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High-Income Surtax: How Not to Pay for Health Care

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Congress is once again proposing a surtax on high-income individuals to help pay for expansive and expensive health care reform.¹ However, lawmakers are forgetting that the person who pays a tax is not always the same person who bears the burden of the tax. Ignoring this economic principle could lead to unintended consequences that burden the economy and slow its recovery from the recession.

Deadweight Loss. Think of the sales tax at the grocery store. The store owner pays the tax to the government, but he charges some of the tax to the customer. Additionally, the store owner, grocery store suppliers, and consumers share an extra burden from the tax in the form of less money available to buy groceries, so fewer overall purchases are made. Economists call this indirect effect a deadweight loss.

A recent Center for Data Analysis paper² shows how all of the direct and indirect effects of a high-income surtax ripple through the economy and burden everyone. All of these individual changes in behavior in response to taxes cause estimates of government revenue to be much higher than actual revenue. For instance, Robert Carroll at the Tax Foundation points out that some of the direct revenue effects of a high-income surtax would be offset by a lower tax base—i.e., the amount of overall taxable income.³

Lost Opportunities. A dynamic model is a simulation tool that gives analysts insight into the unseen opportunities individuals give up when a new policy is implemented. This is done by com-

paring the economic effects of a policy to the baseline scenario.⁴ The net economic effect of a policy is the difference between the opportunities that are given up and the opportunities that are gained.

In the case of a surtax on individuals above a certain income, the opportunities lost are greater than the opportunities gained. Resources that could have been invested in new jobs or better services are now spent complying with, legally avoiding, and paying the tax liability. The total tax burden—the total of these three costs—is estimated to be \$2.50 for every \$1 in revenue that the government actually receives.⁵

Direct effects happen as individuals targeted by the policy make small adjustments in response to the policy. These tiny adjustments produce ripple effects that cause more people to make small adjustments in the way they use their time and money. As more and more individuals make adjustments, the overall economic impact becomes larger and larger.

What sorts of adjustments are made? Because high-income taxpayers tend to be business owners, Congress's surtax would affect millions of businesses that employ millions of workers in other income brackets. Businesses would have to liquidate inventory or equipment or forego investment

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/wm2707.cfm

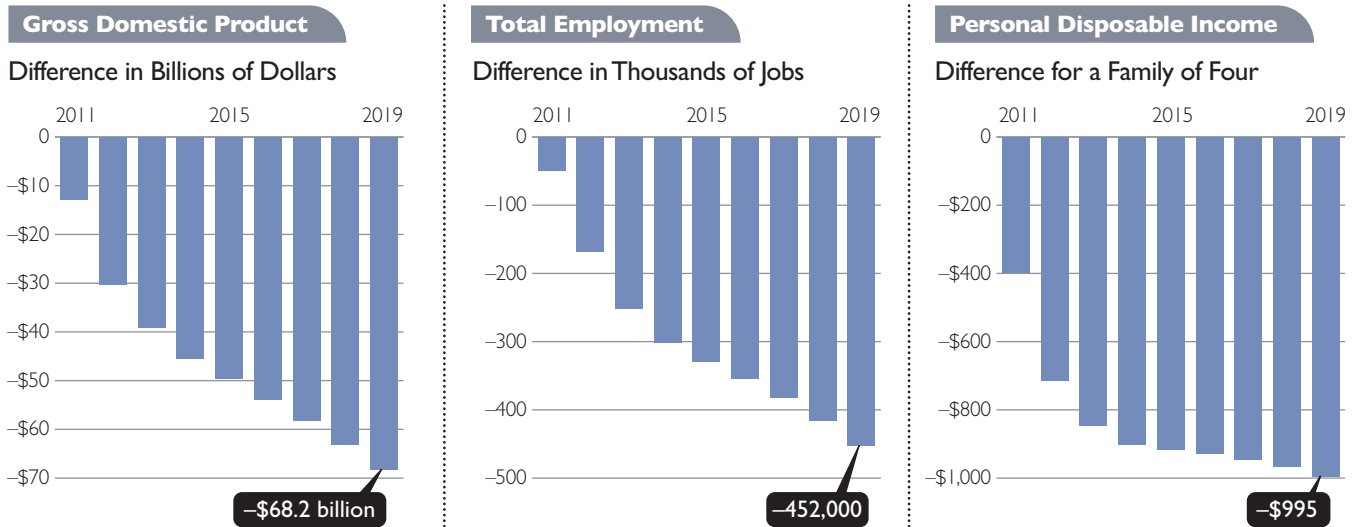
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How the H.R. 3200 Surtax Would Affect the Economy

H.R. 3200 contains a surtax on those earning more than \$250,000 to pay for health care “reforms,” which will result in continuous job losses and lower family income through 2019. The charts below show the differences in key economic indicators as a result of the surtax.



