, Americans will see their wealth decline by a staggering $11 trillion over that same span. Such a massive reduction in wealth will seriously hamper Americans' standard of living not only in the short term, but for succeeding generations as well.

Lost Jobs and Wages

Congress originally designed the 2001 and 2003 tax reductions for middle-income and low-income families as a balance to the pro-growth policies in the tax reduction packages and to provide much-needed tax relief for these families at a time when they were facing the highest tax burden in American history.[4] Congress did not pass them to encourage economic growth. Compared to lower top marginal income tax rates and lower tax rates on dividends and capital gains, these policies, like the 10 percent income tax bracket and the child tax credit, have little, if any, impact on growth.

Congress did pass the pro-growth policies, such as lower top marginal income tax rates and lower rates for capital gains and dividends, to speed economic recovery after a recession and provide a foundation for permanently stronger economic growth in the future. These are the policies that President Obama wants Congress to eliminate. Lower top marginal income tax rates increase the incentives for small businesses to invest and take on new economic risk, and for investors to provide more capital to businesses so they can expand and add new workers. These activities are the basic elements of economic growth and they are mostly absent from the economy today. If tax rates increase at the beginning of next year, what little of these actions is taking place will decrease even more.

Lower top marginal income tax rates also increase the incentives for individuals to work and save more: These are the other necessities for economic growth. Higher rates will discourage individuals from working harder and saving larger portions of what they earn. This will also impede growth, slow economic recovery, and reduce the number of jobs that businesses would have created had tax rates been lower.

President Obama's plan raises the tax rates on dividends and capital gains from 15 percent to 20 percent. This tax hike will raise the cost of capital. Businesses use capital to add new workers and make them more productive. If the cost of capital increases, businesses will demand less of it. The end result is there will be fewer jobs available for those searching for work and lower wages for those employed.

Americans at all income levels will suffer because of the jobs the economy will forgo and the lower wages that will result due to higher top marginal income tax rates.

Small Businesses Suffer

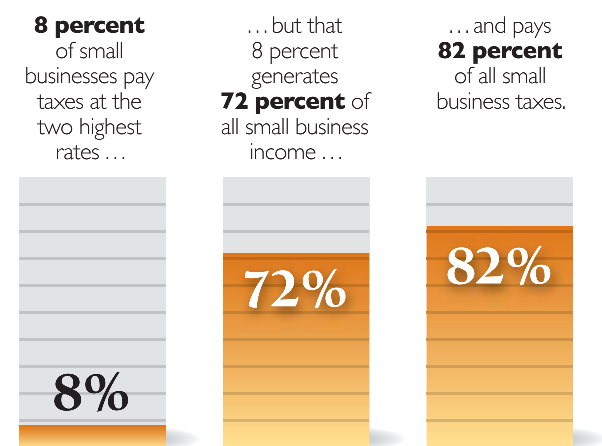
One common argument holds that President Obama's tax hike plan will not hurt small businesses

3. *Ibid.*
4. Office of Management and Budget, "Historical Tables, Budget of the United States Government, Fiscal Year 2011: Table 1.2," 2010, at *http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist01z2.xls* (September 20, 2010).

because only 2 percent of small businesses pay income taxes at the top two marginal rates.[5] According to the Treasury Department, 8 percent of small businesses earn enough income to pay the top two rates.[6] That is still a relatively small amount, but it does not tell the whole story.

Often, small businesses consist of a single person working on the side to earn extra dollars. These people report this side income as small-business income even though they do not hire employees or engage in traditional business activity. Raising the top two income tax rates will not affect many of these side businesses. Those who *will* be hit hard by the tax hikes are the small businesses that employ workers and create the most new jobs. According to the same data from the Treasury Department, those 8 percent of small businesses that earn enough to pay at the top two income tax rates earn 72 percent of all small business income. They also pay 82 percent of all small-business income taxes.[7] This means that the small businesses that will pay higher taxes under the Obama plan are the largest small businesses, which employ the most workers. Targeting them for higher taxes will have the largest possible negative impact on job creation.

Higher Tax Rates on the Rich Would Hit the Bulk of Small Business Economy



Source: U.S. Department of the Treasury, Office of Tax Analysis analysis of unpublished IRS data.

Chart 1 • B 2473 heritage.org

Small businesses are important job providers and creators. Raising their taxes will cause them to cut back on hiring and impede economic recovery.

Fewer New Businesses

Over the next 10 years, President Obama's tax hikes would reduce investment by about $500 billion.[8] This enormous reduction of potential investment will stifle entrepreneurship, which will curtail business formation and job creation.

When a potential entrepreneur decides whether to take the risk of starting a new business, tax rates are an important consideration. Entrepreneurs are often people who leave high-paying jobs to start a business. If their tax rates are higher in the years leading up to the creation of their business, they will have fewer resources to devote to this new endeavor—often causing them to delay their plans, or scratch them altogether.

Potential entrepreneurs will also have less access to outside capital if the Obama plan becomes law. Entrepreneurs not only rely heavily on their own resources to get their ideas off the ground; they also turn to other investors, often family and friends, for help. New small businesses without a track record cannot raise capital from traditional sources like banks, or even the Small Business Administration. As such, "angel investors," those who invest in these kinds of ventures, and family and friends with available funds are vital to new business formation. Higher tax rates will sap these potential investors of the resources they could use to help finance a business that would create new jobs.

