July 16, 2010
Contact: Steve Wamhoff
(202) 299-1066 x33

Douglas Holtz-Eakin Peddles Myths about the Bush Tax Cuts

On July 14, Douglas Holtz-Eakin, chief economic adviser for John McCain's presidential campaign and former director of the Congressional Budget Office, gave written and oral testimony to the Senate Finance Committee concerning the Bush tax cuts.[1] Because these tax cuts expire at the end of 2010, Congress must decide which portions of them to extend or make permanent, and which portions should expire as scheduled.

Holtz-Eakin argued for permanently extending the Bush income tax cuts for the rich, while dropping expansions in the Earned Income Tax Credit and Child Credit that benefit working class people. He also oddly asserted that raising revenue will not reduce deficits. He went on to repeat some common misconceptions about businesses and their reaction to tax rates.

The overall thrust of Holtz-Eakin's testimony was that taxes need to be lower on the rich (to encourage them to work, save and invest) and higher on the poor (to encourage them to work). To make his case, Holtz-Eakin endorsed several myths about the Bush tax cuts.

Myth: President Obama and Democratic leaders want to raise taxes on all taxpayers.

Fact: President Obama and Democratic leaders propose to extend all of the Bush tax cuts for the 98 percent of taxpayers who are either married and have adjusted gross income (AGI) under $250,000 or are unmarried and have AGI under $200,000.

Holtz-Eakin knows full well that no one in Congress is seriously considering letting all the Bush tax cuts expire. Under the President's proposal, 98 percent of taxpayers would continue to enjoy all of the tax cuts enacted under Bush. Nonetheless, Holtz-Eakin perpetuates this particular myth by comparing two policy options. One option is a permanent extension of all the Bush tax cuts. The second option is a one-year extension of just those tax cuts that the President wants to extend (the tax cuts for the 98 percent), followed by letting them all expire thereafter. He models the economic impacts of this option in 2011 (the year the tax cuts would be extended for 98 percent of taxpayers) and 2012 (when he assumes all of the tax cuts will expire). But this is an option that no one is seriously considering.

It's true that some in Congress have suggested limiting the President's proposed extension of most of the Bush tax cuts to just 2011. But no one believes that Congress will, in the following year, allow all the tax cuts to expire. The reason for the one-year extension has more to do with the inability of lawmakers to find ways to pay for these tax cuts, and their inability to

[1]Douglas Holtz-Eakin, "Aspects of the Sunset of EGTRAA and JGTRAA," July 14, 2010. http://finance.senate.gov/imo/media/doc/071410dhetest.pdf

admit that they would increase the deficit by a large amount.

Myth: Government spending should remain the same, as a share of the economy, for all time.

Fact: There is no economic or policy reason why government should be kept at levels that existed when people relied far less on Medicare, Social Security or other public goods and services that are a vital part of our lives today.

A common conservative talking point lately is that taxes and spending are going to be higher, as a percentage of GDP, than they historically have been for the past 60 years. Holtz-Eakin parrots this entirely when he says

> "The CBO projects that over the next decade the economy will fully recover and revenues in 2020 will be 19.6 percent of GDP — over $300 billion more than the historic norm of 18 percent. Instead, the problem is spending. Federal outlays in 2020 are expected to be 25.2 percent of GDP — about $1.2 trillion higher than the 20 percent that has been business as usual in the postwar era."

Is "business as usual in the postwar era" what we want? That includes an awful lot of years before Medicare and Medicaid even existed and years when Social Security was in its infancy. Few Americans would want to go back to those years.

Why are conservatives fixated on an abstract figure (government spending as a percentage of GDP)? Shouldn't we simply ask what important services we believe government provides efficiently and then determine how should we pay for them? Anyone who studies Social Security knows that it would be very difficult to get the private market to provide the package of retirement benefits, disability benefits and death benefits that the program provides. Anyone who studies Medicare knows that its administrative costs are lower than those of private insurance. Most people would agree that federal funding for education helps create a more productive workforce than we would have if the federal government left its hands off education entirely. The list goes on and on.

