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WHY HIGHER TAX RATES ON INCOME WILL SLOW GROWTH, COST JOBS

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INTRODUCTION

The Clinton Administration has proposed the largest tax increase in American history as part of a budget package that the White House claims will reduce the federal budget deficit and restore fairness to the tax code. More than two-thirds of Clinton's $316 billion hike comes from increases in tax rates on income and wealth generation. Most notably, Clinton proposes to increase tax rates for upper-income Americans from 31 percent to as high as 42.5 percent. This 11.5 percentage point increase in tax rates represents a 37 percent increase in the tax burden for society's most economically productive citizens.

If approved, the Clinton budget will:

- ✔ **Create a new 36 percent tax bracket for income above $115,000 for individual returns and $140,000 for joint returns;**
- ✔ **Impose a "millionaires" surtax of 10 percent of tax liability on income above $250,000 (equivalent to a 39.6 percent tax bracket);**
- ✔ **Eliminate the current $135,000 cap on the amount of income subject to the 2.9 percent Medicare payroll tax;**
- ✔ **Increase the corporate income tax rate from 34 percent to 36 percent;**[1]

1 The House Ways and Means Committee, while approving the bulk of Clinton's tax proposals on May 13, voted to raise the corporate income tax rate to 35 percent instead of 36 percent. As this study went to press, the full House had yet to act on the tax hikes. Nor has the Senate voted on Clinton's proposals, so it is unclear which of Clinton's tax

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

✔ **Increase, from 50 percent to 85 percent, the amount of Social Security benefits subject to the personal income tax for senior citizens earning more than $25,000 for individual returns and $32,000 for joint returns.**

The Clinton tax hikes on income would have a devastating impact on long-term economic growth. In particular, the increase in the tax burden would reduce savings and investment, thus hampering the economy's capacity to generate new jobs and higher wages. Specifically, higher tax rates on income would:

- ✘ **Punish productive economic activity;**
- ✘ **Reduce tax revenues;**
- ✘ **Lead to increased federal spending and higher budget deficits;**
- ✘ **Reduce job creation;**
- ✘ **Penalize small business;**
- ✘ **Undermine U.S. competitiveness;**
- ✘ **Encourage greater use of tax shelters;**
- ✘ **Renege on the promise of the 1986 Tax Reform Act;**
- ✘ **Increase the marriage penalty.**

Proponents of increased taxes dismiss such arguments as "trickle-down" economics. But perhaps they may wish to heed the words of the Democrat-controlled Joint Committee on Taxation, which in 1991 wrote:

> When an economy's rate of net investment increases, the economy's stock of capital increases. A larger capital stock permits a fixed amount of labor to produce more goods and services. The larger a country's capital stock, the more productive its workers and, generally, the higher its real wages and salaries. Thus, increases in investment tend to cause future increases in a nation's standard of living.[2]

While Clinton's "tax-the-rich" proposals are supposed to affect only the wealthy, those most harmed will be poor and middle-income Americans. Even for the few rich Americans who will be unable to avoid higher taxes by using tax shelters, the tax hike is unlikely to mean a radical reduction in their quality of life. The poor and the middle class will not be so lucky. They are more vulnerable to economic downturns and most dependent on economic growth to improve their living standards. And they have fewer opportunities to avoid new taxes. When savings and investment fall, as inevitably will happen with higher tax rates on income, the poor will be disproportionately affected by the economy's inability to produce jobs and rising incomes.

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hikes, if any, will be enacted into law.

2 Joint Committee on Taxation, "Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution," report for the House Committee on Ways & Means, Washington, D.C., December 12, 1991, p. 21.

THE WAYS TAX HIKES HURT THE ECONOMY

Higher tax rates on income may be attractive to class warfare politicians in Washington, D.C., but their impact on the economy is unambiguously negative. Higher tax rates have several damaging effects:

Effect #1: Higher rates punish productive economic activity.

