CORRECTING DISTORTIONS AND MYTHS ON TAX RELIEF AND DEFICITS

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Fueled by the unsustainable growth in government spending, the federal government's budget deficits have increased sharply in recent years, eclipsing the $1 trillion mark the past three years and are on track to do so for a fourth. Gross public debt has already surpassed the size of the entire U.S. economy, and the debt trajectory in the years ahead, if left uncorrected, will stifle economic growth and ensure a diminished future for generations to come.

Some in Washington refuse to curb the government's spending appetite, instead insisting that the federal government take more from the paychecks of hardworking American families. However, a quick review of the facts on tax relief and deficits indicates decisively that the federal government's fiscal woes are not the result of allowing Americans to keep more of their own hard-earned money:

- According to the Congressional Budget Office (CBO), 75 percent of the deterioration of the budget deficit over the past decade was due to government spending and the recession. Just 14 percent is attributable to tax relief in 2001 and 2003.

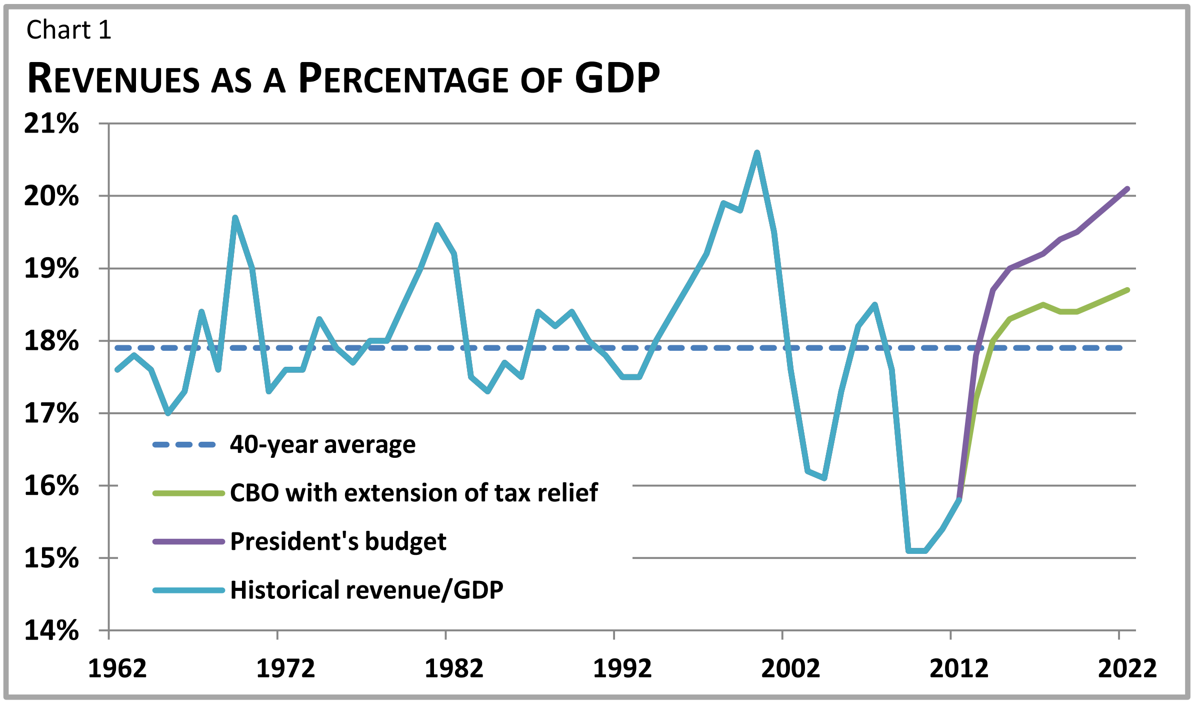
- Over the past 40 years, revenues have averaged about 18 percent of gross domestic product (GDP) and outlays have averaged about 20 percent of GDP, with an average deficit of 2 percent of GDP.

- Before the financial crisis hit, with the 2001 and 2003 tax relief fully implemented, revenues were at 18.5 percent of GDP, and the federal government ran a deficit of 1.2 percent of GDP that year, which is small compared to current deficits.

- The financial crisis caused revenues to plummet, not due to tax relief, but due to high unemployment, the loss of trillions of dollars in personal wealth, and a decline in tax revenues as profits turned to losses and business investment turned to bankruptcies. Revenues plummeted, reaching 15.1 percent of GDP in FY 2009.

