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Can Income Tax Hikes Close the Deficit?

By William Ahern

When David Walker was head of the General Accounting Office, he changed the agency's middle name from Accounting to Accountability, but the concept hasn't caught on in the executive and legislative branches. The commentary pages of the nation's newspapers are filled with foreboding about the nation's finances, urging accountability, but Congress and the President are full steam ahead with their expansive spending plans.

As usual, the one number that everyone talks about is the budget deficit, and sober, nonpartisan fiscal experts are agog at the Administration's toleration of previously intolerable deficits. Everyone has a slightly different idea of how high the federal deficit can be in an ordinary year and still be "sustainable," but in recent testimony to Congress, Federal Reserve Chairman Bernanke said that the structural deficit was sustainable at 2.5 to 3 percent of GDP.[1]

At no point in the next ten years, according to the Obama Budget, will the deficit ever shrink to as little as 3 percent of GDP. According to the CBO, it will never even get as low as 4 percent.[2] And the dire deficit predictions of reliable nonprofit groups like the Pew Trust and Peterson Foundation are even more alarming: the deficit won't even shrink to 5.5 percent of GDP in their analysis.[3]

'Mind boggling' is the term Martin Sullivan of Tax Analysts uses to describe the tax and spending changes that would have to occur just to get the deficit down to 3 percent of GDP.

"Our gridlocked, dysfunctional Congress simply cannot bring itself to absorb these types of painful shocks," says Sullivan. "Given these unprecedented pressures I believe that within the next

[1] Remark made during Q&A after submitting testimony to the House Committee on Financial Services on February 24, 2010.
[2] Congressional Budget Office, "Preliminary Analysis of the President's Budget Request for 2011," March 5, 2010.
[3] Peterson-Pew Commission on Budget Reform, "Red Ink Rising—A Call to Action to Stem the Mounting Federal Debt," December 2009.

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decade there is more than a 50-50 chance there will be an upheaval either of the political system or the economy."[4]

How Big Are the Deficits?

The trouble with political discourse about the deficit is that voters are often numb to the subject, and as a result, politicians are able to avoid the unpopular votes for cutting spending or raising taxes. Whether deficits are expressed in hundreds of billions of dollars or percentages of GDP, their importance is hard for leaders to convey or for the public to grasp.

The politician who is probably most famous for having connected with voters on this issue was third-party presidential candidate Ross Perot. In 1992 he famously discovered that voters liked his infomercials about budget deficits. He said profligate spenders were "robbing future generations," a message people rallied to. He won many people over with his plain English and hand-held charts. To convey his irritation with the deficit that year, he pointed to a simple column chart and said, "This year we ran up $341 billion dollars in new debt. That's our legislators and our president trying to buy our vote this year with what used to be our money. We're not that dumb."

He won 19 percent of the presidential vote and woke up both parties. The lesson was that if leaders can explain effectively how much damage deficits can do to the economy, voters will care.

But as big as deficits were back then, they were never so huge that they couldn't be remedied by holding down the rate of spending growth and adding a couple points to an income tax rate. Now, as the table below shows, that is out of the question. Even in 2012 or 2015 when the effects of the housing bubble and the fiscal stimulus have dissipated, the rate hikes required to balance the budget are unthinkable.

Using the Tax Foundation's Microsimulation Model to analyze the deficits projected by the President's Budget, we can project how much revenue a broad-based increase in federal income tax rates would generate. As usual, the President's Budget forecasts lower deficits than any other reputable source, but we have used those optimistic deficit estimates to show that even the rosiest deficit scenario is far from rosy.

Assuming deductions, exemptions and credits were kept the same as they are now, Congress would have to raise each personal income tax rate by a factor of almost two and a half to erase the 2010 deficit. Even in later years when the President's Budget predicts that the deficit will be "only" in the $700-to-$800 billion range, the rates necessary to close the deficit are untenable.

Table 1 shows the effect on statutory rates of such a hypothetical tax hike in 2010. Instead of taxing couples with rates that range from 10 percent to 35 percent, tax rates would have to start at 24.3 percent and range up to 84.9 percent.