Taxes on income drive a wedge between the amount of income taxpayers earn and how much they are allowed to keep. The Administration's proposal to increase tax rates on income from 31 percent to 42.5 percent, combined with state taxes, means that government would be confiscating approximately one-half of every dollar earned at certain income levels. Since many scholarly studies confirm that high tax rates depress incentives to work, save, and invest, adoption of the Clinton package would reduce income and wealth generation.[3]

High tax rates introduce a particularly strong disincentive for workers considering whether to accept overtime and second job opportunities, spouses considering whether to work outside the home, and all individuals deciding whether to spend or invest. Ironically, the same Administration that openly considers imposing higher "sin" taxes on alcohol and tobacco, in the knowledge that those taxes will discourage consumption, ignores the same elementary economic analysis in the case of higher tax rates on income.

History shows that tax rates have a powerful impact on the economy. The 1920s, 1960s, and 1980s were periods of extraordinary growth in the U.S. economy. Not coincidentally these periods of growth followed steep reductions in tax rates on income. By contrast, the economy stagnated during decades associated with higher tax rates, such as the 1930s and 1970s. Between the 1990 budget deal and Clinton's proposed tax hikes, it appears politicians have failed to learn the lessons of history.

Effect #2: Higher tax rates tend to mean lower tax revenues.

Since high tax rates discourage individuals from engaging in productive economic activity, the amount of reported taxable income shrinks. Therefore, even though income is being taxed at a higher rate, the result may be lower tax revenues. Harvard economist Martin Feldstein points out, for instance, that if a couple with $180,000 of taxable income were to reduce their taxable income by just 10 percent in response to Clinton's

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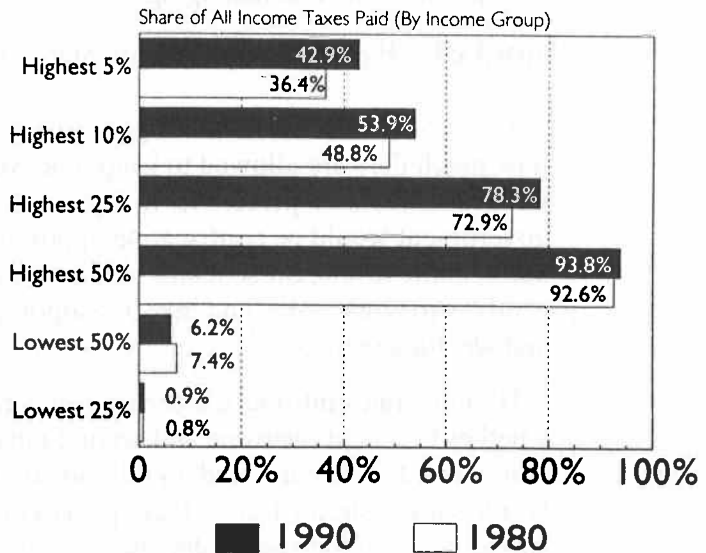
3 Eric M. Engen and Jonathan Skinner, "Fiscal Policy and Economic Growth," National Bureau of Economic Research, Working Paper No. 4223, December 1992; Otto Eckstein, "Tax Policy and Core Inflation, A Study Prepared for the Use of the Joint Economic Committee" (Washington, D.C.: Government Printing Office, 1980); L. Godfrey, "Theoretical and Empirical Aspects of the Effects of Taxation on the Supply of Labour" (Paris: Organization for Economic Cooperation and Development, 1975); Michael Beenstock, "Taxation and Incentives in the U.K.," *Lloyds Bank Review*, Number 134, October 1979, pp. 1-15; Dale W. Jorgenson, "Tax Policy and Investment Behavior," *American Economic Review,* 58:3, pp. 391-414; Keith Marsden, "Links Between Taxes and Economic Growth: Some Empirical Evidence" (World Bank Staff Working Paper Number 605, Washington, 1983); William C. Dunkelberg and John Skorburg, "How Rising Tax Burdens Can Produce Recession," Cato Institute *Policy Analysis*, No. 148, February 21, 1991.

higher tax rates, they would pay nearly $3,700 less in taxes than they did with $180,000 of income at current tax rates. Making modest assumptions about behavioral changes, Feldstein concluded that the proposed higher tax rates would collect only one-fourth of the additional revenue that the Administration estimates.[4]



The impact of higher tax rates on the upper-income taxpayers—and on the amount of taxes they pay—is shown clearly by the reductions in tax rates on income that were enacted in 1981 and 1986. Even though the top tax rate was slashed from 70 percent down to 28 percent, the share of the income tax burden paid by the top ten percent of income-earners rose from 48.8 percent in 1980 to 53.9 percent in 1990.[5]

Effect #3: Higher rates lead to increased federal spending and higher budget deficits.

