Cutting Taxes to Promote Growth and Restore Fairness

A Memo to President-elect Obama

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Barack Obama and Joe Biden's tax plan delivers broad-based tax relief to middle class families and cuts taxes for small businesses and companies that create jobs in America, while restoring fairness to our tax code and returning to fiscal responsibility.

—Office of the President-Elect, "The Obama–Biden Plan"[1]

I'll eliminate capital gains taxes for start-ups and small businesses, the engines of our job creation.

—Barack Obama, "Why You Should Vote for Me"[2]

PRESIDENT-ELECT OBAMA, a centerpiece of your campaign was your pledge to cut taxes for 95 percent of American workers. Middle-class voters, especially, connected strongly with this pledge and expect their taxes to decline. Tax cuts are one key way to strengthen the economy for both the short term and long term, creating jobs and increasing wages. Targeting families, workers, and small businesses is a good starting point, but your promised tax cuts will deliver only minimal benefit to the groups you target. You must go farther if your tax plan is to promote a growing economy—something that is essential in our current situation.

To promote broad economic growth and stronger benefits for the middle class, your tax cuts should follow these basic principles of sound tax policy:

- **Reduce marginal tax rates and the total tax burden on tax-paying families.** You promised Americans that you will cut taxes for 95 percent of workers[3] and restore fairness to the tax code.

To the average American, these words mean reducing federal tax rates and the total tax burden so that all taxpayers—retired or working, student or family—would get to keep more of their own income to spend on their needs or to save and invest as they see fit.

For middle-class families and other Americans, a pledge of "broad-based tax relief" or to "cut taxes" does not mean narrow tax breaks restricted to families who engage in activities that Washington decides are worthy. And it certainly does not mean a check from Washington for the millions of Americans who are not even paying income tax today. Your tax plan features several of these targeted tax breaks such as creating a new exemption for low-income seniors so that they would pay no income taxes at all, or expanding tax credits like the Child and Dependent Care credit and the Hope Scholarship credit for higher education and then making them refundable so that taxpayers could get money back even if they paid no taxes.[4]

Instead of targeted tax relief for groups preferred by Washington, reducing marginal tax rates would provide larger incentives for work, innovation, and entrepreneurship—all things you have emphasized that you intend to encourage.

- **Cut taxes for everyone, and do not increase taxes on those who are most likely to save and invest.** Your plan is to pay for the income tax cuts provided to 95 percent of workers with (1) a tax increase on those who make more than $250,000 and (2) another set of unspecified tax increases. This short-sighted class-warfare argument unfortunately appealed to many Americans, but it would mean raising taxes on key investors and business owners. Higher taxes on these Americans would make it more costly to expand, innovate, and invest, so there would be fewer new factories, fewer new products, and fewer jobs for American families.

  The income tax, moreover, is already highly progressive. Those who earn over $250,000 already pay about 48 percent of all income taxes,[5] yet you would raise their taxes to have them pay an even greater share. On the other hand, 43 million tax filers—nearly one-third of the 135.7 million who filed in 2006—paid no federal income taxes at all after credits, deductions, and exemptions.[6]

  Though it was very popular in the heat of the election to call for tax hikes on the rich in order to "spread the wealth around," the fact is that increasing taxes on the most successful only serves to lower economic growth, discourage entrepreneurial risk taking, and harm opportunities for the poor and middle class. Tax increases are economically harmful at all times, but they are especially harmful during a recession. President Herbert Hoover's decision in 1930 to increase the top tax rate from 25 percent to 63 percent contributed to the Great Depression.[7] As you have appeared to concede since the election, today's economic problems underscore the need to expand your tax cuts to include *all* taxpayers.

- **Lower capital gains taxes generally, not just on small firms.** You have pledged to help small businesses and start-up companies by lowering the capital gains taxes investors pay on the returns they earn from investing in these companies.[8] Small businesses and start-ups are important engines of job growth in our economy, and cutting capital gains taxes for them is an effective way to stimulate this sector because small and start-up firms depend on venture capital and invested savings. However, lowering taxes on only some capital investments is very difficult to apply in practice and likely to be

1. Office of the President-Elect, "Agenda: Taxes," at *http://change.gov/agenda/taxes_agenda*.

2. *USA Today*, November 4, 2008, at *http://blogs.usatoday.com/oped/2008/11/why-you-should.html* (November 24, 2008).

3. Office of the President-Elect, "Agenda: Taxes."

4. William W. Beach, Karen Campbell, Rea S. Hederman, Jr., and Guinevere Nell, "The Obama and McCain Tax Plans: How Do They Compare?" Heritage Foundation *Center for Data Analysis Report* No. 08-09, October 15, 2008, at *http://www.heritage.org/Research/Taxes/cda08-09.cfm*.

