WebMemo

Published by The Heritage Foundation

No. 3232
April 25, 2011

A Rose by Any Other Name: Clarity on Tax Hikes

J. D. Foster, Ph.D.

Fiscal policy debates are loaded with emotion and complex terminology. Even the raw numbers—billions and trillions—are largely beyond human comprehension. It is all the more important, then, to hold tightly to a few simple concepts that clarify the debate. One is the definition of a tax increase.

What Is a Tax Hike? A tax hike occurs when, as a consequence of a change in the tax law, total tax receipts are projected to be higher than they would be under current policy using traditional quasi-static scoring employed by the Treasury Department and by the congressional Joint Committee on Taxation. This change in the tax law may arise because of new legislation or because (through inaction) Congress allows existing tax provisions to expire.

Four concepts are especially important.

1. ***Current policy.*** The reference point is the projected level of total tax receipts under current policy. If taxes are higher under a proposal than under current policy, then that proposal calls for a tax hike.

   The emphasis on current *policy* rather than current *law* arises because Congress has increasingly taken to enacting temporary tax provisions. This is bad tax policy. It is also confusing for identifying when taxes are raised or lowered. What matters for determining whether the policy constitutes a "tax hike" is whether taxes would be higher overall than under current policy.

   Tax hikes can occur as a result of legislative action or inaction, such as allowing tax hikes arising from previous legislation to take effect. A policy of allowing current tax provisions to expire—thus raising revenues—is a tax hike.

   Or suppose Congress were to extend existing tax relief, thus preventing a tax hike, but at the same time offset the budgetary effects of the extension with other changes in tax policy. These other changes would then amount to a tax hike because the total level of receipts would be higher than under current policy. Note that avoiding a tax hike is not a tax "cut."

2. ***Total tax revenues.*** The issue is not the amount of tax paid by any particular individual, group, or industry. Taxes could rise for some taxpayers, and they would certainly label the proposal a tax hike from their perspective. However, as long as taxes fall for other taxpayers so that the overall level of tax revenues is no higher, then the proposal should not be considered to "raise taxes" overall. For purposes of identifying a tax hike, the issue is whether total revenues rise relative to the current policy revenue baseline.

   This point is especially important as the words "tax reform" are tossed about by the President and others. The nation desperately needs good

This paper, in its entirety, can be found at:
http://report.heritage.org/wm3232

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

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation
LEADERSHIP FOR AMERICA

tax reform: reform that would simplify the tax code and make it more conducive to economic growth. Any good tax reform effort would reduce tax rates and broaden the tax base by eliminating various inappropriate deductions and credits. However, the net outcome should not be higher tax revenues as typically scored. Tax reform should be revenue-neutral. A proposal labeled as tax reform that raises revenues using traditional scoring is a tax hike first and tax reform second. Even eliminating bad policy like the ethanol tax credit is a tax hike if overall tax collections rise as a result.

3. ***The relevant period of time.*** The issue is not whether revenues are higher in a given year, but whether revenues are higher over the 10-year budget window. For example, revenues could fall one year from a change in policy and rise the next. This is typical of proposals such as that enacted late last year to allow expensing for a year, allowing companies to deduct their 2011 capital outlays immediately. Expensing also means that these companies cannot take a depreciation deduction in the following years for their current investment, so their taxes are higher in these later years.

   The fact that taxes are higher in the outyears does not mean in such cases that Congress has raised taxes. Whether the legislation is a tax hike or not depends on what happens to total revenues over the relevant period of years.

4. ***Economic growth.*** Many tax policy changes would improve economic performance, and many would worsen it. A change in tax policy is not a tax hike if it would lead to stronger tax revenues solely by producing a stronger economy. For example, a reduction in a tax rate would be a tax cut unless combined with some other change like eliminating a deduction, producing a revenue-neutral bill using traditional scoring. If done wisely, the economy would benefit from the lower tax rate, producing stronger economic growth and higher total revenues. Such an outcome would not render the proposal a "tax hike."

What About Fees? A dicey issue arises when government provides a service and increases the fee for that service. Is that a tax hike? If government institutes a service that citizens may freely choose to buy or not and for which it charges a fee, then the fee is not a tax, and so there can be no tax hike.