- Revenues are now experiencing remarkable growth, despite a weak economy. Last year (FY 2011) revenues grew by $141 billion, or 6.5 percent, and CBO projects revenues will grow by $153 billion, or 6.6 percent this year. If not for the payroll tax holiday, this revenue growth would have been even stronger.

- According to CBO, if 2001 and 2003 tax relief, current estate tax rates, and the alternative minimum tax "patch" are all permanently extended, revenues will still nearly double, from $2.4 trillion in FY 2012 to $4.6 trillion by FY 2022. CBO estimates that revenues will grow faster than the economy, even with the extension of this tax relief, reaching 18.7 percent of GDP by 2022, which is well above the historical average of about 18 percent of GDP (see chart 1)[12].



Background

A deep economic recession and financial crisis in 2008 and 2009 shrank tax revenue, while record spending across the entire government – from temporary initiatives aimed at addressing the financial crisis, to permanent expansions of the role and scope of government – caused deficits to soar. Since the current administration took office in 2009, deficits have exceeded the trillion-dollar mark for four consecutive years. A key challenge for policymakers is to rein in these large deficit levels over time in order to put the budget on a sustainable path. This task often involves diagnosing the causes of the large increase in deficit levels over the past decade in order to inform the process of changing tax and spending policies to bring the budget back toward balance.

In addition to the distortions about 2001 and 2003 tax relief, the President and his allies assert that the deficit can be tamed by raising taxes on those making more than $200,000. His proposal to allow current tax rates to expire for upper-income individuals (i.e., those making above $200/$250K) is sometimes advertised as a key way to rein in deficit levels going forward.

A look at the data, however, reveals that the 2001 and 2003 tax relief have not played a significant role in rising deficit levels over the last ten years. Rather, government spending and the great recession account for 75 percent of the change, according to CBO. When the amount of revenue lost because of the cuts is put into proper context, it's clear that repealing the cuts for high-income earners fails to provide a real solution to the country's fiscal problems.

[1] Office of Management and Budget, Historical Tables, Table 1.1. www.whitehouse.gov/omb/budget/Historicals. Accessed April 26, 2012.
[2] House Budget Committee, "Path to Prosperity," p. 89. March 20, 2012.

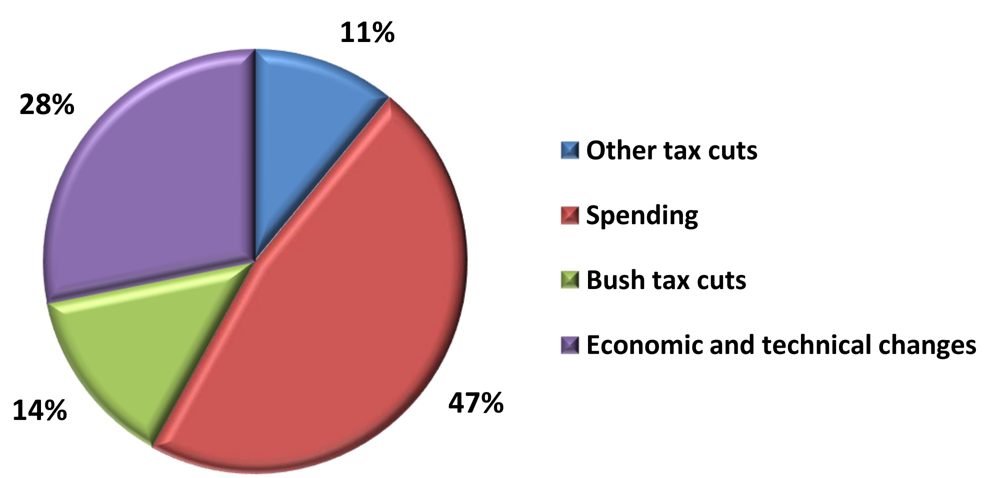
The U.S. Government's deficit was $1.3 trillion in FY 2011, 709 percent higher than it was in 2007. The deficit has nearly tripled since President Obama took office. The data make clear that something much larger than the so-called "Bush tax cuts" is at work. Between 2007 and 2009 – during which there were no changes in the tax rates set in 2001 and 2003 – the deficit as a percentage of GDP went up from 1.2 to 9.9 percent, a sevenfold increase.