If history is any guide, higher taxes will trigger a surge of new spending by Congress. According to historical budget figures, for every $1 that tax revenues grew in the 1970s, federal spending climbed by $1.22.[6] In the 1980s, government data show that federal spending grew by $1.29 for every new dollar of tax revenue.[7] And since 1990, the ratio has grown even worse, with spending climbing by $1.88 for every new dollar of tax revenue.[8] The government's own data are confirmed by scholarly research. According to the Joint Economic Committee, every dollar of higher taxes between 1947 and 1990 has been associated with an average of $1.59 in new spending.[9]

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4 Martin Feldstein "Clinton's Revenue Mirage," *The Wall Street Journal*, April 6, 1993, p. A14.

5 "Top Tenth of U.S. Taxpayers Pay Over Half of U.S. Income Taxes," *Tax Features*, September 1992, p. 6.

6 *Budget Baselines, Historical Data, and Alternatives for the Future*, Office of Management and Budget, Washington, D.C., January 1993.

7 *Ibid.*

8 *Budget of the United States Government, FY 1994*, Office of Management and Budget, Washington, D.C., April 8, 1993.

9 Richard Vedder, Lowell Galloway, and Christopher Frenze, "Taxes and Deficits: New Evidence," Joint Economic Committee, Washington, D.C., October 30, 1991.

While tax increases from all sources tend to trigger higher spending and larger deficits, the higher tax rates on income proposed by Clinton would have an especially pronounced impact because such tax increases are likely to generate very little, if any, new tax revenue. As such, the combination of Congress boosting spending in anticipation of new tax revenues and the fact that the bulk of those projected revenues will never materialize means that the deficit will expand even more than it has following previous tax hikes.

Effect #4: Higher rates will reduce job creation.

Almost all jobs ultimately depend on the amount of savings and investment in the economy. Since high tax rates penalize savings and investment, high tax rates will undermine job creation. Auto workers would not have jobs without individuals willing to invest in the capital—plant and equipment—needed to produce cars. Employees in Silicon Valley could not produce computer software and hardware without the venture capitalists who put their money at risk starting the companies.

"Soak-the-rich" policies are especially damaging to savings and investment because the bulk of income for wealthy taxpayers is earned through investments instead of wages and salaries. Indeed, 60 percent of family income above $200,000, and 75 percent of family income above $1 million, comes from such sources as dividends, interest, rents, and royalties.[10] These families will tend to change their behavior when higher tax rates reduce the expected rate of return for investment income. They will likely reduce the amount of money they are willing to put at risk, choosing instead to increase consumption.

If the tax code were neutral, an individual's decision to consume income rather than devoting it to savings and investing would not be changed by tax considerations. As the following example illustrates, however, tax policy is biased against savings and investment, and Clinton's proposed increase in tax rates simply will exacerbate the problem. Consider the case of an individual who has $10,000, and must choose to use those funds for current consumption or to save and invest the money. If the individual chooses to consume, the tax burden will be fairly small, perhaps consisting of state sales taxes and perhaps some federal excise taxes. In general, a taxpayer who chooses to consume will be able to consume almost the entire $10,000 free of taxes.