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5. William G. Gale, "Five Myths About the Bush Tax Cuts," *The Washington Post*, August 1, 2010, at *http://www.washingtonpost.com/wp-dyn/content/article/2010/07/30/AR2010073002671.html* (September 20, 2010).
6. U.S. Department of Treasury, "Treasury Conference on Business Taxation and Global Competitiveness," July 26, 2007, p. 15, at *http://www.treas.gov/press/releases/reports/07230%2520r.pdf* (September 22, 2010).
7. *Ibid.*
8. Beach, Hederman, Ligon, Nell, and Campbell, "Obama Tax Hikes: The Economic and Fiscal Effects."

Once a start-up business gets off the ground it still needs capital in its formative years to stay afloat. A common source of that vital capital is the income the business itself generates. Higher taxes will shrink the pool of available income the small business has to tap since even small start-up businesses routinely earn more than $250,000. If taxes will take too much of the business's potential profits, many entrepreneurs could conclude that opening a new venture is too risky and pass on the chance. This would mean fewer jobs created.

In the worst -case scenario, a new business that might have become the newest Microsoft, Apple Computer, or Wal-Mart will never get out of the starting blocks. Higher tax rates could mean Americans will not get to enjoy the benefits of the "next big thing."

Tax Hikes Don't Close Deficits

The President claims he needs to eliminate the pro-growth policies to lower the deficit. Even if President Obama's proposed deficits were smaller so that additional revenue estimated to result from higher taxes covered more of the shortfall, a tax increase still would not lower the deficit. Higher taxes never close budget deficits because, in the short run, Congress will spend all the extra revenue it receives from higher taxes. Congress always spends every dollar of tax revenue it raises and however much it can borrow from credit markets. In the long run, the extra revenue will dissipate as individuals adjust their behavior to minimize their tax liability.

Individuals reduce their tax bills in three ways, each of which has a profound negative impact on the economy:

1. **Working less.** Faced with the prospect of keeping less and less of the extra money they earn by working harder and longer hours, workers decide that the extra effort is no longer worth what they ultimately earn for it.[9] By increasing tax rates, President Obama's tax plan would make leisure time more attractive than spending more hours at the office. Workers will logically decide they would rather spend those hours with their family, pursuing their favorite hobby, enjoying the company of friends, or the countless number of other ways people spend their time when they are not working.

   Reduced work effort has a profound negative impact on the economy. The forgone hours that workers otherwise would have put in represent productivity that never materializes. This reduces the income, not only of individuals, but of the businesses for which they work. Lower profitability means businesses have less capacity to expand and hire new workers. The lost productivity across the entire economy adds up to a substantial number of jobs that businesses will never create because of higher taxes.

2. **Changing the composition of compensation.** Businesses do not only compensate their workers with wages and salaries. They also provide benefits, such as health insurance, that are not taxed under the tax code. To keep their total compensation constant, and reverse the reduction in compensation caused by an income tax hike, workers will ask their employers to pay them with non-taxable compensation. More generous health insurance plans are one example. They can also ask for tickets to the local baseball team, a company car, a more generous expense account, more vacation time, flexible hours, or to work from home. More senior employees might ask their employer to compensate them based on the business's profitability so their compensation is in a form of lower-taxed capital gains. There are countless ways workers can adjust their compensation to reduce their taxes. Businesses have little trouble adjusting the mix of compensation because they will not pay their workers more on net. Merely the mix of compensation changes, and for the most part the alternative forms, are deductible business expenses just like wages and salaries.

   When employers and workers adjust compensation based on tax considerations, there are unintended consequences because they change the

9. Martin Feldstein, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act," *Journal of Political Economy*, Vol. 103, No. 3 (June 1995), pp. 551–572, at *http://www.nber.org/papers/w4496* (September 3, 2010).

demand for the non-taxed forms of compensation. The rapidly increasing cost of health insurance is a good example. More and more workers want more generous health insurance plans because the health benefits are not taxed. This in turn has driven up the demand for medical care and therefore health care prices—an important factor raising the overall cost of health care.

3. **Exploiting every tax-reduction provision in the tax code.** When tax rates are relatively low, individuals will take the basic deductions and exemptions afforded them by the tax code, pay their tax bill, and leave it at that. When tax rates rise they will pay accountants and financial planners to exploit every nook and cranny of the tax code to make sure they are paying the absolutely lowest amount of taxes allowed by law. There is nothing illegal about this; these individuals are maximizing the benefits of tax-reduction provisions put in the tax code by Congress.

   But it does create a drag on the economy because instead of using their resources to invest and help create jobs, or spending their income on goods and services they desire, these individuals use them to pay professionals to lower their tax bills. For instance, instead of using available resources to invest with a promising entrepreneur that could have the idea that revolutionizes the economy the way Apple, Microsoft or Wal-Mart did, an investor would use those funds to pay an expensive tax lawyer top dollar to minimize his tax bill. Every American, not only the wealthy investor, is hurt in this scenario because the jobs and income the business would have created never come to fruition because the business did not get the startup capital it needed to advance past the planning stage. The misallocation of resources due to higher taxes leads to less value produced from the nation's resources, and to a lower standard of living.

Higher taxes are never the solution to deficits. The only way to close deficits is to cut spending and to align it with how much revenue the tax code typically raises.

Permanent Extension

Americans, especially those who are out of work, cannot afford a tax hike right now. Raising taxes is always bad for the economy; doing so now would slow down the already sluggish economy even further. Congress should take a pass on President Obama's tax hikes and extend the 2001 and 2003 tax relief for all taxpayers—permanently.

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