

WebMemo



Published by The Heritage Foundation

No. 2817
February 25, 2010

The President's Health Proposal: Taxing Investments Undermines Economic Recovery

Karen A. Campbell, Ph.D., and Guinevere Nell

The new White House proposal to impose a Medicare tax on investment income would reduce demand for investment, which is the last thing that the economy needs right now. It would slow recovery, reduce employment opportunities, and hinder wage growth.

A dynamic macroeconomic analysis helps one see how this policy negatively affects all individuals in the economy, including the low-income individuals that the White House plan was designed to help. Analysis by The Heritage Foundation estimates that between 2011 and 2020, this proposal would:

- Result in an average of 115,000 lost job opportunities per year,
- Reduce productivity by an average 0.01 percentage points per year,
- Lose \$1.37 in gross domestic product (GDP) for every dollar of additional revenue collected,
- Reduce household disposable income by \$17.3 billion¹ per year, and
- Reduce the stock of household real net wealth by an average \$267 billion per year.

The Economics of Investing: A Dynamic Analysis. A well-established economic regularity is that if you tax something, you get less of it. For example, policymakers in the Senate recently proposed a tax on “Cadillac” health insurance plans. The justification was that it would not only generate revenue to help pay for subsidized insurance but also reduce demand for high-priced premi-

ums, putting downward pressure on all health insurance premiums.²

Because investment is what drives productivity and economic growth, less investment—even if only slightly less—leads to lower productivity, slower economic growth, weaker wages and salaries, and lower household wealth. How much less depends on the underlying supply and demand for investment.

A structural model of the U.S. economy, which is used as a forecasting tool for business decisions, can also be used to conduct policy analysis.³ The dynamic results of a Heritage Foundation analysis show that the proposed new taxes would raise the price of borrowed funds on a AAA-rated corporate bond by an average of approximately 0.03 percentage points, while overall nonresidential fixed investment would fall by an average of \$8.9 billion. The productivity losses from these foregone investments average 0.01 percentage points per year. With a less productive economy, there would be fewer job opportunities, and workers would earn less. Thus wages and salaries are estimated to fall by an average of \$14 billion per year nominally.

This paper, in its entirety, can be found at:
www.heritage.org/Research/HealthCare/wm2817.cfm

Produced by the Center for Data Analysis

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002-4999
(202) 546-4400 • heritage.org

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The dynamics for equity investors is similar to that of debt investors (bondholders). Just as bondholders would require higher interest rates to cover the additional tax, equity investors would also require a higher yield on their equity in order to generate the same return that they did before the higher tax. This increases the cost for entrepreneurs and businesses to attract equity financing; thus, some investment opportunities would be foregone.

These lost investments result in less value being created than otherwise would. So while the S&P 500's yield would be slightly higher to compensate for the higher taxes, its overall value is estimated to be an average 1.6 percent lower than it otherwise would be. The other broad stock indices (such as the Dow, Wilshire 5000, and Nasdaq) would experience similar losses in value.

Investment Tax Affects All Americans. Less investment, lower investment values, and lower wages hinder the ability of households to build wealth. A household's stock of wealth (savings) is an important buffer in times of unforeseen expenses such as a sudden illness, injury, or job loss, and it is a source of income for retirement. The value of the investment portfolios of many households—not just the high-income households that directly pay the tax—are reduced by the tax on investment income. The dynamic results show that the stock of household wealth is an average of \$274 billion less per year than what they otherwise could have been.

Fewer investments reduce the stock of physical, human, and technological capital available in the U.S. economy. This causes the economic potential⁴ of the economy to be lower than it could be. Taxing

the investment income of high-income individuals is estimated to reduce the economic potential of the economy by an average \$10.2 billion per year. That is \$102 billion of real accumulated lost opportunities over 10 years.

A lower U.S. economic potential also harms the ability of the government to borrow, because investors lend to the U.S. based on the expected potential of the U.S. economy. Thus a lower potential economy puts upward pressure on government interest rates in order to attract financing for the nation's deficit.

The interest rate of a 10-year U.S. Treasury bond is estimated to be 0.7 percent higher than without the tax. These higher interest payments must be paid by taxpayers on top of the debt principal that they are already liable for. These taxes would subtract even more from household disposable income. Aggregate real (inflation-adjusted) disposable income is estimated to be \$17.3 billion less per year than it otherwise would be.

Increasing Uncertainty. While it is currently popular to target high-income individuals for higher taxation, it is economic folly to target investment income. Raising the tax burden on investment income further damages the economy and ultimately affects all members of society. Investment income is highly elusive, as individuals and businesses can alter the timing of investment income and forego investment altogether if their returns fall below required levels. The current economic uncertainty, which increases risk premiums, is already causing many investments to be delayed or foregone. Policymakers are scrambling to encourage

1. All dollar figures are given in 2009 dollars unless otherwise noted.
2. Jonathan Gruber, "The Tax Exclusion for Employer-Sponsored Health Insurance," National Bureau of Economic Research, Working Paper No. 15766, at <http://www.nber.org/papers/w15766> (February 24, 2010).
3. When using the model to make business decisions, the forecast level is important. However, when using the model for policy analysis, it is the difference between the baseline forecast and the policy forecast that is important. This analysis used the IHS/Global Insight February 2010 short-term model of the U.S. economy. The IHS/Global Insight model is used by private-sector and government economists to estimate how changes in the economy and public policy are likely to affect major economic indicators. The methodologies, assumptions, conclusions, and opinions presented here are entirely the work of analysts at The Heritage Foundation's Center for Data Analysis. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the IHS/Global Insight model.
4. The economic potential of an economy is the amount of goods and services it could produce given its labor force, human capital, physical capital, and technology. The potential GDP of an economy is also known as "full-employment GDP." "Full employment" is a technical term that means that nobody is unemployed because of a cyclical downturn.

businesses and entrepreneurs to start investing again. Why they would then threaten to tax the income from these investments to pay for new entitlements is not clear.

