The Heritage Foundation
LEADERSHIP FOR AMERICA

BACKGROUNDER

No. 2665 | MARCH 19, 2012

Obama FY 2013 Budget Violates Basic Principles of Tax Reform

Curtis S. Dubay

Abstract

The current tax code is an enormous burden on the economy, preventing it from reaching its full potential. Tax reform is long overdue. After initial reluctance, President Obama now agrees that the economy needs tax reform. He frames the numerous tax increases in his FY 2013 budget request as tax reform. In reality, they would be the opposite of reform. If Congress made the mistake of passing President Obama's false tax reform plan, it would damage the economy and set back the movement toward true tax reform. As it has done with the President's previous budgets, Congress should ignore his new tax plan and focus on crafting a true tax reform plan along the lines of the Heritage Foundation's New Flat Tax.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2665**

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

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.

There is a growing consensus among Members of Congress, businesses, and individual taxpayers that the economy cannot adequately recover until Congress frees it of the enormous burden taxes place on it. In order to lift that burden, Congress must undertake fundamental tax reform. After some hesitation, President Barack Obama now agrees that tax reform is necessary.

To that end, the President frames the various tax policy changes he proposes in his fiscal year (FY) 2013 budget as a starting point for tax reform.[1] Yet, Congress's enactment of these policy changes would represent a repudiation of the central goal of tax reform—to improve economic performance—and would delay implementation of true tax reform even longer at a time when the economy badly needs the boost it would provide.

As it has done with each of the President's three previous budgets, Congress should reject the President's current tax proposals. Members should instead work towards true fundamental tax reform.

True Tax Reform

Proper tax reform would alleviate the crushing burden that taxes place

Talking Points

- President Obama frames the net $2 trillion tax increase in his budget as "tax reform," but the policies he proposes contradict the goals of real tax reform.
- Tax reform should encourage economic growth by (1) lowering marginal tax rates; (2) eliminating taxes on saving and investment; (3) stopping the tax code from picking winners and losers in the market; and (4) being revenue and distributionally neutral.
- The enormous tax hike that President Obama's so-called tax reform plan would impose, mostly on high-income earners, would violate all four principles. As a result, if Congress enacted his misguided tax reform plan, it would slow economic growth and destroy jobs rather than create them.
- Like it has done in the past, Congress should ignore the President's backwards tax plan and focus on real tax reform, such as The Heritage Foundation's New Flat Tax.

on the economy and allow faster growth, stronger job creation, and, ultimately, a higher standard of living for all Americans.

Tax reform should accomplish these objectives within the framework of revenue and distribution neutrality. That means that the new tax code should raise the same amount of revenue overall as does the current tax code, and that the distribution of the tax burden across income groups should remain constant.

To enhance economic growth while remaining within the framework of revenue and distributional neutrality, tax reform must succeed in three elemental tasks:

- Lowering marginal tax rates;
- Eliminating taxes on saving and investment; and
- Repairing the tax base so it is neutral toward economic activity (no picking winners and losers with preferential or punitive policies).

President Obama violates each of these basic principles with the tax reform outline in his budget.

Violation #1: Not Revenue and Distributionally Neutral. President Obama proposes some tax cuts and a multitude of tax hikes in his budget. The net effect of his tax policy changes will be more than $2 trillion of tax hikes over the 10-year budget window (all figures hereafter are for 10 years).[2] This would obliterate the revenue-neutrality framework within which proper tax reform should work.

If the President's budget were to become law, it would catapult tax revenue above its historical 50-year average of 18 percent of gross domestic product (GDP) by 2014, and near its record high of 20.6 percent of GDP (reached only in 2000, at the height of the dot-com bubble) by 2022 (the end of the current 10-year budget window). Revenues would grow to new historic heights every year after that.

The massive tax hike desired by President Obama would fall most heavily on those families and businesses that earn more than $250,000 a year. This is part of his effort to make the wealthy pay "their fair share."

The President defines "fair share" as the rich paying 30 percent of their annual income to the federal government, as called for in his "Buffett Rule."[3] President Obama references the Buffett Rule in passing in the text of the budget as a principle that Congress should follow in tax reform, but he does not explicitly lay out a policy to implement it.