Americans want their government to provide certain things. It makes no sense to start from the assumption that we must keep the government at some particular size because that's the way it was in previous decades.

Myth: Raising taxes can't help balance the federal budget, but cutting spending will.

Fact: A budget deficit is a situation in which revenues are less than spending. Of course raising revenues and lowering spending can both be part of the answer.

Obviously, a budget deficit is, by definition, caused by the government spending more than it raises in revenues. Holtz-Eakin argues that if we raise taxes, Congress won't have any incentive to control its spending, so the federal government will just spend more and we'll have to face this budget problem again at some point in the future.

This is entirely illogical. We could just as easily argue that if spending is cut, then Congress will have no incentive to restrain its urge to cut taxes, and the result will be that we'll have to face the budget problem again in the future.

Clearly, there are many ways in which Congress could act irresponsibly on fiscal matters. But arguing that we can't have enough revenue to balance the budget because Congress will then have no incentive to keep the budget balanced is just illogical. Holtz-Eakin is repeating a version of the silly "starve-the-beast" argument made and proven false way back in the Reagan administration in the 1980s — when, of course, the budget never came close to being balanced.

Myth: Tax cuts for the rich are good because they help small business. If tax cuts for the rich are not extended, then small businesses will be less able to create jobs.

Fact: Only a tiny fraction of taxpayers with business income would lose any of the Bush tax cuts under the tax proposal offered by President Obama and Democrats in Congress.

Holtz-Eakin argues that business owners "hoard cash" instead of investing it because of the "uncertainty" about what Congress will do about the Bush tax cuts.

Why exactly would the possibility of higher taxes be the reason businesses are hoarding cash? Higher taxes do not weigh on struggling businesses because a business with no profits is not taxed. Business owners are only taxed on what they have left over after they have paid their employees and subtracted their expenses. Business owners are not taxed on income they use to pay wages to employees, and if they are truly *small* businesses then they don't pay taxes on the income they reinvest in their business (because of Section 179 expensing). Obviously a wealthy person who puts their income in his or her bank account does in fact pay income taxes on that income. So one would think that the fear of higher taxes would not stop small businesses from creating jobs.

Holtz-Eakin knows all of this so he relies on a subtler idea, which is that people are less willing to invest in workers or equipment if they have to give up a larger portion of the profits in taxes. If today I can keep 90 percent of the profits from these investments, but next year I might only get to keep 85 percent of the profits from these investments, then I have less incentive to make these investments. Or so the argument goes.

But few, if any, business people actually think this way. Hoarding cash provides no profit whatsoever. How is that an attractive alternative to making profits and paying a portion of them in taxes? Business people put their money wherever it will make them the largest profits, regardless what the tax rates are. They'll "hoard" cash only when they see no profit-making opportunities (such as during a period of low consumer demand, as is now the case).

In any event, very few small business taxpayers would lose any of their Bush tax cuts under President Obama's tax plan. CTJ has calculated that only 5 percent of the taxpayers whose income comes mainly from business profits would be rich enough in 2011 to lose any portion of their Bush income tax cuts.

Holtz-Eakin, responding to questions from Senator Grassley at the Finance Committee hearing,

said that he thought the more relevant figure was the amount of business income going to those few taxpayers rich enough to pay higher income taxes under the President's plan. The Joint Committee on Taxation (JCT) projects that next year taxpayers will report a trillion dollars of active business income, and about half of that will go to taxpayers who are in the top two brackets (the brackets for which President Obama and Democratic leaders propose to allow rates to go back up to pre-Bush levels).[2]

But everything discussed so far assumes that all business income reported on individual returns (i.e., all business income that is not generated by companies paying the corporate income tax) is what we should be concerned about. As Chairman Baucus pointed out during the hearing, there may be a lot of business income reported on the returns of the rich, but a great deal of that is income from businesses that we cannot possibly call "small." Hedge funds, law firms, accounting firms, medical practices and many other types of entities are included with other businesses that do not pay the corporate income tax.

