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The Obama Tax Hikes: Economic Harm to All Americans

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The end of the August recess brought with it the beginning of a historic tax debate. Congress soon will decide whether to extend tax relief passed in 2001 and 2003 to all income-earning groups or to only some. In the course of making that decision, Congress may set the fate of the U.S. economy for the next decade.

Politically speaking, President Obama and the congressional leadership have framed this debate as one about the "haves" and the "have nots." But economically speaking, the debate is about something altogether different. Anyone who sees this tax debate as one between the "haves" and the "have nots" is watching the wrong debate. Rather, this is a contest between those who want the blessings of strong economic growth versus those in Washington who would willingly sacrifice those blessings solely to satisfy their appetite for more revenues.

A Dynamic Simulation of the President's Tax Plan. What are the economic costs of this appetite for more revenues?

Economists in The Heritage Foundation's Center for Data Analysis (CDA) conducted a dynamic macroeconomic simulation of the President's tax plan studying the economy-wide effects over the next decade of the likely expiration of 2001 and 2003 tax law.[1] The dynamic simulation modeled the likely tax increases on single and married taxpayers earning over $200,000 and $250,000, respectively, compared to the baseline forecast of the economy with an extension of 2001 and 2003 tax laws for all income-earning groups.[2]

Employing a dynamic economic simulation is crucial for this tax policy debate, since it accounts for the compounded effects of the policy change in the economy over the entire forecast period. It makes little sense to assume that changes to tax rates and levels affecting the cost of the productive factors in the economy would not change the behavior of individuals and businesses. Economic theory predicts otherwise and suggests that the feedback cycle from behavioral change continues over time throughout the economy.

Dynamic Economic Results. The CDA study uses a baseline scenario of extending the 2001 and 2003 tax rates on all income-earners.[3] Compared to this baseline, the President's tax plan would result in 240,000 fewer jobs in 2011 alone—continuing to place downward pressure on an already weakened labor market and U.S. economy. Over the next decade, the American economy would have to absorb an average of 690,000 job losses each year. In 2016 alone, lost job growth tops 875,000.

These economic effects would steadily push up the cost of providing labor and investing in new productive capital in the economy. This means the disincentives to work, save, and invest in the U.S.

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economy would rise, largely through the increases in the marginal tax rates on capital gains, dividend income, and ordinary income. A substantial increase in marginal tax rates would raise both the after-tax wage rate and the cost of capital.

Decline in Investment. This increase of the tax burden on capital in the economy is a key concern. Pushing the cost of capital higher through hikes in marginal tax rates would lead to lower levels of business investment and the flow of domestic capital stock in the economy. The simulation results show that real non-residential fixed investment would likely respond negatively, declining an average of $33 billion per year, or approximately $330 billion in total foregone real non-residential fixed investments from 2011 through 2020. Gross private fixed investment spending would fall approximately $47 billion per year during the same forecast period. The lower investment over the next decade would likely mean even lower growth of productive resources beyond the 10-year forecast period.

Reduced Household Wealth. U.S. households would also likely experience a fall in real wealth and spending power over the next decade due to the reduction in jobs and the higher tax burdens. Results from the simulation analysis show a real fall of $72 billion (yearly average) in household income over the next decade.[4] This tax policy change would lead to $180 billion less in total household income in 2011 and 2012 alone. Moreover, U.S. household wealth and residential fixed investment would decline each year—never exceeding the baseline forecast—reaching a low in 2017 and 2019, respectively.[5]

Lower Federal Revenues. The CDA study shows that under the President's tax plan, the federal government would collect less revenue than expected under the static estimates.[6] Over the next decade, if tax rates increase, the tax base would grow less rapidly than expected. Not only would there be fewer dollars from the personal income and corporate profit taxes, but a large drop in payroll tax receipts would occur as well. Indeed, the very revenue stream dedicated to supporting Social Security and Medicare would see a shortfall of $170 billion in forecasted revenues.[7]

Economic Harm to All Americans. Essentially, the President's tax plan would provide a less stable

1. Despite myriad disparate messages, this debate is entirely about allowing the single largest tax increase on Americans since 1996. An extension of the rates and levels in the 2001 and 2003 laws would keep tax incidence the same as today; allowing these tax rates and levels to expire on any income-earning group would translate only to a higher level and rate of taxation—at minimum—on that group.

   Furthermore, this debate is not one of fiscal responsibility. The federal government will operate with projected fiscal deficits over the decade regardless of an extension of the tax laws, including an extension for wealthy individuals and households. An expiration of these tax laws on these wealthy individuals and households would not solve the federal government's fiscal problems—this can be done only through structural reforms in entitlement and federal discretionary spending. See William W. Beach *et al.*, "Obama Tax Hikes: The Economic and Fiscal Effects," Heritage Foundation *Center for Data Analysis Report* No. 10-07, September 20, 2010, at *http://www.heritage.org/Research/Reports/2010/09/Obama-Tax-Hikes-The-Economic-and-Fiscal-Effects.*
2. *Ibid.*
3. For description of the assumptions and the macroeconomic simulation, see Beach *et al.*, "Obama Tax Hikes."
4. The decline in household income would lead to a reduction in personal savings as well as overall investment in the economy over the next 10 years, which would likely force business owners to operate below potential and decrease their investment in new equipment.
5. Total net household wealth would fall by $1.1 trillion on average from 2011 to 2020, with a peak loss of $1.4 trillion in 2017.
6. The discrepancy in revenue estimates between these two methods of analysis is attributed to the feedback effects that occur in a dynamic analysis that is not represented in a static analysis. This is a crucial distinction for this current tax policy debate that cannot be overlooked.
7. Income-earners from all groups could be directly impacted by the planned tax law changes in the President's fiscal year 2011 budget. The higher rates on capital gains and dividends would directly affect tax burdens on all income-earning groups.

investment and business growth environment than the baseline of extending the 2001 and 2003 Bush tax cuts for all income-earners. The forecast of the economy with the President's tax increases would likely leave Americans worse off. Lower household income would depress household consumption, discouraging businesses to increase investment spending and hiring in response to lower overall demand in the economy.

Farther out over the decade, higher costs of capital and lower U.S. equity values would significantly weaken household consumption and business fixed investment. And this lower business fixed investment would reduce both the economy's capital stock and its potential output. The CDA simulation in summary supports these forecast expectations over the next decade.

Policymakers should consider these economic effects on all Americans, and importantly, refocus their efforts on encouraging more work, investment, and entrepreneurship in the U.S. economy. Tax increases on labor, capital, and enterprise—the productive factors that drive economic growth—in this weak economy would absolutely impact all American economic livelihoods.

Spare Americans Even More Economic Hardship. Politics has taken grip on this tax policy debate; the President in particular is making it a political debate rather than one on economic policy. The economic effects of not extending the 2001 and 2003 tax laws would impact all Americans, especially those who will just start their economic lives and the millions more trying to find work after the worst recession in 60 years.

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