

EXECUTIVE SUMMARY



"I thought this Op-Ed piece in today's Wall Street Journal was worthy of sending to you. It fairly outlines the potential dangers we taxpayers face with the next elected administration. Keep this in mind when casting your vote!" Jill



OPINION

The Coming Tax Bomb

By John F. Cogan and R. Glenn Hubbard

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As the presidential campaign enters its final stages, there will be increased debate over budget priorities and how they will be paid for. Many commentators and political leaders, including Sens. Hillary Clinton and Barack Obama, believe that tax increases are needed to restore near-term budget balance and finance longer-term entitlement growth.

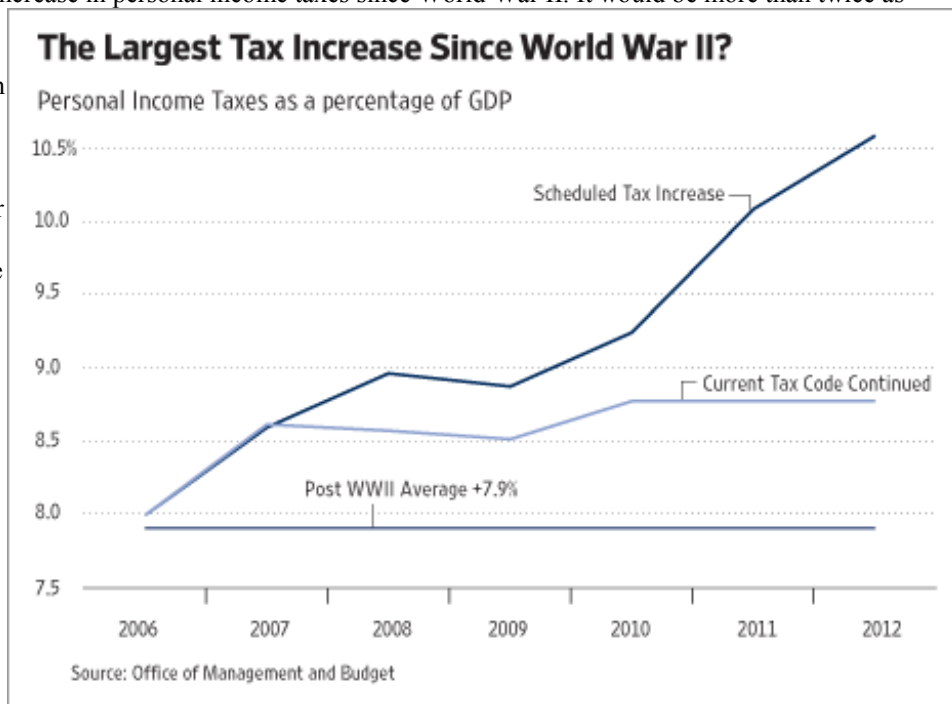
These claims fail budget arithmetic and economics. Worse, they raise serious questions about the nation's broad fiscal policies and its commitment to economic growth.

By historical standards, federal revenues relative to GDP, at 18.8% last year, are high. In the past 25 years, this level was only exceeded during the five years from 1996 to 2000. Still, we stand on the verge of a very large tax increase, one that will occur unless the next Congress and president agree to rescind it. Letting the Bush tax cuts expire will drive the personal income tax burden up by 25% – to its highest point relative to GDP in history.

This would be the largest increase in personal income taxes since World War II. It would be more than twice as large as President Lyndon Johnson's surcharge to finance the war in Vietnam and the war on poverty. It would be more than twice the combined personal income tax increases under Presidents George H. W. Bush and Bill Clinton. The increase would push total federal government revenues relative to GDP to 20%.

Why this large tax increase? The tax code changes enacted in 2001 and 2003 are scheduled to expire at the end of 2010. If they do, statutory marginal tax rates will rise across the board; ranging from a 13% increase for

the highest income households to a 50% increase in tax rates faced by lower-income households. The marriage penalty will be reimposed and the child credit cut by \$500 per child. The long-term capital gains tax rate will rise by one-third (to 20% from 15%) and the top tax rate on dividends will nearly triple (to 39.6% from 15%). The estate tax will roar back from extinction at the same time, with a top rate of 55% and an exempt amount of on \$600,000.



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Finally, the Alternative Minimum Tax will reach far deeper into the middle class, ensnaring 25 million tax filers in its web.