Like most individuals, however, this taxpayer may be willing to forego current consumption if the decision to save and invest has a sufficient expected rate of return (that is, the individual trades consumption today for the expectation of greater consumption in the future). Assume, then, that this individual is willing to forego current consumption if the act of savings and investment is expected to net a five percent rate of return. This is where taxes impose such a barrier to savings and investment. Assume the individual chooses to invest by purchasing shares in a start-up corporation. First of all, there is a danger that the venture will fail, thus leaving the investor with nothing. If this investor is fortunate, and the corporation earns a profit of 10 percent, this generates $1,000 of an-

10 Lawrence A. Kudlow, Testimony to the Joint Economic Committee, U.S. Congress, Washington, D.C., February 12, 1993.

tion is subject to a 34 percent tax (36 percent if Clinton's budget is approved). The $1,000 of profit, representing a rate of return of 10 percent, falls to $660, dropping the rate of return down to 6.6 percent. This money the corporation pays to the investor as a dividend. This $660, however, is then taxed as personal income at a rate of as high as 31 percent (as high as 42.5 percent if Clinton's budget is approved), thus leaving the investor with only $455.40. Assuming there is no state income tax, the investor's actual rate of return has fallen to less than 4.6 percent, below the level at which the taxpayer in this example is willing to forego current consumption and make the investment.[11]

Effect #5: Higher taxes hurt small business.

The increase in the corporate income tax rate certainly will hinder American business, but the proposed tax increases on personal income will be even more burdensome. Approximately 80 percent of U.S. businesses—proprietorships, partnerships, and Subchapter S Corporations— pay taxes through the personal income tax code. If the higher tax rates are approved, these small businesses will have their tax burden climb by as much as 37 percent.

The Clinton plan will make it very difficult for small businesses to expand, since annual earnings often are the main source of capital for many growing firms. As such, the more "profit" the government confiscates, the less money the entrepreneur will have available to plow back into the business. And since small business is the primary source of job creation in the American economy, this reduction in investment will have a particularly harmful impact on job creation.

Effect #6: Higher rates undermine U.S. competitiveness.

Increasing tax rates on income will impede the ability of individuals and businesses in the United States to compete in the global economy. As the following table indicates, country after country around the world followed the lead of the United States in the 1980s by reducing their tax rates. The main reason: investors are not restrained by national boundaries. So when the United States, the world's largest economy, reduced its tax rates, other countries were effectively forced to reduce their rates to compete for investors' capital. If the United States now adopts higher tax rates, this will reduce the expected profitability of investments and investors will seek out more attractive business climates in other countries.[12]

Effect #7: Higher rates will encourage greater use of tax shelters.

If tax rates on income are increased by as much as 37 percent, as the Clinton Administration proposes, higher-income individuals and small business owners will not stand by and watch the government confiscate the fruits of their labor. They will instead do what taxpayers have done throughout time—make financial decisions that protect as much of

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11 This analysis does not include the effect of capital gains taxes, depreciations, and other features of the tax code that impose additional barriers to savings and investment.

12 For an excellent discussion of this phenomenon, see Richard B. McKenzie and Dwight R. Lee, *Quicksilver Capital: How the Rapid Movement of Wealth has Changed the World* (New York: The Free Press, 1991).

taxpayers have done throughout time—make financial decisions that protect as much of their earnings as they can from excessive taxation. The higher the tax rate, the more the taxpayer is prepared to "invest" in avoiding taxes. Many taxpayers already have shifted investments into municipal bonds, which pay lower interest but are not subject to the federal income tax. The impact on the economy of this shift to municipal bonds is significant, since investors are taking funds out of productive private sector investments and putting money in state and local government debt instruments which, at best, do little to produce jobs and increase living standards. In general, of course, any switch to tax shelters means that money is being used less productively than it would be if the taxpayer was investing for economic reasons rather than tax avoidance purposes. It also should be remembered that the very existence of higher tax rates encourages lobbyists to pressure the tax-writing committees to re-establish old tax shelters or create new ones.

MAXIMUM TAX RATES ON INDIVIDUAL INCOME

	1979	1991		1979	1991
Argentina	45	30	Italy	72	50
Australia	62	47	Jamaica	58	33
Austria	62	50	Japan	75	50
Belgium	76	55	South Korea	89	50
Bolivia	48	10	Malaysia	60	35
Botswana	75	40	Mauritius	50	35
Brazil	55	25	Mexico	55	35
Canada (Ontario)	58	47	Netherlands	72	60
Chile	60	50	New Zealand	60	33
Colombia	56	30	Norway	75	49
Denmark	73	68	Pakistan	55	50
Egypt	80	65	Philippines	70	35
Finland	71	39	Portugal	84	40
France	60	53	Puerto Rico	79	36
Greece	60	50	Singapore	55	33
Guatemala	40	34	Spain	66	56
Hungary	60	50	Sweden	87	50
India	60	50	Thailand	60	55
Indonesia	50	35	Trinidad & Tobago	70	35
Ireland	65	53	Turkey	75	50
Israel	66	48	United Kingdom	83	40

