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Income Tax Surtax Should Not Fund Government Health Care Expansion

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Congress is reportedly considering raising taxes by at least $540 billion over 10 years to fund President Obama's health care initiative through a "surtax" on top of the highest individual tax rates.

This should finally put to rest President Obama's implausible claim that expanding government health care benefits will save money, since policies that save money do not typically require painful tax increases to offset their cost.

The latest proposal would impose an income surtax of between one and 5.4 percentage points on families and small businesses earning over $350,000. This latest tax scheme would drive the top rates in the U.S. to among the highest in the industrialized world, leaving economic havoc in its wake. Congress should seriously consider the consequences of such a policy.

Surtax Creates a Cascade of Progressivity. Under the House of Representatives' plan, families and small businesses earning between $350,000 and $500,000 a year would pay a one-percentage-point surtax on top of the top income tax rate. Those making between $500,000 and $1 million would pay a 1.5 percentage point surtax, and those making over $1 million a 5.4 percentage point surtax.

Currently, the top rate is 35 percent. But in his budget President Obama proposed raising the top two income tax rates from 33 and 35 percent to 36 and 39.6 percent. Families in the top 20 percent of income earners already pay 943 percent more income taxes than middle-income families.[1] The new surtaxes would extend progressivity at the top of the income spectrum and raise the disparity in taxes paid between middle- and low-income families and high-earning families.

Moreover, the surtax could rise even higher if certain savings included in the legislation do not materialize by 2012. In that case, the 1 and 1.5 percentage point surtaxes rise to 2 and 3 percentage points, respectively. So, if all the amorphous proposals to "bend the curve" do not pan out, then—presto!—up goes the surtax. Congress should ensure that savings are banked before rushing headlong into an unaffordable, new entitlement benefit.[2]

Higher Tax Rates Than France. Threatening to raise taxes is a sure sign that health care reform has gone awry, and this is underscored in the fact that the tax increases now under consideration are among the most economically harmful the Congress could consider.

U.S. tax rates are already among the highest among the industrialized nations. The average top income tax rate for countries in the Organization for Economic Cooperation and Development (OECD) is currently 42 percent. (The OECD is an association of the 30 most economically developed nations in the world.) The U.S. average top rate—when

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including the top federal income tax rate, the average of state and local income taxes, and Medicare taxes—is also currently 42 percent. This includes the current 35 percent top federal rate, plus the average of the top rates in all 50 states (including state and local income taxes), and the 2.9 percent Medicare tax. It also accounts for federal and state deductibility and other federal adjustments.

But if President Obama's proposal to raise the top two marginal income tax rates becomes law, the average top rate will jump to 47 percent. This would raise the top rate higher than the OECD average and, as can be seen in Table 1, put the top U.S. rate on par with Germany and Australia and leapfrog it ahead of Canada, France, and Italy.

Then this 5.4 percentage point surtax would raise the average top tax rate in the U.S. even higher to above 52 percent.[3] This higher rate would then be higher than the top rate in Finland, Japan, Austria, and the Netherlands and higher than all but three countries in the OECD: Denmark (60 percent), Sweden (56 percent), and Belgium (54 percent).

Raising top marginal tax rates above most European countries is a horrible model for the U.S. to follow. European countries have chronically higher unemployment levels than the U.S. and persistently lower rates of economic growth. The U.S. will suffer from the same afflictions if it follows in the footsteps of European countries—and worse if it actually surpasses their punitive levels of taxation. Moreover, such a misguided policy will drive business and economic activity out of the U.S. and into other low-tax nations.

Top Earners in High Tax States Hit Hard. In the six highest-taxed states, Oregon (11 percent top income tax rate), Hawaii (11 percent), New Jersey (10.75 percent), New York (8.97 percent), California (10.55 percent), and Rhode Island (9.9 percent), the top rates would be higher than all but Denmark among OECD countries if the Obama plan and surtax become law.

Under these higher taxes, families and small businesses making over $350,000 in every state would face higher top rates than 21 OECD countries—including France, Italy, and Spain. Even the nine states with no state income tax at all would have higher rates than these social democracies that are typically regarded as countries with punitively high taxes. Taxpayers in all 41 states that do levy an income tax would pay a top rate that is higher than all but seven of the 30 OECD countries. (See Table 1.)

