Ten Reasons to Extend Tax Relief and Stop Tax Hikes

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Introduction

Detractors often call them "The Bush Tax Cuts," but the taxpayer-relief laws enacted in 2001 and 2003 will expire next year – leading to something more properly called "The Obama Tax Hike" unless the President and Congressional leaders act to avoid it.

The American people are constantly told to have no fear – Washington will get around to extending current tax policy soon, certainly by the end of this year. After all, the President's budget assumes that many (but not all) relief provisions will be extended, and only a small number of "the rich" will see higher tax bills as a result.

With each passing day, these claims become less and less credible, leading taxpayer advocates to ask: "What is it that some elected officials don't understand about the coming tax increase, one that will virtually guarantee a double-dip recession?" To help answer this question, NTU has put together research and commentary from various sources, including its own.

1. <u>Not</u> Doing So Would Represent the Worst Tax Hike in American History, Affecting Every Economic Segment of America.

Through provisions such as a new, low 10 percent tax bracket and expansion of the Earned Income Credit, millions of households dropped off the tax rolls entirely after the 2001 and 2003 tax cuts. For Tax Year 2008 (returns filed in 2009), 51.82 million tax units (out of 142.45 million total) had a zero or negative tax liability. This share of "non-payers," at 36.3 percent, is a record.[1]

A recent study showed that the middle fifth of American households face a nationwide average tax hike of $1,540 unless current laws are extended, but the results vary by area and can reach much higher amounts. When broken down by Congressional District, some families in this solidly middle-class category confront extra tax burdens of nearly $3,000 or even more. Some of the hardest-hit districts include[2]:

CA-14 ($3,194)
CA-30 ($2,852)
MD-08 ($2,776)
NY-14 ($3,066)
VA-08 ($2,895)
VA-11 ($3,180)

2. Doing So Would Maintain, Not Destroy, the "Progressive" Tax System.

According to IRS data for Tax Year 2007 (for which returns were filed in 2008), not only do the richest Americans shoulder a disproportionate burden of the federal income tax, but that burden is also getting heavier. The top 1 percent of income earners in the U.S. paid over 40 percent of all federal income taxes – the highest NTU has ever recorded – while the wealthiest tenth had to bear over 70 percent of the total tax load. This trend continued all the way down the income scale, to the point where just one-fourth of income earners paid the lion's share of the income taxes (87 percent), and the upper half accounted for virtually the entire revenue pot (over 97 percent). The so-called "other half of America" contributed 2.9 percent of the total, **a smaller slice than they did while Bill Clinton was in office.**

Yet, advocates of a more progressive tax system contend that compared to the slice of the *income* pie they earn, the wealthy still don't swallow an equal helping of the *tax* pie. Actually, it's the government that has the feast. While the richest 1 percent of Americans reported about 22.8 percent of all Adjusted Gross Income, they paid almost twice as much (40.4 percent) of the overall income tax bill. The bottom half earned 12.3 percent of the income, but accounted for only one-quarter as much (2.9 percent) in tax payments.

Although a stagnant economy has likely impacted current tax shares across the board, the portion of income taxes paid by the wealthiest Americans has risen every single year for which IRS data is available since 2002.[3]

3. Limiting the Tax Hike to "The Rich" Is Highly Unlikely.

The American people are long familiar with politicians' broken promises to limit tax hikes to the wealthy. It took less than four years to undo the pact that elected officials agreed to with the 1986 Tax Reform Act – do away with popular deductions in exchange for two lower rates and no major change in middle-class tax liabilities. But when President George H.W. Bush signed the Omnibus Budget Reconciliation Act of 1990, breaking his famous "Read My Lips … No New Taxes" pledge, the new 31 percent top bracket wasn't the only tax-hiking provision in the bill. Tax increases on gasoline, beer, and wine were also instituted.

In an October 1, 1992 Presidential Debate, Bill Clinton was accused of stretching the truth about his deficit reduction plan; his opponent George H.W. Bush claimed that Clinton would have to raise taxes on families making more than $36,000 annually to meet his goals. Clinton said: "It is a disgrace to the American people that the President of the United States would make a claim that is so baseless, so shameless, in its attempt to get votes under false pretenses."