5. Heritage Foundation calculations based on 2006 IRS Statistics of Income data.

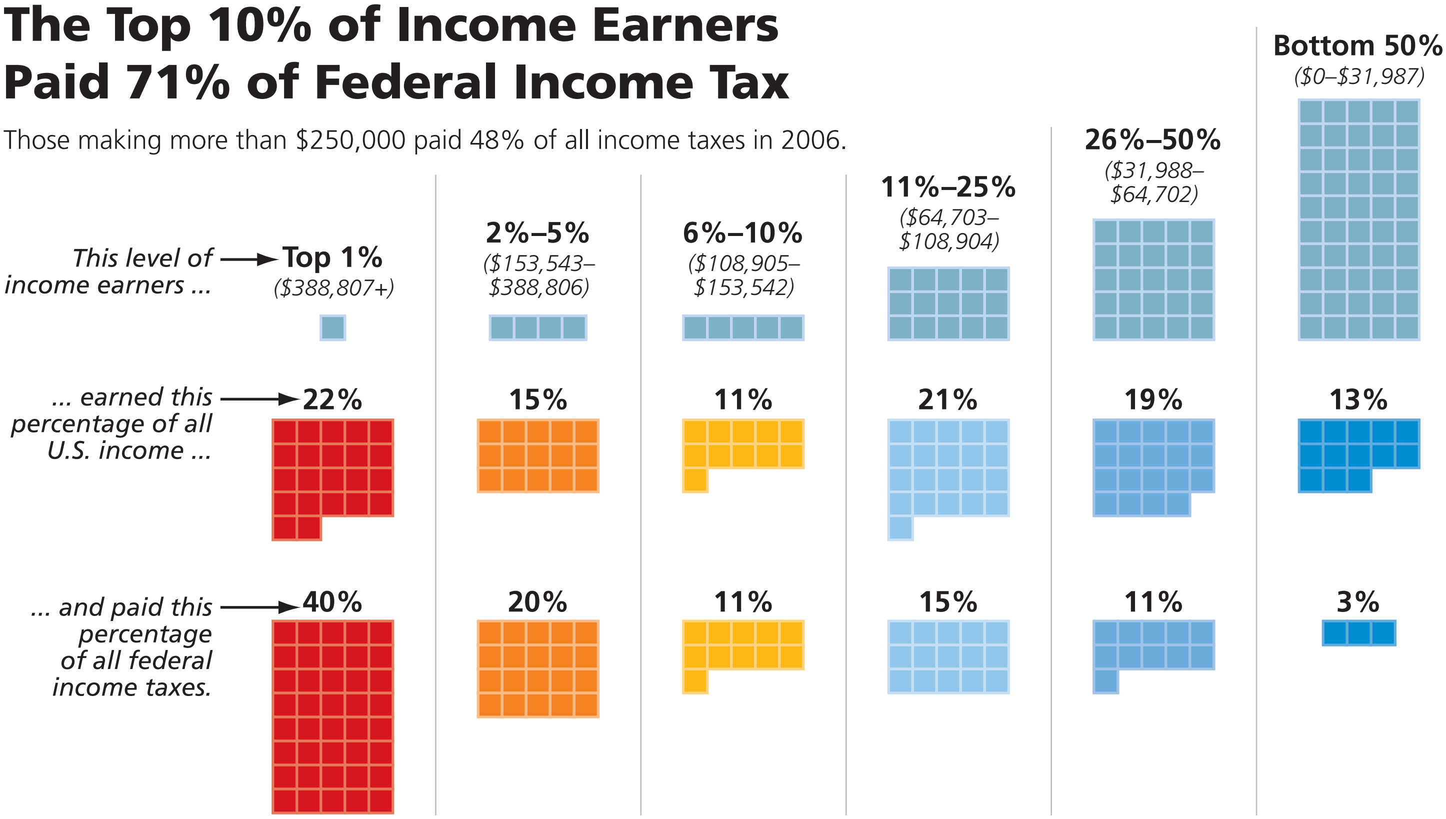
6. Gerald Prante, "Summary of Latest Federal Individual Income Tax Data," Tax Foundation *Fiscal Fact* No. 135, July 18, 2008, at *http://www.taxfoundation.org/news/show/250.html* (November 19, 2008).

7. Daniel J. Mitchell, "Taxes, Deficits, and Economic Growth," Heritage Foundation *Lecture* No. 565, May 14, 1996, at *http://www.heritage.org/Research/Taxes/hl565.cfm*.

8. Office of the President-Elect, "Agenda: Economy," at *http://change.gov/agenda/economy_agenda*.

The Top 10% of Income Earners Paid 71% of Federal Income Tax

Those making more than $250,000 paid 48% of all income taxes in 2006.



Note: Percentages may not add up to 100 due to rounding.
Source: Tax Foundation, Summary of Latest Federal Individual Income Tax Data, Fiscal Fact No. 135.