On May 12, 2011, CBO released an analysis that looked at the change in budget projections since 2001 and attempted to attribute the portion related to the 2001 and 2003 tax relief to develop an estimate of the impact of this tax relief on deficit projections. Even through this "baseline" analysis, according to data from CBO, it turns out that increased government spending has accounted for nearly half of the total increase in the deficit since 2001 (see chart 2)[3]. Economic and technical corrections (i.e., forecasting errors) accounted for 28 percent of the total increase. The Bush tax cuts come in a distant third, contributing just 14 percent. Other tax provisions, such as the rebates enacted as part of the 2008 and 2010 stimulus bills, make up the remaining 11 percent.[4]

In a *Washington Post* article, "Five Myths About the Bush Tax Cuts," the Urban Institute-Brookings Institution Tax Policy Center's William Gale concluded that the Bush tax cuts have not been the chief driver of our large deficit levels. Gale points out that "the main culprit was the recession – and the responses it inspired. As the economy shrank, tax revenue plummeted. The cost of the bank bailouts and stimulus packages further added to the deficit."[5]

Chart 2

CAUSES OF THE CHANGES IN THE DEFICIT SINCE 2001



Regardless of what created the nation's current fiscal challenges, finding a solution to those challenges is of utmost importance. As mentioned earlier, the President has proposed letting current tax rates paid by high-income earners ($200,000 for single filers, $250,000 for those filing jointly) rise to their pre-2001 rates, an increase of 9 percent and 13 percent for the top two tax brackets. The evidence, however, indicates that this would be no solution at all. In fact, raising these rates could hamper an already-fragile economy, muting the intended revenue gain.

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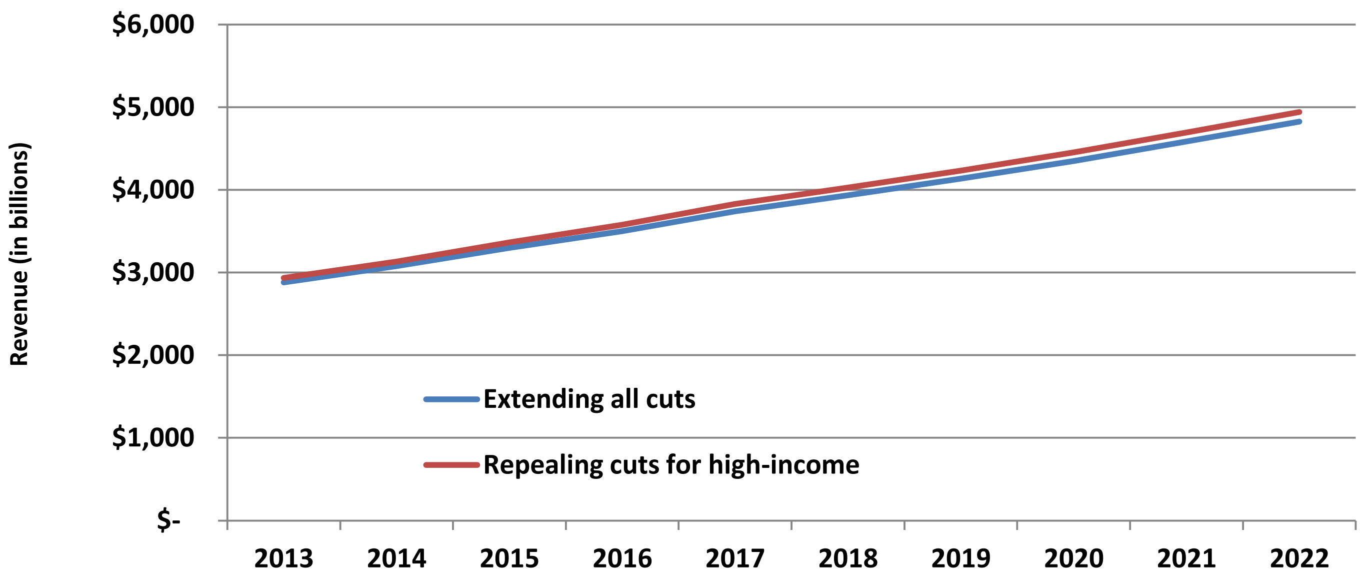
[3] Calculations based on Congressional Budget Office (CBO) data. See the CBO's *Changes in CBO's Baseline Projections since January 2001*. May 12, 2011.
[4] Calculations based on Congressional Budget Office (CBO) data. See the CBO's *Changes in CBO's Baseline Projections since January 2001*. May 12, 2011.
[5] William G. Gale. "Five Myths About the Bush Tax Cuts," *Washington Post*, August 1, 2010.