[4] Martin Sullivan, "Mind Boggling Tax Hikes on the Horizon," Tax Analysts at http://www.tax.com/taxcom/taxblog.nsf/Permalink/MSUN-82ZGEJ?OpenDocument

Table 1 Federal Individual Income Tax Rates for Joint Tax Returns Current Law Versus Rates Necessary to Erase Deficit 2010		
Tax Brackets for Couples Filing Joint Returns	Current Law Tax Rates	Rates Needed to Close Deficit
$0 to $16,750	10%	24.3%
$16,751 to $68,000	15%	36.4%
$68,001 to $137,300	25%	60.6%
$137,301 to $209,200	28%	67.9%
$209,201 to $373,600	33%	80.0%
$373,601 and over	35%	84.9%
Note: The rates are the same for single taxpayers, but the brackets vary. For the bottom three brackets, the threshold amounts are exactly one-half what they are for couples. For the top bracket, the threshold is the same for singles as for couples. Brackets are shown for 2009; inflation adjustment for 2010 will be announced in the summer of 2010. Source: IRS and Tax Foundation		

The federal deficit is projected to be larger in 2010 than in any future year, although it could be argued that the future deficits are more alarming. The anomalous TARP program and the allegedly anomalous fiscal stimulus legislation accounted for roughly one-quarter of 2009's $1.4 trillion deficit, according to Secretary Geithner,[5] and they spilled over into 2010. Some of the components of the stimulus package – aid to state-local governments and unemployment insurance – seem to be acquiring a semi-permanent status, threatening to make future deficits worse.

However, for the time being, projections of the deficit four and eight years out are somewhat lower, according to the President's Budget. They are still huge by historical standards, never falling below $700 billion and rising back above $1 trillion in 2020. As a result, in all likelihood it is true for every foreseeable year that the income tax system would be unable to raise as much revenue as the government plans to spend, absent major changes in our tax code or spending patterns.

Table 2 applies the same method as Table 1 but for the years 2011 through 2020. Two rate increases for this 10-year period are already counted in the deficit projections given by the President's Budget. The top two tax rates will increase on January 1, 2011. The 33 percent rate will rise to 36 percent, and the 35 percent rate will rise to 39.6 percent. Yet the additional tax rate hikes necessary beyond those, and for all the lower brackets, are still remarkably steep if the budget deficit is to be eliminated, especially at the end of the decade when, even with optimistic deficit projections, deficits are expected to rise quickly and hit $1 trillion.

[5] Jackie Calmes, "$1.4 Trillion Deficit Complicates Stimulus Plans," *New York Times,* October 16, 2009, at http://www.nytimes.com/2009/10/17/us/17deficit.html?hp

Table 2: Personal Income Tax Rates Required to Erase the Deficits Projected by President Obama's FY 2011 Budget 2011-2020										
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Projected Deficit ($Billions)	$1,157	$803	$722	$718	$759	$778	$780	$816	$932	$1,010
Current Rates	Future Rates Necessary to Close the Deficit									
10%	19.8%	15.8%	14.7%	14.5%	14.5%	14.3%	14.0%	14.0%	14.3%	14.4%
15%	29.7%	23.7%	22.1%	21.8%	21.8%	21.4%	21.0%	21.0%	21.4%	21.6%
25%	49.5%	39.5%	36.8%	36.3%	36.3%	35.6%	35.0%	35.0%	35.6%	36.0%
28%	55.4%	44.2%	41.2%	40.6%	40.6%	39.9%	39.2%	39.2%	39.9%	40.3%
36%	71.3%	56.9%	52.9%	52.2%	52.2%	51.3%	50.4%	50.4%	51.3%	51.8%
39.6%	78.4%	62.6%	58.2%	57.4%	57.4%	56.4%	55.4%	55.4%	56.4%	57.0%

Note: Assuming proportional increases at each tax bracket, the multipliers necessary to close the deficit are 1.98 in 2011, 1.58 in 2012, 1.47 in 2013, 1.45 in 2014, 1.45 in 2015, 1.43 in 2016, 1.40 in 2017, 1.40 in 2018, 1.43 in 2019, and 1.44 in 2020
Source: Tax Foundation's Federal Individual Income Tax Model

With higher rates, tax payments would rise rapidly as well, of course, though not by exactly the same percentage as the tax rates.[6] Tables 3 and 4 show the additional payments taxpayers would have to remit each year through 2020 to erase the deficit. Average tax payments would have to rise by almost $10,000 in 2010, and by smaller but still intolerably large amounts in subsequent years.

