RSC Republican Study Committee
REP. TOM PRICE, M.D. (R-GA), CHAIRMAN
PAUL TELLER, EXECUTIVE DIRECTOR
424 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
rsc.price.house.gov
ph (202) 226-9717 / fax (202) 226-1633

RSC Policy Brief:
The Democrat Income Tax Hike—*NOT* Clinton's Budget Policies

September 24, 2010

"If the Senate can't do anything, our position is clear… We don't need to have a vote to let the American people know where we stand."

-Steny Hoyer, 9/23/2010, as quoted in Roll Call on September 23, 2010.

Background: The President, along with House and Senate Democrats, propose to increase the top federal income tax bracket from 35% to 39.6% by allowing a portion of the existing tax code (the top income bracket tax relief enacted in 2001) to expire.

This week, to underscore their commitment to this tax increase, Democrat leaders gave strong indications that this Congress will fail to extend (thus allowing a tax increase to occur) *any* of the expiring 2001 and 2003 tax relief prior to at least a potential Lame Duck Congress. The motivation for avoiding this vote is twofold: **1)** to try to avoid being held accountable for their tax policies prior to the election; and **2)** to hold all of the tax relief hostage to their desire to hike the top marginal tax rate.

The common refrain from Democrats is that this action will mark a return to the budget policies under President Clinton. This is not true in several respects:

- The plan would lead to ***higher*** marginal tax rates than those in effect during the Clinton era.
- The plan would lead to a significantly (and completely unprecedented) ***higher*** total federal tax burden than the Clinton era.
- The real reason the budget was balanced in the 1998-2001 period was because of spending restraint. And this tax increase plan would ***not*** come attached to any proposal to return spending levels to Clinton Administration era (when spending legislation was under the control of Republican-led Congress).

The following is an analysis of the consequences of the proposed tax hike:

The Top Marginal Tax Rate Will Be Higher Than the Clinton Era: A common Democrat talking point is that allowing the top income rate reductions in the 2001 relief law to expire will return tax rates to the levels under President Clinton. But with enactment of the new health care law, the top effective federal marginal rate would exceed the level in effect during the Clinton presidency. It is true that the top income tax rate would return to 39.6%, but the top marginal tax rate would be effectively higher with the new 0.9% Medicare surtax (enacted as part of the new health care law). Under the Democrat tax plan, the effective top marginal tax rate would be at the highest level since prior to the enactment of the 1986 tax reform law.

Near 50% Top Marginal Tax Rate: As AEI scholar Alan Viard points out, under the President's proposal—including the Medicare payroll tax hike and the proposal to limit high income itemized deductions—the top effective federal marginal tax rate will be 44.6%. However, this figure does not include state (and sometimes local) income taxes. When these are included, the Democrat plan pushes the top effective marginal tax right around the 50% mark. According to the Tax Foundation, people in Hawaii (49.69%) and California (49.37%)—the two highest burdens—would face top effective marginal tax rates in excess of 49%.

<u>Economic Impact</u>:

- **Huge Job Losses:** The Heritage Foundation's Center for Data Analysis estimates that enacting the President's tax hike will lead to **799,000** job losses a year. (Source: The Heritage Foundation's Center for Data Analysis).
- **Weaker Growth:** Enacting the President's tax increase would decrease annual GDP by $111 billion. (Source: The Heritage Foundation's Center for Data Analysis). Republicans on the Joint Economic Committee point out that the former Chairman of President Obama's Council of Economic Adviser has previously argued that a tax increase of 1% causes a 2.5% decline in real GDP.
- **Harm Small Businesses:** The President's tax increase would hit 65.1% of small business income and 90% of S-corp and partnership income. A total of 2 million tax returns with small business income would be hit by the tax increase. (Source: Joint Economic Committee Republicans)

<u>An Unprecedented Tax Burden</u>: The tax code is projected to collect revenue at a faster rate than economic growth. This occurs because the tax code is not indexed for wage growth, the value of some deductions in the tax code are not indexed for inflation at all, the large projected increase in the number of taxpayers hit by the AMT, significant future tax payments have been deferred such as with IRAs, and finally because under current law the 2001 and 2003 tax relief expires. In short, if federal tax policy is left on auto-pilot, the federal tax burden measured as a percentage of GDP will increase to levels never before seen in American history.

Federal Revenues Under Current Law

(Figures as a Percentage of GDP)

	Historical Average	2009	2020	2035
Federal Revenue	18	14.8	20.7	23.3
Compared to Historic Average	--	-3.2	2.7	5.3

Source: CBO: The Long-Term Budget Outlook June 2010

After 2035, federal revenue would grow still further, reaching 30% of GDP by 2080 (when state and local taxes are included, this would put the total tax burden in excess of 40% of GDP). To put this in perspective, federal revenue has only exceeded 20% of GDP on 3 occasions in U.S. history: 1944, 1945, and 2000. None of these three years should lend any support to the view that the American people will accept a tax level much in excess of the historic average. In 2000, federal revenues were temporarily high because of the stock market bubble. In 1944 and 1945, the U.S. was mobilizing all available resources to win World War II. The past several decades suggest the American people will not bear a federal tax burden much in excess of 18% of GDP.

<u>A Better Budget Solution, Return *SPENDING* to Clinton Administration Levels</u>: As the figures above show, the federal government does not have a revenue problem, it has a spending problem. The common refrain from Democrats is that the tax burden should be returned to the levels of the Clinton Presidency. During this period, federal revenues averaged 19.0% of GDP. Keeping all of the current tax cuts will, in the medium-term, produce revenues far in excess of that. On the spending side, in President Clinton's last two budgets, outlays were **18.2%** of GDP. Unfortunately, under the President's budget, federal spending will be an average of ***23.5%*** of GDP over the next ten years. Spending restraint offers a more useful path to a sustainable budget outlook.

RSC Staff Contact: *Brad Watson, x69719 or brad.watson@mail.house.gov*