Backgrounder

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Obama's 2012 Budget: Higher Taxes, Slower Growth

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Abstract: *President Obama recently unveiled his 2012 budget proposal and the 43 tax hikes it contains. The multitude of—utterly unnecessary—tax hikes will burden Americans to the tune of $1.5 trillion over the next decade. The President is proposing to raise federal tax revenues and federal spending as a percentage of GDP above historic levels, and keep them growing. This plan is a disaster for the economy—slowing down recovery, hurting job creation, making American companies less competitive, and burdening all Americans with higher taxes and consumer costs.*

In what is becoming an annual tradition, President Barack Obama's newest budget proposes a host of unnecessary tax hikes that will slow economic growth. His fiscal year 2012 budget contains 43 tax hikes that will needlessly confiscate an additional $1.5 *trillion* from Americans over the next decade. That works out to $12,000 per household over that time.

These enormous tax hikes will slow down economic growth because they will transfer resources from the productive hands of the private sector to the wasteful hands of Congress, raise energy prices, and reduce incentives to work, save, and invest.

Tax hikes are not the right solution for Americans—nor are they needed to reduce the deficit. Congress should pass on all of President Obama's tax increases and instead cut spending and reform the tax code so it inflicts less of a burden on businesses and families and is more conducive to job creation.

Talking Points

- President Obama's 2012 budget calls for 43 tax hikes that would raise taxes to historically high levels. Each of the hikes is unnecessary—since tax revenues will surge above their historical average in a few years even if they remain on their current course.
- The tax hikes would stifle job creation and slow the emerging economic recovery.
- In his State of the Union Address earlier this year, the President stated he wanted to reform the corporate tax code, yet his budget mentions no reform and *raises* taxes on U.S. corporations operating internationally, further eroding their competitiveness in the global market.
- The President plans to resurrect the death tax, which would again inflict financial hardship on America's family-owned businesses, putting the jobs they provide at risk.
- The individual and corporate income taxes are serious drags on the economy and are long overdue for fundamental reform. *This* is what Congress should focus on.

This paper, in its entirety, can be found at:
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Unnecessary Tax Hikes

The unsustainable deficits that President Obama outlines in his budget are exclusively the result of overspending—not a lack of tax revenue. No tax hikes are necessary to fix this problem of deficits and spending.

Historically, federal spending as a percentage of gross domestic product (GDP) has averaged around 20 percent. Obama's budget averages almost 23 percent from 2012 through 2021.

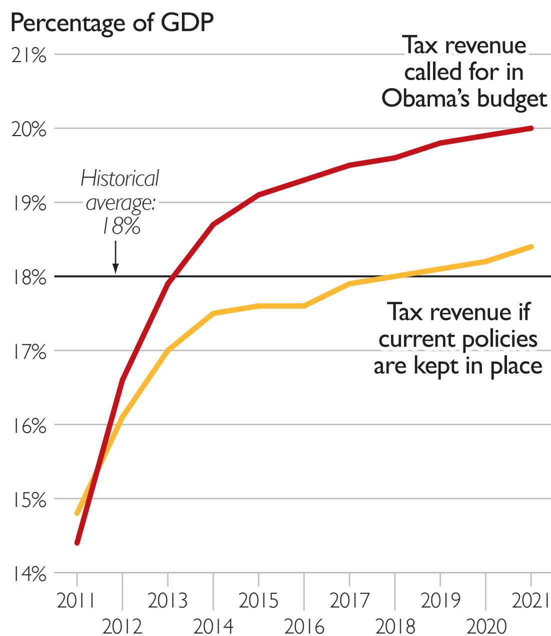
Federal tax revenues have averaged about 18 percent of GDP. Although below that mark currently because of the recession, according to the Congressional Budget Office (CBO), federal tax receipts will be above that historical threshold by 2018 if all current tax policies are left in place—including making all 2001 and 2003 tax cuts permanent. If spending were kept to 20 percent of GDP, the deficit would fall below its historical average after 2018 and the national debt would stabilize.

President Obama's budget calls for racing past the historical level of tax receipts by 2013. His budget calls for tax revenues to reach as high as 20 percent of GDP in 2021. That would be just shy of the federal government's all-time record high achieved in 2000 and would result in taxes being $493 billion higher than necessary in 2021 alone. If Congress passes President Obama's tax policies, tax receipts will continue to grow after 2021 and will far surpass their historical record thereafter.

The President's budget contains almost no tax cuts, and not one of the long-overdue reforms he promised. Most of what he refers to as tax cuts are extensions of current policy. In total, the new tax cuts he proposes amount to less than 3 percent of the tax increases he plans.

Obama's Budget Needlessly Hikes Taxes Well Above Historical Average

President Obama's budget permanently raises tax revenue above its historical average by 2014 and then continues to raise it to record levels.



Source: Heritage Foundation calculations based on data from the White House Office of Management and Budget and the Congressional Budget Office.