High-income earners only make up about 2 percent of taxpayers.[6] And though their average tax bill is quite large, letting current tax rates expire for this population would have only a small impact on deficits. Letting the upper-income tax provisions expire would raise approximately $850 billion over the next ten years[7], which represents just 13 percent of the $6.39 trillion in cumulative deficits proposed in the President's budget.[8] Chart 3[9] compares a revenue path in which all 2001/2003 tax provisions are extended versus a path in which tax cuts for upper-income individuals are allowed to expire. The difference in overall revenue levels, and therefore the resulting impact on the deficit, is fairly small.

Chart 3

REVENUES UNDER DIFFERENT SCENARIOS



Though the deficit impact is small, the economic impact of tax rate increases would be disproportionately large. Standard economic theory indicates that high marginal tax rates dampen the incentives to work, save, and invest, reducing economic output. This lower economic output largely mutes the revenue gain intended by increasing marginal tax rates. In contrast reforming the tax code by broadening the base and lowering marginal tax rates would increase incentives to work, save, and invest, increasing economic output without any budgetary effect.

Some make the point that the planned increase in top tax rates will only impact the very wealthy, who should be called upon to pay their "fair share." But it's important to point out that three-quarters of the nation's small businesses file taxes as individuals, meaning that higher top individual tax rates will hurt these engines of job creation. It is estimated that nearly 50 percent of small business profits are taxed at the top two tax rates (i.e., the brackets typically targeted for rate increases under the logic of +250K = "rich"), according to the Joint Committee on Taxation.[10] And small

[6] Timothy F. Geithner, "Statement of Secretary Timothy F. Geithner," Committee on Finance, U.S. Senate. February 14, 2012.
[7] Office of Management and Budget, "*Fiscal Year 2013 Budget of the U.S. Government*," Table S-9. February 2012.
[8] Office of Management and Budget. *Fiscal Year 2013 Budget of the U.S. Government*. February 2012.
[9] Based on data from the Office of Management of Budget's historical table 1.1. http://www.whitehouse.gov/omb/budget/Historicals: Accessed February 29, 2012.
[10] Joint Committee on Taxation, "Present Law and the President's Fiscal Year 2011 Budget Proposals related to selected individual income tax provisions scheduled to expire under the sunset provisions of the economic Growth and Tax Relief Reconciliation Act of 2001," Staff of the Joint Committee on Taxation. July 14, 2010.

businesses as a whole are responsible for almost two-thirds of annual job creation in the U.S.[11] It is clear that these planned tax increases at the upper end of the income scale will end up lowering business expansion and dampening job creation in the coming years.

Raising taxes on capital – on dividends, capital gains, and estates – is another idea that purports to affect the wealthy but actually hurts all participants in the economy. Mainstream economics, not to mention common sense, teaches that raising taxes on any activity generally results in less of it. Economics also teach that the size of a nation's capital stock – the pool of saved money available for investment and job creation – has an effect on employment, productivity, and wages.

Taxes on dividends, capital gains and estates are taxes on savings and investment. Less savings and investment mean a smaller stock of capital available for job creation. That means fewer jobs, less productivity, and lower wages for all American workers.

Despite the rhetoric of raising taxes on the so-called "rich" for deficit reduction, the President's budget doesn't devote tax increases to deficit reduction. His budget largely devotes these tax increases to higher spending. Whether measured against CBO's current law or a current policy baseline, the President's budget increases spending by either $1.2 trillion or $1.5 trillion. Relative to a current policy baseline, his budget increases tax revenue by $2 trillion.[12]

Researchers at the Tax Policy Center (TPC) recently looked into what effect increasing individual income tax rates by varying magnitudes would have on the deficit and debt. The study specifically focuses on what rate increases would be necessary to put debt on a sustainable path by three target years: 2020, 2025, and 2035. Under a current policy baseline, raising the top two individual income tax rates to an unprecedented 96.2 percent[13] would raise $689.6 billion in revenues annually beginning in 2015,[14] yet would still not bring the debt to GDP ratio down to 60 percent by 2035.[15]

Manipulating the top three income tax rates to accomplish the same task would require hiking those rates to 89.3, 84.2, and 71.4 percent, respectively.[16] Even this would be a stretch, since these results do not take likely changes in behavior into account. Imposing a 96.2 percent income tax would cause an exodus of high-income earners from the country and create powerful incentives to reorganize future compensation in order to avoid the tax, thus effectively making it a one-year tax. This is not just economic theory. It is borne out by actual results. Take the Rolling Stones as just one example. In 1972, they left England to avoid a 90% income tax rate and titled their next album "Exile on Main Street."[17]

[11] U.S. Small Business Administration, FAQs: Frequently Asked Questions, Advocacy Small Business Statistics and Research. http://web.sba.gov/faqs/faqIndexAll.cfm?areaid=24.