Of the more than $2 trillion in tax hikes called for by President Obama, more than $1.4 trillion (71 percent) would come from an assortment of higher taxes on high-income earners. Raising the almost three-quarters of the increased tax receipts he proposes from high-income earners would increase the already sizeable share of the income tax burden they shoulder.[4] That would break the distributional neutrality principle of tax reform.

Violation #2: Raises, Not Lowers, Marginal Income Tax Rates. The President has an assortment of tax hikes to be imposed on the rich. The most economically damaging hike would be to raise $442 billion by increasing the top two marginal income tax rates from their levels of the past 10 to 12 years to the levels they were before the 2001 and 2003 tax cuts. This increase would initially raise those rates from 33 percent and 35 percent to 36 percent and 39.6 percent, respectively.

Those would be the rates *before* the 3.8 percent surtax for incomes higher than $250,000 that begins in 2013, passed as part of the Patient Protection and Affordable Care Act (PPACA), popularly known as Obamacare. After including the surtax, the top income tax rate would be 43.4 percent if President Obama's budget became law. Despite the frequent protestations from President Obama that he merely wants to raise taxes back to 1990s levels, this would be a rate higher than the top rate signed into law by President Clinton in his 1993 tax hike.

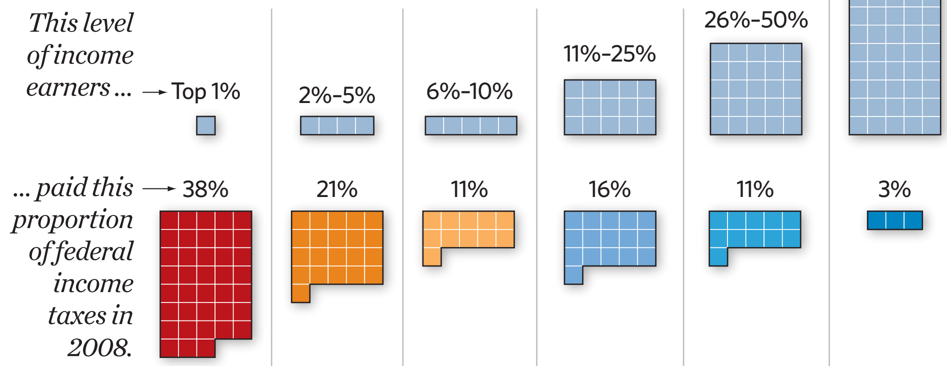
Higher marginal income tax rates would discourage working hard, saving frugally, and taking prudent entrepreneurial risk. These activities are the foundational behaviors

1. U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013* (Washington, D.C.: U.S. Government Printing Office, 2012), pp. 218–225, pp. 37, at *http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf* (March 6, 2012).
2. Curtis S. Dubay, "Obama's Budget Badly Undercounts Tax Hikes," Heritage Foundation *Issue Brief* No. 3522, February 29, 2012, at *http://www.heritage.org/research/reports/2012/02/obamas-budget-undercounts-tax-increases*.
3. Keith Hennessey, "The President's Buffett Rule is Vaporware," KeithHennessey.com, February 22, 2012, at *http://keithhennessey.com/2012/02/22/the-presidents-buffett-rule-is-vaporware/* (March 6, 2012).
4. Heritage Foundation 2011 Budget Chart Book, "The Top 10 Percent of Earners Paid 70 Percent of Federal Income Taxes," Federal Revenue Chart 2, at *http://www.heritage.org/budgetchartbook/pdf/2011/top10-percent-income-earners.pdf.*

CHART 1

The Top 10 Percent of Earners Paid 70 Percent of Federal Income Taxes

Top earners are the target for new tax increases, but the U.S. tax system is already highly progressive. The top 1 percent of income earners paid 38 percent of all federal income taxes in 2008, while the bottom 50 percent paid only 3 percent. Forty-nine percent of U.S. households paid no federal income tax at all.



Source: Internal Revenue Service, Individual Income Tax Returns with Positive Adjusted Gross Income (AGI) Returns Classified by Tax Percentile data, at *http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133521,00.html* (March 15, 2012).

B2665 heritage.org

of economic growth, and tax reform should maximize the incentives for families and businesses to engage in them rather than further discouraging them.