Since we assume a proportional increase in each tax bracket, the steeply higher payments of high-income people would be preserved. This analysis is "static," meaning that it assumes individuals would not change their income-earning or tax-planning behavior in response to higher tax rates. They would earn the same amounts they would have under current rates, and they would fill out their tax returns in the same way they do now, except that the payments would be much higher.

Revenue estimators would dispute this assumption, knowing from experience that even smaller tax increases have altered taxpayer behavior in the past. With high-income people paying a federal tax rate in the 65-to-85 percent range, and most states adding on about 8 percent, plus local income taxes and payroll taxes, tax rates would be close to 100 percent for some households. In other words, beyond some point government would be taxing away all earnings and there would be no incentive to work.

There can be little doubt that the high tax rates necessary to balance the budget in any of the next several years would discourage all manner of income-producing endeavors. Consequently, even when the deficit is projected to be as "low" as it is in 2012 and 2013, it is probably not possible to close the deficit with personal income tax hikes.

[6] Raising the statutory tax rates would proportionately raise the value of deductions, but fixed-dollar credits and exemptions would be comparatively less valuable. Therefore, each income group's average tax payment under the hypothetically high tax rates rises by a slightly different percentage, depending on which credits and exemptions are used the most at each income level.

Table 3 Extra Income Tax Payments Over and Above Current Law Required to Erase the Deficit 2010-2015						
	2010	2011	2012	2013	2014	2015
Average Increase for All Tax Returns	$ 9,825	$ 7,588	$ 4,935	$ 4,323	$ 4,474	$ 4,752
$1 - $5,000	$5	$4	$2	$2	$2	$2
$5,000 - $10,000	$42	$28	$17	$14	$13	$13
$10,000 - $15,000	$240	$162	$94	$76	$74	$71
$15,000 - $20,000	$587	$398	$230	$182	$167	$162
$20,000 - $25,000	$1,138	$771	$453	$357	$341	$331
$25,000 - $30,000	$1,844	$1,231	$700	$562	$536	$519
$30,000 - $40,000	$2,841	$1,937	$1,131	$908	$855	$835
$40,000 - $50,000	$4,227	$2,871	$1,676	$1,343	$1,280	$1,264
$50,000 - $75,000	$6,945	$4,779	$2,782	$2,233	$2,122	$2,090
$75,000 - $100,000	$11,164	$7,640	$4,512	$3,637	$3,474	$3,440
$100,000 - $200,000	$22,466	$15,618	$9,267	$7,473	$7,137	$7,119
$200,000 - $500,000	$68,772	$51,966	$30,024	$23,907	$22,728	$22,488
$500,000 - $1,000,000	$214,463	$171,506	$101,936	$82,715	$79,166	$79,041
$1,000,000 and Over	$969,505	$792,420	$476,008	$389,415	$376,134	$379,363

Table 4 Extra Income Tax Payments Over and Above Current Law Required to Erase the Deficit 2016-2020					
	2016	2017	2018	2019	2020
Average Increase for All Tax Returns	$ 4,737	$ 4,694	$ 4,937	$ 5,491	$ 5,947
$1 - $5,000	$3	$3	$3	$3	$3
$5,000 - $10,000	$12	$11	$12	$13	$13
$10,000 - $15,000	$67	$61	$60	$61	$62
$15,000 - $20,000	$151	$138	$137	$143	$147
$20,000 - $25,000	$301	$272	$262	$267	$266
$25,000 - $30,000	$481	$444	$430	$447	$454
$30,000 - $40,000	$769	$710	$704	$732	$742
$40,000 - $50,000	$1,179	$1,096	$1,068	$1,106	$1,119
$50,000 - $75,000	$1,952	$1,807	$1,779	$1,849	$1,881
$75,000 - $100,000	$3,208	$2,992	$2,967	$3,111	$3,159
$100,000 - $200,000	$6,665	$6,240	$6,211	$6,558	$6,736
$200,000 - $500,000	$20,885	$19,388	$19,182	$20,269	$20,781
$500,000 - $1,000,000	$74,570	$69,971	$69,783	$74,017	$76,404
$1,000,000 and Over	$361,600	$343,186	$345,902	$368,022	$382,650