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Tax Policy: Obama Is Still Wrong on Tax Rates

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In his first press conference after the election, President Barack Obama said, "What I'm not going to do is extend the Bush tax cuts for the wealthiest 2 percent that we cannot afford and according to economists will have the least positive impact on the economy."[1]

The good news is that President Obama apparently truly believes what he is saying. The bad news is that what he is saying is flat-out false.

Can the U.S. "Afford" Not to Raise Taxes? As to whether the nation can afford not to raise taxes on the wealthiest 2 percent, consider that according to his budget, Obama's proposal to raise taxes on individuals with incomes more than $250,000 would generate $835.6 billion over 10 years *if one ignores the damage done to the economy in the process.*

Accept the revenue estimate for a moment and ignore the economic damage that would ensue—and thus the lesser increase in revenues it would generate. Even after granting all the phony spending cuts and similar gimmicks in Obama's budget of last February, federal debt held by the public rises by $8.5 trillion over the next 10 years without the tax hike and by $7.7 trillion with the tax hike. Expressed another way, allowing some of the Bush tax cuts to expire as Obama demands represents less than 10 percent of the projected debt increase.

More recently, President Obama has upped the ante significantly, first to $1.4 trillion and then to $1.6 trillion in higher taxes. These numbers do not come out of thin air. The $1.4 trillion figure represents the noted expiration of the Bush tax cuts plus $574 billion in all-new tax hikes. To get to the $1.6 trillion figure, the President would also abandon the recent agreement on the death tax and go back to an earlier, more punitive formulation.

Two observations are immediately apparent. First, Obama is no longer talking about allowing tax cuts to expire. These are all new tax hikes. Second, even after doubling the amount of tax hike, the national debt still goes up by about $7 trillion over the next 10 years.

The only possible conclusion is that the revenues from Obama's tax-hike demand—either his original demand or the double-up—barely dent today's deficit or the projected increase in the debt. Obama's revenue demands express his vision of social justice, not an economic policy or even a budget policy. To address the deficit, Obama should focus on the problem: an excess of spending. What we cannot afford is to continue spending money at the rate Obama demands.

The Economic Impact. Obama says that "according to economists," keeping taxes from rising "will have the least positive impact on the economy." Apparently, Obama continues to talk only to his economists and their fellow travelers.

Recall that these are the same economists who said that Obama's 2009 stimulus would drive down the unemployment rate. It did not work. They are the same economists who told us the payroll tax holiday would create jobs. It did not work. They are close cousins, by the way, to the economists plying their trade in Europe, driving national unemployment rates above 25 percent in country after country while driving the continent toward another deep recession.

This paper, in its entirety, can be found at **http://report.heritage.org/ib3781**

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Of all the Bush tax cuts, the reductions in the top rates were not the least effective in strengthening the economy as Obama claims. In fact, they were the *most effective* because they struck at the very heart of the economic dynamic: incentives. Higher tax rates discourage entrepreneurship and risk taking. They discourage saving by those most capable of saving and, as even the Congressional Budget Office now admits, discourage work effort.[2]

Higher tax rates have these effects because those who are subject to the rates can and do adjust their behavior—sometimes immediately, sometimes after a period. They then take fewer business risks, work fewer hours (or even retire), and save less.

Tax-hike advocates will no doubt once again claim that when they raised tax rates in 1993 under President Clinton, not only did warnings of a recession prove to be unfounded, but the economy subsequently boomed. In fact, though Clinton's tax hikes didn't trigger recession, they certainly took the wind out of the economy's sails at a time when it should have come roaring back from recession.[3] The famous Clinton boom did not follow the tax hikes. The subsequent boom came four years later after an anemic recovery, slow wage growth, and slow job growth. The famous Clinton boom followed the cut in the capital gains tax rate in 1997. Supporters of higher rates tend to skip over these inconvenient facts.

With metaphysical certainty, raising tax rates will slow the economy now and leave wages and incomes permanently lower. Whether the tax hike produces a recession or not depends on how weak the economy is as it faces this new headwind. Hopefully, the economy will be strong enough to take the hit if it comes and then pick up steam as best it can under the new burden.

Inconsistency on Incentives. It is perhaps the greatest irony in American economic policy that those advocating higher income tax rates believe that incentives matter only when the advocates are trying to dictate behavior. For example, *The Washington Post* recently editorialized in favor of higher cigarette taxes to discourage smoking.[4] The sad, growing fascination with a carbon tax is another case in point. Why a carbon tax? Aside from the massive revenues it promises, proponents argue (correctly) that a carbon tax would create incentives for businesses to move away from carbon-producing activities.

But when it comes to the behaviors that are truly relevant for a strong economy, President Obama and friends turn a blind eye to incentives.

The Real Problem. The nation cannot afford the spending surge initiated under President Obama. The nation's workers cannot afford the sustained additional upward pressure on unemployment that would follow from raising tax rates. The problem is government spending, especially entitlements. President Obama and Congress should focus on the problem and forget these destructive tax-hike obsessions.

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