[12] See "Additional Fiscal Comparisons on the Path to Prosperity," House Budget Committee, March 20, 2012 (http://budget.house.gov/News/DocumentSingle.aspx?DocumentID=285549). CBO is required by law to use a current law baseline that assumes expiration of tax relief, which assumes revenues increase by $4.4 trillion over 10 years. As a result, most groups, including the Office of Management and Budget, the House Budget Committee and non-partisan groups such as the Committee for a Responsible Federal Budget and the Bipartisan Policy Center, adjust the baseline to assume extension of all or most of 2001 tax relief to provide a more realistic measure of the fiscal impact of budget proposals. Relative to a current policy baseline using CBO data, the President's budget increases taxes by $2.0 trillion and spending by $1.4 trillion. Using OMB's own numbers, the President's budget increases revenues by $1.9 trillion over 10 years (see: House Budget Committee, "Analysis of the President's Budget for FY 2013," February 24, 2012, http://budget.house.gov/UploadedFiles/POTUS_FY13budget.pdf).

[13] This is the top possible rate possible in order to cap the statutory income and payroll tax rates on wages, self-employment income, and net investment income (save capital gains and dividends) for high-income earners 100 percent.

[14] Only fiscal year 2015 revenues resulting from the tax rate increases are explicitly stated in the published analysis.

[15] The authors set the target debt to GDP ratio at 60 percent.

[16] Eric Toder, Jim Nunns, and Joseph Rosenberg, "Reducing the Deficit by Increasing Individual Income Tax Rates," Tax Policy Center and The Pew Charitable Trusts. March 2012.

[17] "The Rolling Stones Shine a Light on 'Exile on Main St.' Reissue," Los Angeles Times, May 16, 2010. http://articles.latimes.com/2010/may/16/entertainment/la-ca-rollingstones-20100516

The CBO has also recently looked into how high marginal tax rates would need to increase in order to reign in deficits and hold them steady using only tax increases as a tool. In a letter submitted to House Budget Committee Chairman Paul Ryan, CBO Director Douglas Elmendorf specifies the level to which tax rates would have to be increased in order to stabilize the deficit for the foreseeable future. To accomplish this task, tax rates would have to be increased to as high as 65 percent.

Unlike TPC's analysis, Elmendorf specifies the potential negative behavior—or feedback—effects resulting from raising marginal tax rates. He specifies three responses expected in individual behavior following such an increase in tax rates. Individuals would:

- Accelerate bonus payments or asset sales in anticipation of higher tax rates on income and or capital gains,
- Substitute tax-preferred fringe benefits for cash wages if the tax rate on wages went up and,
- Choose to work or save less if tax rates on earnings or capital income rose.

Regarding the macroeconomic effects of higher marginal tax rates, Elmendorf points out that raising marginal tax rates to levels as high as 65 percent would lead to much lower economic output and income than the amounts in CBO's long-term economic benchmark.[18] Increases in marginal tax rates would (absent other changes in policy) also raise effective tax rates—the real percentage of income each taxpayer remits to the federal government. Naturally, this rise in effective rates would yield the same feedback effects outlined by Director Elmendorf with regard to marginal tax rate increases. Thus, policy intended to raise effective rates would be just as harmful to the economy as raising statutory rates.

Yet recently, the President has emphasized the so-called "Buffet Rule" – a new minimum effective tax rate on high-income taxpayers – as a means of getting deficits and debt under control.[19] However, the data belie the efficacy of the proposal. According to JCT, instituting the Buffett Rule would raise only $46.7 billion over the next decade, just 0.7 percent of the cumulative deficit spending in the President's budget. This is only enough revenue to cover 26 days of proposed deficit spending over the next decade under the President's budget, or less than three days per year. The tax would simply serve as an additional Alternative Minimum Tax (or an "Alternative-Alternative Minimum Tax") further complicating the tax code for no economic gain. Data and theory both tell the same story: The policy would negligibly decrease the deficit while distorting business and investment decisions, all at the expense of the U.S. economy.

Underlying the President's insistence that wealthy Americans need to pay their fair share is the assumption that these individuals are not currently doing so. The table[20] below clearly shows that this is not the case. "Fair share" is a debatable point, but the data bears out that higher income individuals pay an overwhelming share of total income tax and tax collections. The top 1 percent of all taxpayers pays 37 percent of all income taxes in the United States. Even more surprising, given the administration's ongoing rhetoric, is that the top 5 percent pay a larger share of U.S. income taxes than the bottom 95 percent combined.