This becomes obvious when one considers data on gross receipts of these "flow-through" businesses (so-called because the income is not taxed at the corporate level but at the individual level under the personal income tax). Most of the gross receipts from these businesses are generated by the minority that have more than $10 million in receipts.[3] This is not to say that large companies are not an important consideration for policymakers. But it's important to note those business owners who actually would pay higher taxes under the President's proposal are not likely to be of the "mom and pop shop" variety.

Myth: Tax credits for poor people are bad because they discourage work.

Fact: Plenty of studies show that tax credits for poor people encourage work.

Holtz-Eakin makes it clear that the parts of the Bush tax cuts that do not contribute to economic growth, in his opinion, are the expansions of the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC) — which help low- and moderate-income working families. He argues that these tax breaks raise marginal tax rates for some workers and that causes some of those workers to have less incentive to work longer hours or seek higher wages.

Refundable tax credits like the EITC and CTC (and many other credits in the tax code) are phased out for people above certain income levels. For example, a $1,000 tax credit could be created that is phased out for taxpayers whose adjusted gross income (AGI) is between $30,000 and $40,000. That would mean that the credit is reduced slightly for someone whose AGI is $30,010, and it would be reduced to zero for someone whose AGI is $40,000. There would thus be a "phase-out" range of $10,000. As a result, someone whose income is within the phase-out range temporarily faces an additional marginal tax rate of 10 percent, because each dollar of income above $30,000 reduces the tax credit by 10 cents (until income reaches

---

[2]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," July 12, 2010. JCX-36-10. http://www.jct.gov/publications.html?func=startdown&id=3691

[3]Joint Committee on Taxation, "Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity," June 4, 2008, JCX-48-08. http://www.jct.gov/publications.html?func=startdown&id=1291

$40,000). Combined with the marginal rate under the regular income and payroll tax, this could temporarily push a person's total tax rate on an additional dollar earned to about 40 percent.

According to Holtz-Eakin and some other economists, this temporary high marginal rate will discourage many workers from seeking higher incomes. It would be better for these workers, it's argued, if they didn't get the tax credit and paid higher taxes.[4]

Does this make sense? Would a person struggling to make ends meet give up working extra hours to earn another $1,000 because they get to keep only $600 of it, rather then the $700 they would keep if not for the phase-out of the tax credit? Do many people even know what their effective marginal tax rate is? Do people struggling to make ends meet use spreadsheets to determine exactly what their effective marginal tax rates will be and then decide to turn down extra shifts that they could work if they wanted to?

In fact, there is considerable evidence that refundable credits, particularly the EITC, encourage poor parents enter the workforce, particularly parents who would otherwise rely on welfare.[5] The initial benefit of the tax credits does seem to make the prospect of work more tantalizing than not working. It's important to remember that the EITC and the CTC are available to poor people only if they work, and they are phased in as earnings rise before they are phased out at higher income levels.

It's hard to believe that a person who is working will stop working exactly at the point when their effective marginal tax rate (calculated only with extreme effort) rises because of the phase-outs. Holtz-Eakin's conclusions about refundable tax credits therefore seem quite detached from the real world.

---

[4]This is not to say that the workers would be better off financially without the tax credit. In fact, at every point in the phase-out of the credit, they still pay lower taxes than they would if the credit did not exist. The higher marginal tax rate in the phase-out only means that they keep less of each additional dollar earned during the phase-out than they would without the credit and its phase-out.

[5]A recent report from the Center on Budget and Policy Priorities cites studies finding that the EITC encourages work. See Joseph Holtz, Charles H. Mullin, and John Karl Scholtz, "Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare," National Bureau of Economic Research Working Paper No. 11968, January 2006; Nada Eissa and Hilary W. Hoynes, "Behavioral Responses to Taxes: Lessons From the EITC and Labor Supply," paper prepared for NBER Tax Policy and the Economy Conference, September 15, 2005; Bruce D. Meyer and Dan T. Rosenbaum, "Making Single Mothers Work: Recent Tax and Welfare Policy and Its Effects," National Bureau of Economic Research Working Paper No. 7491, January 2000; and Nada Eissa and Jeffrey B. Liebman, "Labor Supply Response to the Earned Income Tax Credit," Quarterly Journal of Economics, May, 1996.