Chart 1 • B 2533 heritage.org

Five Types of Obama Tax Hikes

President Obama's unnecessary tax hikes break down into five categories:

1. Repeal of the 2001 and 2003 Tax Cuts for Upper-Income Families

President Obama reached an agreement with Congress in late 2010 to extend all 2001 and 2003 tax cuts for two more years, through 2012. After praising that agreement immediately after its passage, the President changed quickly back to his long-held preference of allowing those tax cuts to expire for families and small businesses that earn more than $250,000 a year ($200,000 for single filers).

It comes as no surprise, then, that he calls for the permanent expiration of the tax cuts for those families and small businesses when the deal runs out in 2012. Under President Obama's budget, the top two tax rates would increase from 35 percent and 33 percent to 39.6 percent and 36 percent, respectively. The tax rates on capital gains and dividends would both rise from 15 percent to 20 percent for high-income earners, and certain deductions and exemptions for these same taxpayers would be phased out.

The budget scores *raised* tax rates on capital gains and dividends as a tax cut. That is because the

rate on dividends before the 2003 tax cut was equal to the taxpayers' top income tax rate. In President Obama's world, the failure to raise it back to that level is a cut. In the real world, taxing dividends at the same rate as capital gains has been policy for more than 10 years now. Raising it by any amount is an increase. Not raising it is *not* a tax cut.

President Obama calls for eliminating the capital gains tax for investments in small business in the budget. This proposal shows that the President understands the tax on capital gains impedes economic growth, yet he insists on raising it for capital gains from all other sources. It would be better for the economy if the President applied his capital gains proposal for small businesses to all capital gains.

In total, the tax increases on upper-income families are $709 billion over 10 years.

Raising income taxes on upper-income families will reduce incentives to work and save at the worst possible time. In 2013 the economy will still be getting on its feet and higher tax rates will only slow recovery. Higher taxes on capital gains and dividends will lower the incentives for investment, which will also slow recovery.

2. Higher Death Tax

As part of the 2010 tax deal, the "death tax" was resurrected from its year-long burial. The estate tax had expired in 2010, but the deal between the President and Congress brought it back to life at 35 percent with a $5 million exemption for 2011 and 2012.

Just like in the case of the upper-income tax-relief provisions, the President was unsatisfied with this compromise. In his budget, he calls for raising the death tax to 45 percent and reducing the exemption amount to $3.5 million starting in 2013.

President Obama also proposes making it more difficult for family-owned businesses to shield portions of their businesses from the devastating impact of the death tax.

Despite its reputation of applying only to the *über*-wealthy, the death tax is the scourge of family-owned businesses. These businesses cannot afford the extensive planning that larger estates can pay for. As a result, the growth of these businesses is curtailed as families save for the dreaded day when they must fork over the death tax. In the worst-case scenario, family businesses must be broken up to pay the tax.

As a result, the death tax is a tax on capital because families divert resources from productive activities either to pay the tax or prepare for it. With less money allocated to capital formation, these businesses create fewer jobs than they would have otherwise, and economic growth is slowed.

President Obama's death tax hike will destroy many jobs and raise taxes by $118 billion over 10 years.

3. Limited Deductions for Upper-Income Families

Congress originally designed the alternative minimum tax (AMT) to prevent a small percentage of high-income families from using the multitude of legal deductions and credits in the tax code to lower their tax liability too much. But the AMT threatens to raise the taxes of middle-income families each year because Congress never indexed for inflation the income threshold above which taxpayers are subject to the AMT.

Congress annually passes an AMT "patch," which raises the threshold for inflation to prevent the AMT from falling on middle-income families. The patch is not a tax cut. It is the prevention of a steep tax hike on middle-income families that Congress never intended. Since it is not a tax cut, and is long-held policy, there is no need for Congress to "offset" the revenue the AMT would have raised had it applied to middle-income families.

President Obama's budget would also "patch" the AMT for the next three years so it does not catch middle-income families. The patch raises the income threshold above which families pay the AMT. But then, he proposes a completely unnecessary hike to offset this phantom revenue loss. His proposed tax hike would place a cap on the total amount of deductions that upper-income families could claim by limiting their total deductions to the maximum amount they would be able to deduct if they had paid taxes at the 28 percent income tax rate.

The limit on deductions would raise taxes by $321 billion over 10 years. It would be a permanent tax hike, while the AMT patch would last only the three years.

Capping deductions for high-income taxpayers is a way of reducing "tax expenditures," the myriad credits and deductions that riddle the federal tax code today.[1] Reducing tax expenditures is currently a popular proposal for reducing the deficit because many argue they are nothing more than surreptitious spending through the tax code and benefit only a narrow minority of varying special interests. To be sure, there are many tax expenditures that are spending through the tax code. However, there are certain provisions currently classified as tax expenditures that are not spending and are economically justifiable.

When addressing the numerous problems in the tax code, eliminating tax expenditures should not be used as an excuse to raise taxes like some bookkeeping exercise. It should be done only through fundamental tax reform where Congress can weigh the efficacy of each provision separately and decide which it wants to keep and those it wants to discard. Tax rates should then be lowered permanently, in order to prevent the government from raising additional revenue by eliminating these tax-reducing policies.