High Tax Rates Punish Incentives to Grow. Raising the top tax rates on individuals is especially damaging to the economy because these individuals are often the most productive in the economy, as evidenced by their incomes. They are also those most able to respond to higher rates by working less, shifting their compensation to more lightly taxed forms, moving taxable activity offshore, and retiring early.

These tax rates also fall on various forms of capital income, discouraging saving and investment on the one hand while on the other distorting the pattern of saving and investment toward more lightly taxed yet less efficient forms.

Small businesses typically pay taxes at the individual rate, so raising the top individual income tax rates is a hard slap at small businesses. The President and his congressional allies repeatedly—and correctly—praise small businesses as the job creators and great innovators in the economy. Yet repeatedly in tax policy and elsewhere, President Obama has threatened to depress small businesses.

In the global race for capital, income tax rates that are higher than all but a few of the highest-tax

1. Curtis S. Dubay, "Income Tax Will Become More Progressive Under Obama Tax Plan," Heritage Foundation *Backgrounder* No. 2280, June 1, 2009, at *http://www.heritage.org/Research/Taxes/bg2280.cfm.*
2. Stuart M. Butler, "Senate Finance 'MedPAC' Health Proposal Needs Savings Guarantee," Heritage Foundation *WebMemo* No. 2507, June 26, 2009, at *http://www.heritage.org/Research/HealthCare/wm2507.cfm.*
3. The 50 percent figure includes the 39.6 percent top federal rate under the Obama budget plus the average of the top rates in all 50 states (including state and local income taxes), the 5.4 percent surtax, and the 2.9 percent Medicare tax. It accounts for federal and state deductibility and other federal adjustments. See Tax Foundation, "If Health Surtax Is 5.4 Percent, Taxpayers in 39 States Would Pay a Top Tax Rate Over 50%," July 14, 2009, at *http://www.taxfoundation.org/publications/show/24863.html* (July 14, 2009).

Surtax Would Push Income Tax Rates to More Than 52 Percent

The expiration of the 2001 and 2003 tax cuts, coupled with the addition of a 5.4 percent surtax on high-earners, would push the average top marginal income tax rate in the U.S. above 52 percent. This would be higher than just three of the 30 most economically developed countries in the world. On the state level, total taxes paid by top-income earners would exceed countries such as Canada and France. Here's how the total top income rates in each state would fare against countries from the OECD.

State Rank	State/Country	Top Income Tax Rate
	Denmark	60.00%
1	Oregon	57.54%
2	Hawaii	57.22%
3	New Jersey	57.07%
4	New York	56.92%
5	California	56.81%
	Sweden	56.44%
6	Rhode Island	56.22%
7	Vermont	55.77%
8	Maryland	55.61%
9	Minnesota	54.36%
10	Idaho	54.32%
t-11	North Carolina	54.27%
t-11	Wisconsin	54.27%
t-11	Ohio	54.27%
	Belgium	53.70%
14	Delaware	53.69%
15	Arkansas	53.65%
16	South Carolina	53.59%
17	Maine	53.46%
18	Nebraska	53.45%
19	Kentucky	53.37%
20	West Virginia	53.14%
21	Kansas	53.09%
22	Missouri	52.79%
23	Georgia	52.69%
24	Virginia	52.46%
25	Oklahoma	52.23%
	U.S.	52.14%
26	Massachusetts	52.05%
	Netherlands	52.00%
t-27	Connecticut	51.78%
t-27	Mississippi	51.78%
t-27	Utah	51.78%
30	New Mexico	51.69%
31	North Dakota	51.65%
32	Iowa	51.61%
33	Michigan	51.59%
34	Colorado	51.44%
35	Indiana	51.38%
36	Arizona	51.36%
37	Pennsylvania	51.16%
38	Montana	50.48%
39	Louisiana	50.05%
	Finland	50.05%
	Japan	50.00%
	Austria	50.00%
40	Illinois	49.97%
41	Alabama	49.67%
	Germany	47.48%
t-42	Alaska*	47.25%
t-42	Florida*	47.25%
t-42	Nevada*	47.25%
t-42	New Hampshire*	47.25%
t-42	South Dakota*	47.25%
t-42	Tennessee*	47.25%
t-42	Texas*	47.25%
t-42	Washington*	47.25%
t-42	Wyoming*	47.25%
	Australia	46.50%
	Canada	46.41%
	France	45.80%
	Italy	44.90%
	Spain	43.00%
	Portugal	42.00%
	Switzerland	41.67%
	Ireland	41.00%
	Greece	40.00%
	Poland	40.00%
	United Kingdom	40.00%
	Norway	40.00%
	New Zealand	39.00%
	Luxembourg	38.95%
	Korea	38.50%
	Hungary	36.00%
	Iceland	35.70%
	Turkey	35.60%
	Mexico	28.00%
	Slovak Republic	19.00%
	Czech Republic	15.00%