[18] Douglas W. Elmendorf, Director, Congressional Budget Office, *Letter to Paul Ryan*. March 23, 2012.
[19] The rule would force those making more than $1 million per year to pay a minimum effective individual income tax rate of 30 percent.
[20] Internal Revenue Service (most recent data available)

Total Income Tax Shares, 2009 (Percent of federal income tax paid by each group)								
Year	**Total**	**Top 0.1%**	**Top 1%**	**Top 5%**	**Top 10%**	**Top 25%**	**Top 50%**	**Bottom 50%**
2009	100%	17.11%	36.73%	58.66%	70.47%	87.30%	97.75%	2.25%

These numbers reflect taxes paid even under the extension of the 2001 and 2003 tax cuts. Even with the cuts, this illustrates the effects of the United States having the most progressive individual income tax system in the industrialized world. Tax rates go up exponentially with respect to income, and do so to a greater extent than any other country in the Organization for Economic Cooperation and Development (OECD).[21]

Economists are in agreement that broadening the tax base would allow policy makers to responsibly lower tax rates and decrease the number of them – both of which would instantly make the tax system less distortionary. The House Budget Committee's FY 2013 budget included the recommendation made by the House Ways and Means Committee to lower the top marginal individual income tax rate to 25 percent. Also included was the recommendation to eliminate or scale back tax expenditures. As shown below, these individual income tax expenditures disproportionately benefit the top 1 percent of earners.

Distribution of Benefits of Various Categories of Individual Income Tax Expenditures[22]

Cash income percentile	Exclusions	Capital gains and dividends	Itemized deductions	Above-the-line deductions	Non-refundable credit	Refundable credits	Other	**Taxes Paid**
Lowest quintile	0.7%	*	*	0.4%	1.2%	19.7%	0.4%	**0.2%**
2nd quintile	6.8%	0.2%	0.7%	5.7%	16.4%	38.6%	3.4%	**2.7%**
3rd quintile	11.2%	0.9%	3.8%	17.5%	26.4%	20.4%	8.0%	**9.3%**
4th quintile	14.8%	2.8%	14.2%	24.3%	25.8%	14.1%	14.0%	**18.2%**
80–90	16.5%	3.5%	18.6%	18.1%	12.5%	5.7%	12.4%	**15.1%**
90–95	13.9%	4.2%	15.9%	9.4%	5.7%	1.0%	10.2%	**11.3%**
95–99	20.3%	13.3%	20.4%	16.3%	3.8%	0.2%	19.4%	**17.5%**
Top 1	15.9%	75.1%	26.4%	8.3%	8.3%	*	32.2%	**25.6%**

The tax code is littered with deductions, credits, exclusions and other exemptions. As income tax rates rise, the value of these tax loopholes and the incentive to use them increases. Raising marginal tax rates discourages work, savings, and investment and encourages more aggressive use of tax loopholes. Conversely, tax reform that lower rates and clears

[21] Organization for Economic Cooperation and Development, "Growing Unequal? Income Distribution and Poverty in OECD Countries," p. 112. 2008.
[22] Eric Toder and Daniel Baneman, "Distributional Effects of Individual Income Tax Expenditures: An Update," Urban-Brookings Tax Policy Center, Table 3. February 2, 2012.

out these distortions in the tax code has the opposite effect: it would increase incentives for work, savings, and investment, increase economic growth, and make the U.S. tax code fairer, simpler, and much more efficient.

Restoring revenues to their historical average is a critical part of getting the nation's fiscal house in order, but this must be done through policies that encourage economic growth, not policies designed to redistribute wealth. The House-passed budget achieves this goal. Revenue grows every year under this budget, eventually rising to 18.7 percent of GDP by the end of the 10-year window, well above their historical average of just above 18 percent.

Revenues alone, however, cannot bring deficits and debt under control. Any serious solution must encourage economic growth and actually address the drivers of the debt – government spending, especially spending on government health care programs.

Spending – driven by entitlements – is poised to double in the coming decades according to CBO. Spending is the problem and getting spending under control is the solution. The idea that the Bush tax cuts created the nation's current fiscal problems – and that these problems can be fixed by hiking top marginal tax rates – is simply erroneous. Blaming previous administrations and proposing ineffective solutions only distracts from the vital work ahead: averting a debt-fueled economic crisis and restoring the nation to a new era of prosperous growth.