Chart 1 heritage.org

counterproductive. Your limited capital gains tax proposal would be difficult to implement, would make the tax code even more complex, and would be less effective in stimulating economic activity than you desire.

You will help small businesses and start-ups more if you lower the tax rate on *all* capital gains. All businesses, large and small, would benefit from the lower cost of capital and would have a stronger incentive to begin or expand operations and make new investments in equipment or other purchases. Cutting the tax on all capital gains will also free capital that is currently "locked-in" by the tax and allow it to move penalty-free to investments that are more likely to spur growth.

- **Kill the death tax once and for all.** The estate tax is called the death tax for a good reason: It strikes when families are dealing with the loss of a loved one. Though you have called this a "Paris Hilton" tax, in reality the death tax harms owners of small and medium-size businesses, often women and minorities; farmers who poured their savings into their farms; and workers who lose jobs as businesses are liquidated to pay the tax. This harmful economic policy, another class-warfare relic, is estimated to cost between 170,000 and 250,000 new jobs each year.[9]

Congress began to phase out the death tax in 2001, with a full phase-out scheduled for 2010. But this tax cut will expire in 2011, and the death tax will return with a vengeance with its high rate and low exemption revived. Your proposal to allow it to rise like a phoenix, albeit at a lower rate and higher exemption, will not mitigate its many economic and moral flaws. Dying should not be a taxable event, but under your plan, the federal government will still capture nearly half of a grieving family's assets.

9. William W. Beach, "Now Is (Still) the Time to Permanently Repeal Federal Death Taxes," Heritage Foundation *WebMemo* No. 720, April 12, 2005, at *http://www.heritage.org/Research/Taxes/wm720.cfm*.

Instead, you should kill the death tax permanently so that taxpayers do not have to waste valuable time or capital in estate planning, families will not have to sell their businesses or property just to pay this immoral tax, and no workers will suffer when business are liquidated to pay the tax. It will also encourage more saving and investment and higher jobs and wages.

- **Do not allow PAYGO and the Congressional Budget Office (CBO) to back you into a corner on tax cuts or the AMT.** You have promised a return to fiscal responsibility and that you plan to stick with "Pay As You Go Budgeting," or PAYGO,[10] and you rightly proposed to adjust the way these PAYGO rules are applied. The measure to which PAYGO is applied is determined by two contradictory policies. The CBO projects its spending baseline by assuming that all the laws authorizing spending, such as the highway or farm programs, will be extended year after year and that their spending levels will continue even though they expire regularly under existing law. However, when it comes to taxes, the CBO bases its baseline on current statute, and any rates, deductions, credits, etc. that are scheduled to expire will do so as scheduled.

  You were right to dismiss this lopsided practice, which creates a bias in favor of higher taxes and higher spending. If you adhere to your PAYGO pledge, you must fix the CBO's unfair baseline disparity; otherwise, your promised tax cuts for the middle class will require hefty tax increases or spending cuts. Preserving current law is not a tax cut, and allowing the tax cuts to expire is a massive tax hike that neither the taxpayers nor the economy can afford.[11]

  Next year, over 20 million taxpayers, many of them middle-class, will be snared into the pernicious trap of the alternative minimum tax (AMT), which needlessly adds uncertainty and complexity to the tax code. The AMT income exemption is not indexed for inflation, so the AMT will continue to raise taxes on an ever-increasing number of Americans. In response, Congress regularly passes a band-aid "patch" so that middle-class taxpayers do not have to pay the AMT.

  You should make the patch permanent—or, better yet, repeal the AMT completely—instead of settling for temporary patches. Then you won't be raising taxes through the AMT on a growing number of Americans at the same time you are cutting their taxes. Here again, preventing a tax hike is not a tax cut, so there is no valid argument that this fix should be paid for by imposing higher rates on other taxpayers.

Conclusion

Your promise to cut taxes on 95 percent of Americans struck a strong chord with voters, and your pledge to lower the capital gains tax makes strong economic sense. If you follow the right steps to cut taxes—cut marginal income tax rates for all taxpayers, lower or eliminate capital gains taxes, and kill the death tax—you will allow all taxpayers to keep more of their money, improve fairness, and also take strong steps to encourage economic growth. This is important at any time but essential in this troubled economy.

Cutting taxes only for the selected groups you targeted in the campaign and then raising them for high-earners will not generate the growth America needs. Your first priority when taking office must be to help stabilize a flagging economy, and that means lowering taxes for all Americans.

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10. Office of the President-Elect, "Agenda: Fiscal," at *http://change.gov/agenda/fiscal_agenda*.

11. J. D. Foster, "Obama to CBO Revenue Baseline: Nuts—and He's Right!" Heritage Foundation *WebMemo* No. 2019, October 15, 2008, at *http://www.heritage.org/Research/Budget/wm2019.cfm*.

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