Proponents of bigger government invariably argue that allowing all or some of President Bush's tax cuts to expire is necessary in the near term to balance the federal budget, and necessary in the longer term to finance the retirement and health-care promises made to the baby-boom generation. But a tax increase is neither wise nor necessary.

As has so often been true in the past, the economic damage caused by the tax increases and tax avoidance behavior will prevent the promised revenues from being realized. At the same time, the promise of higher revenues will encourage Congress to continue its profligate spending. As a result, a tax increase won't lower the budget deficit.

Moreover, current tax rates can be maintained and even reduced and still allow for necessary increases in national security appropriations and the balancing of the federal budget. Although budget balance may not be achieved overnight, a firm commitment by the next president to spending control will enable balance by the end of his or her first term.

Balancing the federal budget without a tax increase will require strong fiscal restraint. To achieve balance by the end of the next president's term in office, federal nondefense spending growth needs to be restrained to 2% per year instead of the currently projected 4.5%. This will be tough, but the federal government has been on a bipartisan spending binge for a decade. How large is this binge? Compared to the 1997 level adjusted for inflation and new homeland security spending, in 2007 actual nondefense appropriations were \$125 billion higher, or cumulatively, a nearly \$900 billion excess for the decade. If the next two congresses were to remove this excess gradually and shave 1% per year from projected entitlement growth, the budget could be balanced.

But what about national security? Certainly, balancing the budget without raising taxes requires that the wars in Iraq and Afghanistan be brought to a successful conclusion over the next five years. However, it does not require that the U.S. troop presence in either country be eliminated. Nor does balancing the budget preclude overdue and necessary increases in the defense budget.

The costs of needed improvements in our national security, though seemingly large, are small when measured in the context of the federal budget. According to the Congressional Budget Office, adding 100,000 active duty soldiers and 60,000 Army or National Guard members costs about \$25 billion per year. Increasing the size of the Defense Department's procurement budget by 25% costs a similar amount. Each of these adds just 0.1% to annual federal spending – a small difference in the federal budget, but a powerful addition to our nation's security.

The current economic slowdown will increase the federal budget deficit this year and, in all likelihood, next year as well. But as the economy enters its recovery phase, raising taxes would choke off the recovery. The right policy, for both the economy and the budget, would be to make current tax rates permanent well before the scheduled increase. Giving investors greater certainty that current tax rates will be maintained will spur investment and aid the economic recovery, as it did in 2003. Federal budget balance will be achieved once the economy is again operating on all its cylinders.

This near-term budget debate foreshadows the more significant long-term budget debate the next president must lead. The CBO tells us that after a generation, Social Security and Medicare spending, left unchecked, will rise by 10 percentage points of GDP. Continuing the current hands-off entitlement policy will have severe consequences. The strategy of ratifying spending with higher taxes would require that all federal taxes rise by nearly 60%, bringing them to a European-level tax burden.

We still have time to prepare for the looming entitlement problem. Although baby boomers soon begin their retirement, the real impact of their numbers on the federal budget will not be felt for a decade. According to official budget forecasts, Social-Security costs will claim 4.5% of GDP in 2013, no higher than its claim on GDP during the first half of the 1990s.

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Having time is no excuse for inaction, but a near-term tax increase is the wrong way to prepare. Higher revenues will encourage Congress to raise spending, compounding the long-term budget problem. And, the long-term tax increase required to fund unchecked long-term spending would likely reduce annual GDP growth by a full percentage point.

The proper way to prepare to meet the entitlement challenge consists of three essential elements: Change entitlements to slow their cost growth; eliminate all nonessential spending in the remainder of the budget; and, most important but often overlooked, adopt policies that promote economic growth. The greater the economic growth, the larger the economic pie, and the greater the public and private resources available to finance entitlement obligations and other national priorities.

Last year's federal budget illustrates the importance of economic growth to the federal budget's overall health. The federal budget deficit was recorded as 1.2% of GDP, half its average level over the past four decades. This modest deficit occurred despite the fact that Congress has been on a decade-long spending binge; despite the fact that not a single entitlement program has been significantly reduced since the late 1990s and two entitlements, Medicare and farm support payments, have been significantly increased; and despite the fact that we are in the midst of costly but necessary wars in Iraq and Afghanistan.

The consensus that tax increases are needed for fiscal balance is wrong. The next president can fund our defense priorities, maintain tax cuts, and balance the budget. A tax-increase consensus blurs the basic debates over our budget priorities in 2008 – and severely limits our choices in 2028.

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