Policymakers have long known that taxing something discourages it. Taxing investment income would therefore reduce investment in the economy, which is dangerous during a period of recovery. The Obama Administration is currently subsidizing investment through the stimulus program and trying to boost private investment with tax credits for small

businesses. Yet in order to fund health care reform, Obama has now proposed a new burdensome tax on investment. Not only would this be counterproductive, but these types of contradictory policy proposals also increase uncertainty in the economy, further hindering economic recovery.

—Karen A. Campbell, Ph.D., is Policy Analyst in Macroeconomics and Guinevere Nell is Research Programmer in the Center for Data Analysis at The Heritage Foundation.

APPENDIX: METHODOLOGY

Model-based policy analysis consists of two steps:

1. Forecasting a “baseline” economic future without the policy change being enacted, and
2. Simulating the effects of the policy change on the economic variables in that baseline.

For example, the baseline forecast for personal income may have the national average growth of that variable increase by a certain percent per year without the policy change. However, this growth rate may decline once the policy change is introduced into the baseline forecasts.

The baseline represents the most likely path of the U.S. economy in the next 10 years. The relationships in the model are calibrated by historical U.S. data and mainstream economic theory. Introducing a policy change to this baseline economy helps analysts quantify the likely magnitude and direction of the changes. This gives policymakers the information they need to determine which policies will lead to a stronger, more robust economy and which policies will weaken the economy and lead to fewer opportunities for citizens in the future.

Heritage analysts used the IHS/Global Insight February 2010 short-term model of the U.S. economy to estimate the effect of placing an additional 2.9 percent Medicare tax on interest, dividends, and capital gains.⁵ The average additional tax revenue was used to subsidize insurance premiums according to the White House proposal of paying for the additional insured enrolled in state Medicare beginning in 2014.

The amount was reduced by 5 percent between 2017 and 2019 and to 10 percent in 2020 in accordance with the White House proposal.⁶ These amounts were treated as Medicare transfers to individuals. The proposal also seeks to control some Medicare spending. An estimate of net savings in Medicare was estimated by the Congressional Budget Office for the Senate health care bill. The average of these savings was used as an approximate savings to Medicare in the White House proposal.⁷ These savings reduced slightly the transfers to individuals as well as flowed through to state and local Medicare grants.

5. The IHS/Global Insight model is used by private-sector and government economists to estimate how changes in the economy and public policy are likely to affect major economic indicators. The methodologies, assumptions, conclusions, and opinions presented here are entirely the work of analysts at The Heritage Foundation’s Center for Data Analysis. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the IHS/Global Insight model.
6. This provision can be found at <http://www.whitehouse.gov/health-care-meeting/proposal/titleii/medicaid-working-families> (February 24, 2010).
7. Letter from Douglas Elmendorf, Director, Congressional Budget Office, to Hon. Harry Reid, Majority Leader, United States Senate, concerning the spending and revenue estimates of the Patient Protection and Affordable Care Act, December 19, 2009, at http://cbo.gov/ftpdocs/108xx/doc10868/12-19-Reid_Letter_Managers_Correction_Noted.pdf (February 23, 2010).

Recycling the revenue in this way mitigated some of the negative effects (as some people who receive transfers are potentially better off and mitigated some of the increase in health care prices, though health care prices are still estimated to rise above the baseline level). However, the results show that the overall cost of lost investment opportunities—which leads to lower overall incomes for most people—outweighs any positive benefits of the insurance subsidy program.

The macroeconomic analysis utilizes aggregate variables and therefore cannot target the earnings of different income groups. To get around this, the analysis imposed only half of the proposed tax on dividends and interest income as an estimate of the weighted average increase in aggregate taxes on investment income. In order to verify this, the tax was explicitly modeled using the microsimulation model of the U.S. tax system. Using half of the increased tax resulted in initial year average effective rates and tax revenues to be close to those estimated in the static micro model.

The macroeconomic results show highly fluctuated changes in tax revenue as investment income timing can be more easily managed than labor

income. Furthermore, the macro results show a decreasing personal tax base, even as revenues are higher due to the weakening of the economy that lowers labor income.

The maximum capital gains tax was increased by the 2.9 percent, as this variable does not affect all capital gains earnings but weighs into the trade-off between re-investing earnings or distributing earnings as dividends. Thus, the full maximum tax is needed to correctly estimate the trade-off effect. The corporate tax rate was increased by 1.45 percent to capture the tax on dividends and the most likely behavioral responses for corporate dividend policy.

Lastly, the interest rates on the three-month, six-month, one-year, and 10-year Treasury notes—as well as the interest rate on the corporate AAA bond—were add-factored by 1.73 percent. This is the additional percent increase a 1.45 percent tax on interest income would need to yield in order for the lender to lend the same amount lent prior to the tax.⁸ (Note that the results show the actual increase is not as high because borrowers ration themselves at the higher price at therefore the final increase in interest rates is somewhere between the original and the maximum.)

8. To find the required interest rate, let r_1 , t_1 , and t_2 be the baseline interest rate, with tax t_1 and the new tax rate t_2 . The implied rate, r_2 , needed to leave the investor with the same after-tax earnings is $(r_1(1-t_1))/(1-t_2)$. The percentage increase in interest rates is $(r_2-r_1)/r_1 * 100$.