Note: Figures are in 2009 dollars.

Source: Heritage Foundation calculations based on the IHS Global Insight U.S. Macroeconomic model.

Chart 1 • WM 2707 heritage.org

opportunities so they will have the cash to pay the tax liability. This means that less value (i.e., income) is created by these businesses in future years. This foregone income will never be realized by the business owners and their employees.

Liquidating assets rather than using them productively affects the businesses’ suppliers and customers as well as employees and the business owners. Suppliers need to alter their production plans, customers have to either purchase less or pay higher prices, and employees have less

income to make purchases from other retailers, and so on.

Some of these small business owners will be on the threshold margins—that is, the margin right below where the tax hits. This is where creating additional value would put them into a high-income bracket, where they would be liable to pay more taxes. Many would decide that taking that extra risk to grow their income would not be worth it at the higher tax rate, leading to less value created for their customers and less work for employees. In

1. BNA, “Section-by-Section Analysis of Affordable Health Care for America Act (H.R. 3962),” *Daily Report for Executives*, October 30, 2009, at http://news.bna.com/drln/display/alpha.adp?mode=topics&letter=HC&frag_id=15676448&item=745CE5BC6E3557B01BF4CFBD90721AE7 (October 31, 2009).
2. Karen A. Campbell, “Current Health Insurance Reform Proposals vs. Real Reform and Economic Growth,” Heritage Foundation *Backgrounder* No. 2321, September 23, 2009, at <http://www.heritage.org/Research/HealthCare/bg2321.cfm>.
3. Robert Carroll, “The Excess Burden of Taxes and the Economic Cost of High Tax Rates,” Tax Foundation, August 2009, at <http://taxfoundation.org/files/sr170.pdf> (August 24, 2009).
4. The baseline is a weighted average forecast of the most likely paths the economy could take absent any major unpredictable events (e.g., a natural disaster, collapse of a major industry, or a terrorist attack).
5. Campbell, “Current Health Insurance Reform Proposals,” p. 7.

turn, employees and potential employees would not have the additional income they could have had.

Individuals Above the Margin. Individuals at the higher end of the bracket have access to multiple professional services and financial products that can help them avoid the higher tax. This helps explain why taxable incomes that are higher up on the income scale have a larger decrease in response to higher tax rates than lower incomes. This suggests that raising taxes on high-income individuals would not produce as much revenue as the surtax's advocates suppose.⁶

The deadweight loss of a high-income surtax increases, too, because more resources are being wasted to relocate and re-classify income in order to avoid the tax. High-income individuals often donate their income to nonprofit organizations or invest it in venture capital funds for new technology. They also channel their money through financial intermediaries that provide credit to entrepreneurs, small businesses, and households. Thus, the higher tax burden and increased deadweight losses means that fewer resources are being re-invested in these productive ventures and less credit is available to businesses and households.

These negative and compounding feedback effects from entrepreneurs, small business owners,

and higher-income individuals minimizing their tax burden weakens the economy. As this discouragement builds over the years, fewer and fewer will strive to find new opportunities. This can be seen visually from graphs of the dynamic macroeconomic analysis. The growing difference between the baseline and the policy over the next decade shows how the snowball effect unfolds.

Who Wants a Lower Living Standard? All parts of the economy are interconnected; a small change in one sector can have ripple effects throughout the entire country. A policy that causes more resources to be wasted than created will be borne by all members of society no matter who is liable to remit the tax.

So far, health care reform proposals and the financing of them are asking Americans as a whole to trade a higher standard of living for a lower one. Does this mean that there would not be some in the economy that are made better off? No, some people will be made better off. But on net, more people are going to be made worse off. But tragically, they would not even know the opportunities they would miss out on.

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6. Emmanuel Saez, Joel B. Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," National Bureau of Economic Research, May 2009, at <http://www.nber.org/papers/w15012> (August 25, 2009).