4. Higher Taxes on International Businesses.

For the third year in a row, President Obama included a host of tax increases on multinational businesses. They include limiting interest deductions, reducing the foreign tax credit, and other tax increases on businesses that operate internationally. Combined, these tax hikes will raise more than $129 billion over 10 years.

These tax hikes will further reduce the competitiveness of U.S. businesses in the global marketplace. U.S. businesses that operate internationally are already at a sizeable disadvantage compared to their foreign competition because U.S. businesses pay the highest tax rate in the industrialized world. The U.S. recently surpassed Japan as the country with the highest corporate tax rate in the world when Japan lowered its rate.[2]

The high rate makes the U.S. uncompetitive in the global race for capital investment and the jobs it creates. Businesses, both foreign and domestic, can earn higher returns in other countries in large part because the rate in the U.S. is so high. Until the rate is lowered to the average rate of other developed countries (25 percent), the U.S. will continue losing badly needed jobs to foreign competitors.

The President rightfully called for Congress to reform the corporate income tax in his State of the Union address in January 2011. But his plan to raise taxes on U.S. businesses that operate internationally would counteract the positive benefits of reform.

It is hard to reconcile the President's long-overdue call for corporate tax reform to improve U.S. competitiveness with his tax hikes on multinational businesses. Either he did not think through how the policies would work against each other, or he is not serious about reforming the corporate income tax.

Assuming he is serious, President Obama needs to show real leadership. Any tax reform requires focus and guidance from the presidential level, but President Obama failed to provide a plan for Congress to follow. Corporate tax reform will not become a reality, and the U.S. will fall further behind its global competition, unless the President provides Congress with direction in the near future.

One beneficial policy for businesses that the President did include in the budget was increasing the "research and experimentation" tax credit and making it permanent. Making the credit permanent will give businesses certainty going forward. Increasing it will give them more incentive to invest in research and development. The President, however, should

1. J. D. Foster, "Eliminating Tax Expenditures: Beware the Third Wave of Tax Hikes," Heritage Foundation *Backgrounder* No. 2480, October 21, 2010, at *http://www.heritage.org/Research/Reports/2010/10/Eliminating-Tax-Expenditures-Beware-the-Third-Wave-of-Tax-Hikes*.
2. Curtis S. Dubay, "Corporate Tax Reform Should Focus on Rate Reduction," Heritage Foundation *WebMemo* No. 3146, February 11, 2011, at *http://www.heritage.org/Research/Reports/2011/02/Corporate-Tax-Reform-Should-Focus-on-Rate-Reduction*.

not claim this as a new tax cut. The research and experimentation credit has been in the tax code for many years. It expires annually, and Congress has always extended it. Making it permanent simply removes the small chance that Congress might not extend it at some point in the future.

5. Miscellaneous Tax Hikes on Businesses

President Obama also included in his budget an assortment of other tax increases on businesses that total more than $207 billion over 10 years.

The largest tax increase in this group is the repeal of the "last in, first out" (LIFO) method of inventory accounting. This tax increase will cost businesses $53 billion over 10 years. It will hurt retail and wholesale companies the most because it will force them to deduct their least-costly inventory from income first.

The next-largest tax hike in this group falls on energy production. President Obama proposes the elimination of tax-reducing provisions for coal, oil, and gas companies. The provisions the President wants to eliminate are mostly policies that allow energy companies to more quickly deduct the cost of capital investment (called expensing) rather than depreciate those investments over a longer period of time.

Expensing is the proper treatment of capital purchases, so these policies actually improve the tax code. Instead of abolishing these and similar provisions, the President should propose making expensing permanent for all capital purchases. It would be consistent with the provision he pushed in the 2010 tax deal that allows all businesses to expense capital purchases for 2011.

If the President's budget becomes law, energy companies will pass the tax increases on to consumers—in the form of higher energy prices totaling more than $46 billion over 10 years.

The remaining tax increases in this category include:

- Higher taxes on financial institutions, including the bank tax that President Obama previously called for ($33 billion over 10 years);
- Reinstating Superfund taxes ($21 billion);
- Increasing taxes on insurance companies ($14 billion);
- Taxing carried interest as regular income ($15 billion); and
- Assorted other tax increases on businesses ($26 billion).

Focus Should Be on Tax Reform

The country cannot afford the economy-slowing taxes that President Obama calls for in his budget. Congress should ignore the President's tax increases and keep taxes at their current levels until it can undertake fundamental reform of the entire tax code.

The individual income tax and corporate income tax are both serious drags on the economy and are long overdue for fundamental reform. If the President and Congress worked together to reform the tax code in a revenue-neutral manner—that is, without raising taxes—the resulting simpler tax code would free individuals and businesses to use their time and resources to seek out more promising opportunities.

This, in turn, would strengthen economic recovery in the immediate future, provide the basis for more robust growth in the future, and create more jobs at all points along the way. As an added benefit, a stronger economy will raise tax receipts back to their historical level and will help return the deficit back to an acceptable level more quickly.

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