Just four and a half months later, in a nationwide address to the American people (2/15/93), Clinton said: "We just have to face the fact to make the changes our country needs, more Americans must contribute … ." The Omnibus Budget Reconciliation Act of 1993 raised taxes on gasoline, Social Security benefits, and other activities affecting the middle class (including every American family earning over $30,000 a year).

The Alternative Minimum Tax (AMT) began in 1969, in response to reports that 155 wealthy Americans had utilized the laws to escape paying any tax the year before. By 2011, nearly 30 million taxpayers will have to compute and pay the AMT (for the Tax Year 2010) unless Congress repeals the tax or renews a "patch" that limits the reach of the tax.[4]

Barack Obama has insisted that his Administration will support a top tax rate on capital gains of no more than 20 percent. However, the new health care "reform" bill he signed into law would, without additional corrective action, allow the rate to climb to 23.8 percent.

Because the income thresholds for the new payroll and investment tax increases are not indexed for inflation, it is quite feasible that the new, un-indexed Hospital Insurance tax in the bill could grow to snag between four and five million taxpayers after ten years of its operation. That number could double after 20 years, especially if economic growth improves the wealth of upper-middle-income Americans.[5]

4. It's Not about Deficits.

Earlier this year House Majority Leader Steny Hoyer (D-MD) told the Associated Press he was concerned over "whether we can afford to permanently extend" the 2001 and 2003 tax cuts (which actually boosted the economy and in turn kept federal revenues high). In a change from previous rhetoric, however, his remarks pertained to *all* of the tax reductions, including those for middle-class taxpayers.

But is Hoyer's worry over "affordability" of the tax cuts and their impact on the deficit reflected in his legislative agenda? The National Taxpayers Union Foundation's BillTally system, which totals up the cost of bills each lawmaker sponsors or cosponsors, has some clues. As the following chart indicates, Congressman Hoyer has supported an average of nearly $50 billion in new federal spending during the most recent five Congresses. Although his total "agenda cost" has been declining, he has yet to sponsor spending legislation whose net effect would actually cut the budget deficit.

Words vs. Deeds: Steny Hoyer's Legislative Agenda Costs (in Billions)	
Congress	**Net Spending Agenda**
111th	$2.4
110th	$45.5
109th	$57.1
108th	$97.8
107th	$35.4
Average	**$47.6**

Overall, the typical House Democrat in the 111th Congress proposed a net spending agenda of $500.2 billion – less than the $547 billion he or she backed in the 110th Congress. The typical House Republican had an agenda that would cut spending by $45.3 billion – the first "net-cutting" average for the House GOP in over a decade. Despite these signs of improvement, both parties' averages rose in the Senate, while in each chamber, lawmakers offered more than 15 bills to boost federal spending for every bill to reduce expenditures. Members of Congress who display this kind of reckless behavior toward spending hikes lack credibility when they say that the only way out of the deficit mess is to raise taxes. The agenda of most tax-hikers is to grow government, not shrink deficits.[6]

5. The Tax System Could Get a Lot More Complicated.

According to an NTU study of tax system complexity, individual taxpayers alone will spend an estimated 2.43 billion hours complying with the income tax laws this year. This time is worth an incredible $71.4 billion as calculated from the most recently reported average employer cost for civilian workers by the Bureau of Labor Statistics of $29.37 per hour.

Individual taxpayers will spend a lot of money too: an estimated $31.5 billion this year for tax software, tax preparers, postage, and other out-of-pocket costs, according to the most recent Internal Revenue Service regulatory filing.

Counting time and money for individual taxpayers, the compliance burden would total a massive $103 billion for individual taxpayers alone. Keep in mind that these costs do not account for tax minimization strategies, nor do they account for the huge "growth penalty" that high tax rates impose on the nation's economy.

The return of the death tax, "Pease Limits" on itemized deductions, and the Personal Exemption Phase-out are just three provisions that will add to this tremendous complexity burden if current tax laws are not extended.[7]

Furthermore, simply allowing the death tax to remain dead could free the economy from an entire complex industry of tax planning and avoidance. A study from American Family Business Foundation and Family Research Council, citing three landmark sets of research, concluded that, “Eliminating the estate tax would increase business capital, jobs for workers, and government revenue.”[8]

6. Tax Hikes Are Already Hitting the Middle Class.

President Obama broke one of his biggest political pledges (not to raise taxes on the middle class) in early 2009, when he signed into law an expansion of the State Children’s Health Insurance Program. That legislation more than doubled the federal cigarette tax. According to Congress’s Joint Committee on Taxation, about two-thirds of all federal tobacco taxes come from those earning less than $40,000 per year.