Higher tax rates will also fall heavily on businesses that pay their taxes through the individual income tax code *and* employ workers. According to the Treasury Department, 90 percent of the income earned by flow-through businesses that employ workers would be taxed at higher rates under President Obama's plan.[5] By virtue of earning almost all the employer income, these businesses are the biggest employers that pay their taxes through the individual tax code.

The President's tax rate hikes are a direct assault on the very employers that the economy desperately needs to create jobs and bring unemployment down. With more of their income taken by Uncle Sam, these important job creators will have fewer resources to invest in their businesses and will not be able to employ as many workers as they could have in the absence of President Obama's tax hikes.

Damage Compounded by Capped Deductions and Exemptions

President Obama would further compound the damage of hiking marginal income tax rates by raising the effective tax rate for upper-income taxpayers. He would do this by reducing the value of their exemptions and itemized deductions.

He would revive the personal exemption phase-out and the itemized-deduction limitation, which both existed before the 2001 and 2003 tax cuts, for families earning more than $250,000 a year.

He would also cap the value of all itemized deductions that high-income taxpayers could claim. He would do so by limiting the amount by which they could reduce their tax bill. Instead of itemized deductions reducing high-income taxpayers' tax bills by the dollar value of the deductions multiplied by their marginal tax rate, the President would cap their deduction at the value of deductions multiplied by the lower 28 percent rate.

President Obama's limitations on deductions and exemptions would raise a total of $749 billion, considerably more than his rate hikes would raise.

Capping deductions for high-income taxpayers is a way of reducing "tax expenditures," or "closing loopholes" as many refer to it. The President wants to reduce tax expenditures because, he argues, they are surreptitious spending through the tax code and overwhelmingly benefit top-income earners. There are some tax expenditures that constitute spending through the tax code: the refundable portions of some tax credits. However, there are certain provisions currently classified as tax expenditures that do not count as

5. Matthew Knittel *et al.*, "Methodology to Identify Small Businesses and Their Owners," U.S. Department of the Treasury, August 2011, table 15, at *http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf* (March 6, 2012).

spending and that are economically justifiable.

The President's method of solving this problem is imprecise and will do more harm than good. Eliminating tax expenditures should not be used as an excuse to raise taxes as if they were a bookkeeping exercise.[6] Tax expenditures should only be eliminated to improve the neutrality of the tax code. Congress should make that improvement through fundamental tax reform where it can weigh the efficacy of each provision in the tax code separately and decide which it wants to keep and which 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.

President Obama's plan would make it harder for Congress to undertake the proper approach by adding an extra layer of complexity to the process and "raising the cost" for Congress to fix the issue.

Violation #3: Increases Taxes on Investment. Another plank of President Obama's "tax the rich" policy is to increase tax rates on capital gains and dividends for taxpayers earning more than $250,000 a year. These hikes would raise more than $240 billion.

The President wants to raise the capital gains tax rate from its current 15 percent to 20 percent, and the dividends rate from 15 percent to 39.6 percent. In this scenario, dividends

The Cap on Itemized Deductions

The cap would work in two ways. It would make income taxable that is currently exempt from tax. This includes tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or with before-tax employee dollars, health insurance costs of self-employed individuals, employee contributions to defined-contribution retirement plans and individual retirement arrangements, the deduction for income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, contributions to health savings accounts and Archer MSAs, interest on education loans, and certain higher-education expenses.

This is a drastic change from the current treatment of these forms of income, especially the treatment of health insurance and health care expenses. It would, in essence, turn these long-in-law exclusions into ordinary deductions and cap their value. If this sweeping policy change became law, it would raise the cost of borrowing for state and local governments and make it more difficult for families to save for future medical expenses, retirement, and higher education.

The policy would also cap itemized deductions, such as the mortgage-interest deduction, the charitable deduction, and the deduction for state and local taxes. The cap would work by limiting these deductions for high-income taxpayers to the 28 percent marginal rate instead of the higher 36 percent and 39.6 percent rates they would be subject to under Obama's plan.