OECD country

* No state income tax

** Top rate if top rates increase as proposed in President Obama's budget and a 5.4 percent surtax is enacted.

Note: Rates include national and average sub-national rates. In the U.S., state rates equal the 39.6 percent top federal rate under the Obama budget plus the top rates for each state (including local income taxes), the 5.4 percent surtax, and the 2.9 percent Medicare tax. It accounts for federal and state deductibility and other federal adjustments. The national U.S. rate is calculated using an the average of state income tax rates.

Sources: Organization of Economic Coooperation and Development, at *http://www.oecd.org/dataoecd/46/18/2506453.xls* (July 15, 2009), and Tax Foundation, at *http://www.taxfoundation.org/publications/show/24863.html* (July 15, 2009).

Table 1 • WM 2544 heritage.org

countries will be a further hindrance to the ability of the U.S. to attract new investment, entrepreneurs, and businesses. The income tax creates perverse incentives driving business activity toward the Slovak Republic, for example, where it faces a 19 percent top income tax rate, or the Czech Republic's 15 percent, as compared to 45 percent in the *lowest-tax U.S. state*.

Unless the U.S. keeps its top tax rate comparable to competitor nations like those in the OECD, it will continue to loose capital to lower-tax countries. Less capital will mean fewer jobs and lower wages for American workers.

Tax Hikes during a Recession? In addition to damaging America's international competitiveness, the surtax would surely worsen the recession. Not a single economic school of thought advocates raising taxes during a recession or threatening to do so in its aftermath. To call for a tax increase during the largest recession in 70 years is downright reckless.

The proposed tax increase would likely go into effect after 2010, yet many expect the economy to remain in a weak recovery at best 18 months from now. The surtax will threaten even a weak recovery if small businesses are facing a tax hike.

Furthermore, the negative economic effects would not wait until 2011. Small businesses typically plan investments, expansions, and new hiring years in advance. Learning that their tax rates will rise in 2011 businesses would immediately curtail investments and long-term hiring plans.

Overall, the higher tax rates on small businesses and upper-income families would rob the economy of vital investment dollars at a time when large budget deficits are already soaking up the economy's savings. This will result in less job creation and slower economic growth.[4]

Lawmakers will surely claim that a surtax of one to 5.4 percentage points is too small to harm the economy. Weary taxpayers must wonder if this is a case of the camel's nose getting in the tent. There is already a provision in the bill that allows the lower surtax rates to increase. How long will it be before the top rate goes up too? How high would they go? Small businesses struggling to make payroll during tough economic times would surely disagree that these taxes are too small to matter. Upper-income families may be better able to afford the tax, but the negative effects on savings, investment, and the overall economy would harm everyone.

Try Belt-Tightening. It is time for lawmakers to stop unaffordably expanding government. Over the past eight years, lawmakers have created a new Medicare drug entitlement, doubled the education budget, enacted a $700 billion financial bailout, and passed a second "stimulus" bill that cost $1.1 trillion—all on top of unaffordable entitlement programs in Social Security, Medicare, and Medicaid.

Adding another colossal health care entitlement just digs the nation's financial hole deeper. It would add to a future of record debt, European-sized tax increases, and economic stagnation. Instead of dumping these costs on recession-weary taxpayers, lawmakers should tighten their belts and offset any new health spending with reductions to lower-priority programs.

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4. This deals with net tax increases. A tax shift, such as capping the health care exclusion and cutting taxes elsewhere, would not necessarily be economically destructive since the total net tax burden would not increase.