The new health care law enacted earlier this year contains additional surprises. One rarely-mentioned defect is a $2,500 cap on annual contributions to Flexible Spending Accounts (FSAs) in cafeteria plans. These accounts have become ever more popular as a way to use pre-tax dollars to pay for doctor’s office visits, prescriptions, and other out-of-pocket medical costs. By some estimates, 30 million or more Americans take advantage of FSAs. The average earnings level for an FSA participant is approximately $55,000.[9]

Another change that will affect many middle-class Americans is a boost in the minimum amount of medical expenses a person must incur before they could be written off against an income tax liability. Once fully phased in, the law requires these costs to exceed 10 percent of Adjusted Gross Income (AGI) before a portion would become deductible (compared to 7.5 percent under current law). IRS data shows that of the 10.15 million taxpayers who claim the medical expense deduction, all but 103,000 reported AGIs of less than $200,000.[10]

7. Jobs May Depend on It.

History shows that tax reductions can create jobs while tax hikes destroy them. This is not limited to the Reagan-era rate reductions.

President John F. Kennedy first proposed a large federal income tax cut in late 1962, although the final enactment of the proposal did not occur until after his death in 1964. The resulting Kennedy-Johnson tax cut slashed individual income tax rates across the board. The highest rate fell from 91 percent to 70 percent, while the lowest rate dropped from 20 percent to 14 percent. Even 40 years ago, sophisticated economic models permitted analysts to pinpoint results attributable solely to the tax reductions. One study by Arthur Okun found that the Kennedy-Johnson initiative increased Gross National Product by $36 billion. Lawrence Klein concluded that the tax reduction eased the unemployment rate by 0.5-0.8 percent, due to the increased business activity it triggered.[11]

According to Labor Department data, private sector employment rose from roughly 108 million in 2003 to more than 115 million by 2008 – a steady run-up in job creation that followed the stimulative tax cuts of 2003.

Conversely, raising taxes can destroy jobs. A Heritage Foundation study estimated that the first three years of the Omnibus Budget Reconciliation Act of 1993 (the Clinton-era tax hikes) prevented 1.2 million private-sector jobs from being created.[12]

As the President has said, small businesses are responsible for 70 percent of all new job creation in the economy, and would be badly hurt by new tax hikes. But what if the tax hikes were limited to incomes of above $200,000? The effect would still be devastating. In 2009, Senate Finance Committee Ranking Member Charles Grassley noted that[13]:

- "According to NFIB survey data, 50 percent of owners of small businesses that employ 20 to 249 workers would fall in the top two brackets.
- According to the Small Business Administration, about two-thirds of the nation's small business workers are employed by small businesses with 20-500 employees.
- Newly developed data from the Joint Committee on Taxation demonstrates that 55 percent of the tax from the higher rates will be borne by small business owners with income over $250,000.
- This is a conservative number, because it doesn't include flow-through business owners making between $200,000 and $250,000 that will also be hit …"

8. Small Businesses' Survival May Depend on It.

Most small businesses file and pay taxes using the personal 1040 tax form. For Tax Year 2008 (returns filed in 2009), 16.4 million returns (out of 142.5 million filed) reported net income from a business or profession (an additional 5.7 million reported net losses). Also, 5.0 million reported net income from an S Corporation or partnership (3.0 million reported losses).[14]

If current tax laws are not extended, even the lowest-income businesses would face serious tax increases. For a married couple filing jointly, the disappearance of the low 10 percent bracket would instantly add nearly $850 to their business's tax bill.

Some argue that limiting the tax increases to those making more than $200,000 or $250,000 (single/married) would minimize the impact on the economy. Fewer than one million returns reporting business/profession income, and about 1.3 million returns reporting S Corporation and partnership income, declared amounts of more than $200,000 on their tax returns in 2008.

These figures, however, overlook the extreme volatility of business profits and the mobility of taxpayers up and down the income scale. According to a Tax Foundation report[15]:

- "Nearly 60 percent of households in the bottom income quintile in 1999 were in a higher quintile in 2007, and roughly 40 percent of tax returns in the top quintile in 1999 were in a lower quintile in 2007.

