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Fiscal Cliff Deal: Tax Increase Spoils Permanent Victory for Most Taxpayers

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Congress and President Obama hurriedly agreed to a "fiscal cliff" deal on January 1, after the New Year's Eve deadline. Given the hasty vote, a summary of what the deal did and did not do is in order.

Permanence a Victory for Taxpayers. The deal did not extend all the tax policies that made up the "Taxmageddon" portion of the fiscal cliff, but it did extend most of them.[1] Congress kept in place the Bush-era tax policies for all families with taxable income below $450,000 and single filers with taxable income below $400,000. It also kept certain expanded tax credits—some refundable—from the 2009 stimulus and "patched" the alternative minimum tax (AMT) to keep it from raising taxes on middle-class families.

The silver lining of the deal—one that taxpayers cannot overlook—is that Congress made these policies permanent. No longer will Congress have to scramble to extend policies whose expiration would raise taxes on American families and slow the still-ailing economy. After 12 years of taxpayers' uncertainty about what their tax rates will be, this is unquestionably an important victory. Businesses that pay their taxes through the individual tax system especially can applaud the certainty that the deal has brought them.

Permanence also means that the "current policy" and "current law" baselines are mostly the same. Wrongheaded arguments about whether extending current policy is a tax cut, and therefore needs to be "paid for" under PAYGO budgeting rules, are thankfully a thing of the past—for now.

One area where Congress beneficially departed from permanence was with the "tax extenders." This is a group of over 50 tax-reducing policies that expire regularly. Congress usually extends all of these policies at the same time with little thought about whether individual provisions reflect sound policy. To its credit, Congress allowed a handful of the extenders to expire in this deal, even though it extended the vast majority of them for one year.

Congress should use 2013 to work through the package further, cull those remaining policies that are unsound, and make pro-growth tax changes in their place so as not to create another tax hike.[2] If it does that, Congress should also make the policies that pass the cut permanent.

Fiscal Cliff Deal Did Not Prevent All Tax Increases. Regrettably, the permanence that the deal provided also applies to the tax policies that Congress failed to extend. By not extending these policies, the following permanent tax increases occurred:

- **Payroll tax.** This is the largest tax increase that resulted from the fiscal cliff deal. The payroll tax cut reduced the Social Security portion of the payroll tax from 6.2 percent to 4.2 percent for workers in 2011 and 2012. Its expiration will raise revenues by more than $1.6 trillion over the next 10 years, primarily from middle-class families.[3]

- **Top marginal income tax rate.** The fiscal cliff deal allowed the top marginal income tax rate to rise to 39.6 percent from 35 percent for families with taxable income over $450,000 and single

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filers with taxable income over $400,000. This tax increase will fall heavily on small businesses and investors. Higher taxes on these job creators will lessen their incentive to take risks that would have created new jobs.

As a side effect of the rate increase, Congress created another tax bracket. It retained the 35 percent rate for taxable incomes roughly between $380,000 of taxable income for families and single filers and the new thresholds for the top rate. There will now be seven tax rates in the income tax system: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent. Congress created the new rate to prevent certain taxpayers from paying a lower marginal tax rate because of the fiscal cliff deal. As part of the deal, it increased the income threshold for the new top rate above $380,000, where it had been previously, but left where all the other rates begin intact. Without the new rate, taxpayers earning above the old top rate threshold ($380,000) but below the new top rate threshold ($450,000) would have paid a top rate of 33 percent—lower than the 35 percent rate they paid previously.

President Obama has frequently said that he wanted to raise the top rate back to where it stood under President Clinton. Yet because Obamacare previously raised the Medicare Hospital Insurance (HI) portion of the payroll tax from 2.9 percent to 3.8 percent for family incomes over $250,000, the top rate is higher now than it ever was during Clinton's presidency. The HI tax applies to every dollar of wage income, so to calculate the top rate properly, it must be added to the top marginal income tax rate. President Clinton's top rate was 42.5 percent; President Obama's is now 43.4 percent.

- **Effective marginal tax rates.** The fiscal cliff deal raised *effective* marginal tax rates by allowing the reinstitution of the Personal Exemption Phase-out (PEP) and the phase down of itemized deductions (known as the "Pease" provision). Both provisions begin at $250,000 of adjusted gross income (AGI) for singles and $300,000 for families. These provisions raise tax liabilities without raising the top statutory rate paid by taxpayers. However, they raise effective rates, which hurts economic growth the same as an increase in statutory rates because they lessen work incentives the same. And because both PEP and Pease begin at the same income level, they combine to sharply raise effective tax rates, which compounds the damage to work incentives they would cause separately.

- **Tax increase on investment.** Higher tax rates on capital gains and dividends increase the tax bias against investment. The fiscal cliff deal allowed these tax rates to increase from 15 percent to 20 percent for families with taxable incomes over $450,000 and singles with taxable incomes over $400,000. Obamacare, as with the top marginal income tax rate, raises these rates further. It levies a 3.8 percent surtax on capital gains and dividends for incomes over $250,000 for families and $200,000 for singles starting this year. This is also the first time that a payroll tax applies to investment income—which sets a dangerous precedent. The total rate on capital gains and dividends therefore rose from 15 percent to 23.8 percent. That is a 59 percent increase in the tax rate. This large increase will lower investment across the economy. Less investment will reduce capital formation, which means that businesses will create fewer jobs and pay their workers less.

- **Death tax.** The fiscal cliff deal allowed the death tax rate to rise from 35 percent to 40 percent but, in a small consolation to grieving families, kept the exemption amount above $5 million ($10 million for married couples) and indexed it for inflation. A higher death tax, like higher capital gains and dividends taxes, represents a tax increase on capital which will

1. Curtis S. Dubay, "Taxmageddon: Massive Tax Increase Coming in 2013," Heritage Foundation *Issue Brief* No. 3558, April 4, 2012, http://www.heritage.org/research/reports/2012/04/taxmageddon-massive-tax-increase-coming-in-2013.
2. Curtis S. Dubay, "Tax Extenders and the AMT Patch: Time to Pull the Plug on Congress's Annual Dance," Heritage Foundation *Backgrounder* No. 2654, February 16, 2012, http://www.heritage.org/research/reports/2012/02/tax-extenders-and-the-amt-patch-time-to-pull-the-plug-on-congresss-annual-dance.
3. Heritage calculations using the Congressional Budget Office revenue baseline. See Congressional Budget Office, "An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022," August, 8, 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update_to_Outlook.pdf (accessed January 4, 2013).

result in the same negative effect on jobs.

- **Expensing tax.** In 2011 and 2012, all businesses could expense, or immediately deduct from income, the full cost of new capital expenditures. This approach represents sound policy, and Congress should have maintained it permanently. However, it allowed expensing to lapse, which will raise the cost of capital and slow job creation.

Other Half of Balanced Plan Comes Next. One of the key components of reducing deficits and debt is stronger economic growth. Stronger growth puts more people to work and raises wages. Both raise revenue to the government without raising taxes. The fiscal cliff deal, however, raised taxes, which will slow growth. Moreover, the revenue that the tax increases will bring in is miniscule compared to the deficits the federal government is on track to amass over the next 10 years.

President Obama has said repeatedly that he wants a "balanced plan" to reduce deficits and debt, supposedly meaning a mix of higher taxes and spending reductions. The fiscal cliff deal delivered the tax increase portion but not the spending cuts. In the rapidly approaching debates on raising the debt limit, replacing the delayed sequester spending cuts, and the continuing resolution to fund the federal government for the rest of the 2013 fiscal year, Congress must demand that spending be cut to deliver on the other side of President Obama's promised balanced approach.

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