SOURCE: Alan Reynolds, "International Comparisons of Taxes and Government Spending," in Stephen T. Easton and Michael A.Walker (eds.) *Rating Global Economic Freedom* (Vancouver, British Columbia, Canada: The Fraser Institute, 1991).

Proponents of "soak-the-rich" tax policies seem to forget, moreover, that many upper-income taxpayers have considerable discretion over what form their income takes and when they receive it. As mentioned earlier, the majority of income received by such taxpayers is not in the form of wages and salaries. These individuals can take steps not available to most workers, yet all perfectly legal, to minimize their tax liability. Last year, for instance, many professional athletes, corporate executives, and even law firm partner Hillary Rodham Clinton arranged to receive earnings before the 1993 tax year began. The reason, of course, was their expectation that income received in 1993 would be subject to higher tax rates.

Effect #8: Higher rates renege on the promise of the 1986 Tax Reform Act.

The 1986 Tax Reform Act was based in part on the uncontestable premise that the economy would perform better if tax rates were lowered. The government was not expected to lose revenue because, even though tax rates were lowered, the elimination of many credits, deductions, and exemptions meant that the tax base (that is, taxable income) was expanded.[13]

Many taxpayers expressed concern at the time that politicians, having expanded the amount of income subject to tax, would come back later and raise tax rates. Although policy makers assured voters that this was not the case, the higher tax rates enacted as part of the disastrous 1990 budget deal, combined with the massive increase in tax rates proposed by Clinton, suggest that these concerns were justified. This will make it far more difficult in the future to win support for lower rates by widening the tax base.

Effect #9: Higher rates will increase the marriage penalty.

The tax code already punishes families by imposing an extra tax burden on married couples. The Clinton plan will exacerbate this counterproductive policy.

Consider a couple, a school administrator making $65,000 and a rising executive in a local company earning $100,000. Married, they will pay $1,250 more in taxes on their combined income of $165,000 under Clinton's proposal than they would if they remained single and paid lower tax rates on their separate incomes.

One effect of the marriage penalty is to impose a harsh tax burden on the spouse with the lower income, usually the woman. This is because the income of the lower-earning spouse, when added to joint income for tax purposes, is taxed at the highest applicable marginal rate. Adding in the effect of payroll taxes, the lower-earning spouse could receive less than 50 cents in take-home pay for every dollar earned if the Clinton plan is approved, a tax burden that would significantly affect the decision to work outside the home. Scholarly studies have found that increasing the tax rates for married women from 50 percent to 65 percent reduces their work force participation by one day a week.[14]

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13 The 1986 Tax Reform Act also involved a transfer of the tax burden from the individual income tax to the corporate income tax. Nor surprising, individual income tax revenues, at least prior to the 1990 budget deal, grew rapidly in response to lower tax rates. Corporate income tax revenue, on the other hand, fell in response to the steeper tax rates.

14 Martin Feldstein, "Tax Rates and Human Behavior," *The Wall Street Journal*, May 7, 1993, p. A 15.

CONCLUSION

Raising tax rates on income is the most economically damaging element of the Clinton plan. There is little reason to expect that the higher rates would generate much, if any, additional revenue. By contrast, there is every reason to believe that higher rates on income would fuel new government spending, increase the budget deficit, depress savings and investment, destroy jobs, boost tax shelters, punish families, and hinder America's international competitiveness.

Notwithstanding these serious drawbacks to enacting higher tax rates on income, the Clinton Administration seems determined to push forward, apparently believing that lower- and middle-income taxpayers will acquiesce to tax increases on their own incomes if they think that wealthier taxpayers are being punished even more. This calculation may work politically, but it will mean only harm to the American economy.

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