- Roughly half of millionaires during the 1999 through 2007 period attained this status just once during those nine years. Only 6 percent of this group were millionaires in all nine years."

9. Revenue "Losses" Are Speculative.

Supporters of raising taxes claim that extending current tax relief for ten years will "cost" $3.1 trillion; government spending will amount to almost 15 times that figure over the same period.[16]

However, this assumes that people will not change their behavior in response to heavier penalties on working, saving, investing, and starting new businesses. The evidence shows that tax policies do indeed affect economic decisions, producing results that confound government forecasts based on "static" revenue assumptions[17]:

- The Tax Reform Act of 1986, which raised the effective capital gains tax rates from 20 to 28 percent, helped cause capital gains realizations to plunge by half. The result was billions of dollars locked into unproductive investments.
- In 1997, Congress and President Clinton agreed to reduce capital gains tax rates from 15 and 28 percent to 10 and 20 percent. The results, according to a detailed analysis by Standard & Poor's DRI, were significantly higher economic growth and stock prices. The capital gains revenue boom, along with prudent spending restraint, led to a brief period of federal budget surpluses in the late 1990s.
- In the five years preceding John F. Kennedy's tax cut proposal, individual income tax receipts grew by an average of 6.5 percent annually. From 1963 to 1968, the period including the rate reductions, those average receipts grew faster – 7.8 percent each year.
- The average rate of individual income tax revenues increased by 5.2 percent annually between 1982 and 1988, during the Reagan tax cuts and later comprehensive tax reform (and often rose even after accounting for inflation in those years).
- Research from Steve Moore of the Club for Growth determined that the 1997 capital gains tax cut yielded 80 percent more revenue over the following four-year period than would have been possible under the older, higher rates.

More modern comparisons are possible. Between 2011 and 2013, the Administration hopes that its personal income tax increases on upper brackets, combined with cuts for lower ones, will still lead to a 29.2 percent increase in individual income tax revenue. Over that same period, its business tax changes, consisting primarily of punitive, uncompetitive policies on U.S. firms' earnings abroad, are supposed to lead to a large (also 29.2 percent) increase in corporation income tax revenue. Such a huge jump would be relatively rare for peacetime. Ironically, the last time personal income tax revenues increased by near this amount (29.0 percent) in a given three-year period was between 2004 and 2006 – the first full three years after the rapid tax cuts contained in the Jobs, Growth, and Tax Relief Reconciliation Act. Corporate income tax revenues rose a whopping 87.3 percent over that same period.[18]

10. The People and the Economy Need More Certainty from Policymakers.

Earlier this year, Congress's Joint Committee on Taxation reported that 69 separate tax law provisions are expiring in 2010, not to mention 72 others that have already lapsed during the year 2009. Many of the latter items would be addressed in what has become an annual rite in Washington – "tax extenders" legislation, a version of which is still being debated in Congress.

Congress and the President waited until after Christmas Day of 2007 to enact a one-year "patch" sparing about 20 million Americans from having to wrestle with the Alternative Minimum Tax (AMT)... or did it? Because Washington was so late to act, the IRS was forced to reprogram and test its systems after the agency had already prepared for a tax filing season without the patch. As a result, taxpayers with possible AMT issues were told to wait until February 11 of 2008 to file their returns. This included not only taxpayers filling out the AMT form, but also those using five other forms with AMT consequences – including Schedule 2 of Form 1040A, *Child and Dependent Care Expenses.*[19]

If Congress and the President wait too long this time around to extend current tax laws, the IRS will face much bigger problems in revising systems as well as publications. Items such as tax tables, rate schedules, lines on the tax forms themselves, worksheets for eligibility for deductions and credits, instruction booklets, and many other fundamental elements of the tax filing system would need to be updated. In the private sector, tax-preparation firms and software makers would face disruptions of their own, as would retirement advisors, financial planners, and the accounting departments of millions of businesses.

Uncertainty over a portion of the Tax Code inflicted enough pain on Americans three years ago, when times were good. Now that the economy is in the tank, such uncertainty – **<u>on a much broader scale</u>** – is downright deadly to the prospects of a recovery.

<u>About the Author</u>
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Notes

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