For instance, if a taxpayer who earns enough to qualify for the top marginal tax rate claimed $10,000 of mortgage interest, charitable contributions, and state and local tax deductions, under today's tax code, he would reduce his tax bill by $3,500 (value of the deductions multiplied by the top 35 percent marginal tax rate). Under the President's plan, these taxpayers would now be subject to the 39.6 percent income tax rate. This taxpayer's itemized deduction, then, would reduce his tax bill by $3,960. However, the Obama plan would also cap this taxpayer's deduction at $2,800, or the value of the deduction had he paid at the 28 percent marginal rate. This taxpayer would experience a tax hike of $1,160 from the cap alone. This would make the tax code less neutral and, in the case of the cap on charitable contributions, tip the scales in favor of the government, not private institutions, providing all manner of social services.

6. J. D. Foster, "A Rose by Any Other Name: Clarity on Tax Hikes," Heritage Foundation *WebMemo* No. 3232, April 25, 2011, at *http://www.heritage.org/Research/Reports/2011/04/Understanding-Tax-Hikes-and-Why-Taxes-Rise*.

would be taxed at the same rate as wage and salary income, like they were before the 2003 tax cuts.

These rates, as with the top marginal income tax rates, are the rates before the imposition of the new 3.8 percent PPACA surtax that begins in 2013. That surtax would raise the capital gains rate to 23.8 percent. The dividends rate would rise all the way to 43.4 percent—almost triple what it is today.

The effective tax rate on dividends would be considerably higher than that because it is a double tax (as is the capital gains tax). Dividends are paid from corporate earnings on which businesses must first pay the highest-in-the-world 35 percent corporate income tax. The President's dividends tax rate would raise the effective rate on dividends to more than 63 percent.

Investors priced the current tax rate into the returns they expected when they made their existing investments. Raising rates on capital gains and dividends now would be a transfer of wealth from these existing owners of capital to the federal government. While this transfer of wealth is problematic, these tax hikes are even more worrisome because they would slow investment while the economy remains weak.

Higher capital gains and dividends tax rates would raise businesses' cost of issuing new capital. The higher cost causes existing businesses to cut back on their plans to expand their operations and discourages budding entrepreneurs from starting new enterprises. This will further slow growth in addition to the diminished growth that would come from higher marginal income tax rates.

Once again, President Obama's tax proposals contradict the goals of proper tax reform. President Obama's tax hikes would leave tax rates on investment well above today's top marginal income tax rates: a sure sign that his budget is going in the wrong direction. True tax reform would, at a minimum, reduce the tax burden on investment and, ideally, eliminate it completely to provide the maximum incentives for new investment that increases economic growth and job creation.

Higher Death Tax Further Punishes Investment

President Obama would compound the increased disincentive to invest by raising the federal estate tax, better known as the death tax. After it was temporarily eliminated in 2010, the death tax stands at 35 percent with a $5 million exemption for 2011 and 2012. President Obama proposes to raise it to 45 percent with a permanent $3.5 million exemption beginning in 2013. He also proposes to make it harder for families to protect their hard-earned assets from the long arm of the IRS after a loved one passes away. The President's death tax hikes would raise $143 billion.

While the President may see a higher death tax as part of his "tax the rich" plan, the death tax does not plague the wealthiest families. They have the financial wherewithal to pay lawyers and accountants to shield their assets from the death tax. It is family-owned businesses that bear the brunt of the death tax.[7]

Family-owned businesses can look valuable on paper because they control high-value assets; in reality these families often have comparatively little cash to pay a death tax bill in the event of an untimely passing. To prepare for this, many families take out expensive life insurance policies that help pay the death tax. The pricey premiums soak up resources that the family could have poured back into the business to hire more workers or better compensate their current workers.

Family-owned businesses that do not have insurance plans are often faced with the difficult proposition of selling some of the business's assets, or selling the business completely, to pay the death tax liability.

Regardless of how family-owned businesses pay the death tax, it slows their growth, and they create fewer jobs because their scarce resources are diverted or liquidated to pay the government tab. Because it functions this way, the death tax should properly be thought of as a tax on capital that discourages investment.

The death tax is yet another example of President Obama getting a tax policy exactly backwards. Proper fundamental tax reform would abolish the death tax once and for all.

Violation #4: Picks Winners and Losers. Taxes should not favor or punish a particular industry, group, or activity with preferential or punitive treatment. To do so would mean that Congress and the President pick winners and losers through the tax code. The recent and historical track record of the federal government's investments is clear proof that it is not as efficient at directing resources as the private market.