But suppose government has been providing the service for some time. For example, suppose the service costs $100 to provide and the current fee is $25. Obviously, general revenues are then offsetting the other $75 in cost. Raising fees by $15 to $40 need not mean a tax hike; it depends on what else occurs. The higher fee means government has freed some amount of general revenues for other purposes. Taxpayers are paying more and receiving no additional services, so absent a tax cut equal to the additional fee, the increase in fees should be considered a tax hike. The fee increase may well be good policy, but to avoid a tax hike, other taxes must be reduced in tandem.

Bowles–Simpson: A Case Study. The distinctions of what is and is not a tax hike are especially important because they seem to have been lost, forgotten, or misunderstood as the recommendations of the Bowles–Simpson deficit reduction plan were considered. This misunderstanding appears to continue in some quarters. For example, it permeates President Obama's recent comments about what he referred to as "tax reform," and it therefore is important to set the record straight.

The Bowles–Simpson plan proposed tax reform based on eliminating all so-called tax expenditures. It then wisely reduced tax rates. However, it used only part of the revenue increase from eliminating tax expenditures for rate reduction, using the balance of the revenue increase to reduce the budget deficit. The plan was very clear about this. Page 25 of the report states that the commission proposes tax reform that relies on "zero-based budgeting" by eliminating "all income tax expenditures (but maintaining the current payroll tax base, which should be modified only in the context of Social Security reform), and then using the revenue to lower rates and reduce deficits."

Using traditional scoring, a tax proposal can reduce budget deficits only if it raises aggregate tax receipts. The Bowles–Simpson exercise was mislabeled. It is not tax reform; it is a tax-hiking exer-

cise in tax reform garb, a common ruse of tax hike proponents.

One can argue whether the commission's tax policy proposals per se were wise—broadening the base without regard to issues arising from the proper definition of income to lower statutory tax rates—but it is beyond reasonable dispute that the plan raised taxes. In fact, the best calculation is that the plan raised taxes by $3.3 trillion over 10 years.[1] Whether the figure is $1 trillion or $4 trillion is incidental to the point, however. The commission was very explicit that it intended to raise taxes, and it did so substantially. To argue that the Bowles–Simpson plan does not raise taxes flies in the face of the data and the statements of the report.

Definitions Aside, Must Taxes Rise? The nation's fiscal policy is disastrous. Countless reports and studies have explained in great and consistent detail that the long-term policy is unsustainable. What has changed under President Obama is that the near-term fiscal policy is almost equally disastrous. In response, the credit rating agency Standard and Poor's released yet another warning on April 18, changing its outlook on U.S. securities to "negative" from "stable."

The basic facts are plain. The federal government spends far too much today—and far more than is normal as suggested by modern U.S. history. Worse, federal spending is slated to soar in the near future to flatly unsustainable levels, thanks especially to promises made in Social Security, Medicare, and Medicaid. Even if one raised taxes substantially and slashed defense spending deeply, spending under these three programs would have to be pared sharply.

Little of this spending is constitutionally required beyond providing for the national defense. This excess spending is all the result of laws passed by Congress and signed by Presidents past and present. Except for net interest and national defense, it can and should be pared back to align with normal levels of tax receipts. In short, the resolution of budget deficits is a matter of choice, and a choice must be made.

Those who argue that taxpayers must pay more to create a fiscally responsible federal policy are simply incorrect. Spending must come down far below current projections. Even those who advocate tax hikes grudgingly acknowledge that reality. The debate is whether spending should come down enough to restore a sound overall fiscal policy (it should), or whether spending should come down less and taxes should go up more to pay for the additional spending. This is a policy choice. To argue that taxes must rise does nothing but indicate where one comes out in that debate.

Even some conservatives have said they oppose tax hikes "in principle" but still insist that tax hikes be on the table to foster a debate on basic reforms. As a negotiating strategy, this approach is unwise, and the opposition carefully avoids making the same mistake. The problem is spending. That is where the debate needs to start, and that is where it should end.

*—**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.*

1. Brian M. Riedl, "Fiscal Commission Report: Too Much Taxes, Not Enough Spending Cuts," Heritage Foundation *WebMemo* No. 3071, December 3, 2010, at *http://www.heritage.org/Research/Reports/2010/12/Fiscal-Commission-Report-Too-Much-Taxes-Not-Enough-Spending-Cuts*.