Preferential policies already plague the tax code, mostly through tax breaks for alternative energy and ostensibly energy-efficient durable

7. Curtis S. Dubay, "The Economic Case Against the Death Tax," Heritage Foundation *Backgrounder* No. 2440, July 20, 2010, at *http://www.heritage.org/research/reports/2010/07/the-economic-case-against-the-death-tax*.

goods like cars and household appliances. True tax reform would weed out these policies in order to make the tax code more neutral, and use the extra revenue to lower marginal tax rates. Again, the President takes the opposite approach.

Instead of removing troubling policies, President Obama doubles down on the industrial planning policies lurking in the tax code. In accordance with his desire to shift from a fossil-fuel-based economy to one based on "green" energy, the President seeks to raise the price of fossil fuels with tax hikes of almost $30 billion on oil, gas, and coal companies. He raises that revenue with an assortment of different tax increases, including repealing expensing provisions, limiting their use of the Domestic Manufacturers credit, and repealing percentage depreciation allowances.

Expensing is the proper way to treat capital expenditures and should be expanded to all capital purchases. Preventing oil, gas, and coal companies from expensing is a step in the wrong direction. Similarly, the manufacturing credit is available for all domestic manufacturers. Singling out these companies to take away provisions that represent good policy and those that are broadly available is using the tax code punitively.

Percentage depreciation allowances deserve closer examination, but any adjustment to them that raises revenue should be used to lower other taxes.

That $30 billion in higher energy taxes will show up in higher prices for energy users and artificially shift demand to alternative fuels, assuming they exist on the market at competitive prices. President Obama would help manipulate alternative energy prices to make these sources competitive by giving preferential treatment through new and expanded tax *cuts* for alternative fuels, cars that use them, and products deemed energy efficient.

Energy is not the only area where the President is meddling in the free market. He would also punish U.S. businesses that seek new opportunities abroad while rewarding businesses that "insource" jobs to the U.S. from foreign locales. He would do so by subjecting the foreign income of multinational businesses to the high U.S. corporate tax rate sooner than under current law, while at the same time providing new tax cuts for businesses that bring jobs back to the U.S.

These policy mistakes are rooted in a fundamental misunderstanding of the global economy. President Obama seems to assume that U.S. multinational businesses that expand overseas are bad for the U.S. economy. But a U.S. business investing abroad is good for the U.S. economy because it makes the company more competitive at home and abroad in selling products into foreign markets. When a U.S. company moves into a foreign market to meet growing demand, it creates jobs not only in the new market but in the United States as well. President Obama also seems to assume that businesses expanding overseas are doing so at the cost of domestic jobs, when, in fact, expansion in foreign markets also means growth here at home.[8]

By punishing companies that seek opportunity abroad, and rewarding those that happen to bring jobs to the U.S., President Obama is operating under the assumption that businesses doing the latter are better for the economy and are creating more jobs. But he cannot possibly know which businesses create more jobs, which is precisely the reason he should not use the tax code to direct the economy's scarce resources. He should leave that to the diffuse network of individuals and businesses that comprise the free market.

Conclusion

President Obama frames his myriad tax hikes in the rubric of tax reform. In reality, his tax proposals are antithetical to the motives and policy changes proper fundamental tax reform should seek. Congress should, like it has done with President Obama's last three budgets, reject the President's ersatz tax reform and focus on true tax reform.

The Heritage Foundation's New Flat Tax is one model of tax reform that Congress should emulate.[9] The New Flat Tax's single rate is considerably lower than today's top rate, does not tax saving and investment, and does not pick winners and losers. It accomplishes all those feats while being revenue and distributionally neutral.

The important work of tax reform is doable. It is time for Congress to do it the right way.

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

8. Curtis S. Dubay, "Obama's 'Insourcing' Agenda: Punishing Job Creators for Competing Overseas," Heritage Foundation *WebMemo* No. 3464, January 18, 2012, at *http://www.heritage.org/research/reports/2012/01/obamas-insourcing-agenda-would-hurt-economy-and-cost-jobs*.
9. J. D. Foster, "The New Flat Tax—Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, at *http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three*.