IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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DYNAMIC ANALYSIS OF SURTAXES IN THE HOUSE AND SENATE HEALTH BILLS

Executive Summary

The paper examines two proposed surtaxes on upper-income individuals in the House and Senate versions of the health care bill. The official budget scores of the bills claim the burden of the surtaxes would fall only on the rich. These claims are based on unrealistic static economic assumptions. In reality, the bills would depress GDP, and everyone would feel the effect of the taxes, not just the rich. Much less revenue would be raised than forecast. The bills would increase the federal deficit. State and local budgets would be hit too. If paired with expiration of the portions of the Bush tax cuts that had applied to upper-income taxpayers, the adverse economic effects would be even worse.

Based on static economic assumptions, the House health bill's 5.4% of AGI surtax on high incomes is officially forecast:

- To raise $460.5 billion over ten years;
- To affect only about 0.3% of taxpayers, those with incomes above $500,000 ($1 million for joint filers).

In reality, we calculate that on a dynamic basis, after economic reactions to the tax, the House 5.4% AGI surtax would:

- Depress annual GDP by about 1.7% (not factored into the official analysis) and lower the capital stock about 3.4%;
- Reduce after-tax income for the remaining 99.7% of the population by about 1.5% across the board (so that everyone would be hurt, not just the rich);
- Lose about 73% of its anticipated annual addition to federal income tax revenue due to lower GDP;
- Reduce other federal revenues, resulting in a net drop in annual total federal revenues, bringing the combined dynamic loss to 115% of the anticipated static gain.
- Reduce state and local tax revenues due to lower GDP.

On a static basis, the Senate bill's 0.9% "Hospital Insurance (HI)" surtax on high labor incomes is officially forecast:

- To raise $86.8 billion from 2013 to 2019;
- To affect only a small number of individuals, those with wages, salaries, and self-employment income in excess of $200,000 ($250,000 for joint filers).

In reality, on a dynamic basis, the 0.9% labor surtax would:

- Depress GDP and capital formation by about 0.04%;
- Reduce the after-tax incomes of the people supposedly not touched by the "HI" surtax by about 0.04% across the board;
- Lose 16% of its anticipated income tax revenue due to lower GDP;
- Reduce other federal tax revenues, bringing the total offset to 27% of the expected revenue gain;

The AGI surtax on capital and labor income would harm GDP and incomes more than the "HI" surtax on labor income for two reasons. First, a tax on capital and labor income does far more economic damage (to workers as well as savers), than a tax on labor income alone because capital formation is far more sensitive to taxation than are hours worked. Second, the AGI surtax is a larger tax. However, both surtaxes would damage the economy, as well as generating less revenue than is being officially estimated.

Introduction

In early November, the House narrowly approved the "Affordable Health Care for America Act" (H.R. 3962). Just before Christmas, by a straight party-line vote, the Senate passed the "Patient Protection and Affordable Care Act" (H.R. 3590). Both versions of the health care bill would hugely increase government spending. Nevertheless, the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT), claim that the bills are fully funded by revenue increases big enough to match their outlays.[1]

Two earlier IRET studies concluded that both versions of the bill would sharply increase the federal budget deficit. One study found that the official estimates seriously understate the costs of the bills.[2] The other determined that the revenue provisions would raise much less money than predicted.[3] The revenue shortfalls stem from the tax proposals' adverse effects on work, saving, and investment, which would lead to lower incomes and less GDP.

This study subjects two surtaxes on upper-income individuals, one in the House bill and the other in the Senate bill, to dynamic revenue estimation.[4] The House proposal is a 5.4% surtax on gross income above ceratin levels. The Senate proposal is a 0.9% surtax on wages, salaries, and self-employed income above certain levels. The study also looks at the combination of the House surtax provision with a third tax change, the increases in marginal tax rates if Congress allows the top income tax rate reductions and other provisions of the 2001 and 2003 Bush tax cuts to expire for upper-income taxpayers. The results of this study reinforce our earlier conclusion that the taxes would adversely affect GDP and taxable income. As a result, the revenues expected from the taxes would fall short of

expectations, and leave the House and Senate bills substantially underfunded.

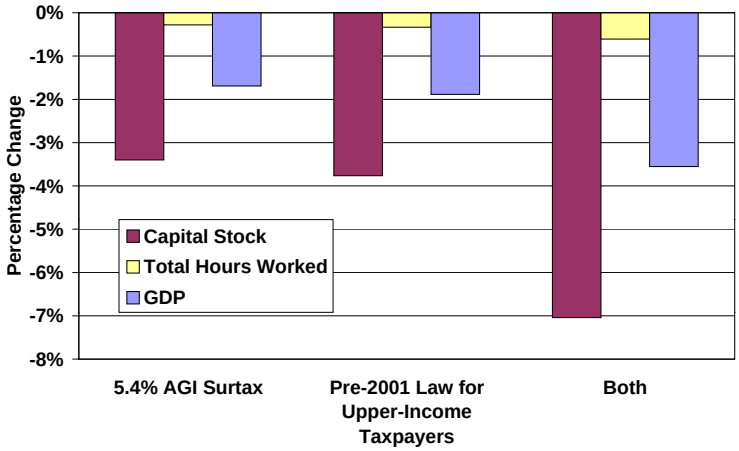
Official government revenue estimates often overpredict revenue gains from tax increases and revenue losses from tax cuts. The main reason is that they assume, wrongly, that taxes do not affect total economic output and income, or other large economic aggregates, such as saving, investment, and total work hours, that drive output. The static output assumption may be acceptable for certain tax changes, such as lump-sum rebates and reduced rates on the first dollars of income, that do not alter the marginal tax rates that affect people's economic incentives. However, when taxes change after-tax rewards up or down "at the margin" on additional productive effort, people increase or decrease their work effort, saving, and capital formation in ways that affect macroeconomic aggregates. In such cases, a dynamic analysis that includes the macroeconomic consequences and resulting effects on revenues is essential.[5]

Dynamic estimation results for the House bill's 5.4% AGI surtax and a return of pre-2001 tax rates for upper-income individuals

The surtax in the House bill would equal 5.4% of an individual's modified adjusted gross income (AGI) above $500,000 ($1 million for joint filers).[6] It would be on top of the regular income tax and also on top of the alternative minimum tax (AMT). Because the surtax would be based on AGI, not taxable income, there would be no relief for taxpayers with unusually high state and local taxes, charitable contributions, miscellaneous business expenses, most other itemized deductions, or personal exemptions. The threshold for owing the tax would not be indexed for inflation, which means the exempt amount would fall in real dollars over time, and the surtax would hit more and more taxpayers. The AGI surtax would be the largest single revenue raiser in the House version of the health care bill. Congress's JCT scores the provision as collecting $460.5 billion in added federal income taxes over 10 years.[7]

Under the Bush Administration, Congress approved income tax cuts for people at all income levels. Many of those tax reductions will expire at the end of 2010 unless Congress renews them. The betting in Washington is that Congress will vote to keep most of the tax reductions for lower- and middle-income individuals, but not for upper-income individuals. This study compares static and dynamic revenue estimates if the 33% individual income tax bracket reverts to the pre-2001 rate of 36%, the 36% bracket reverts to 39.6%, the itemized deduction limitation and the personal exemption phase-out are reinstated, and the top tax rates on capital gains and dividends both rise to 20%.[8] If the maximum statutory dividend rate climbs above 20% (contrary to the Administration's word), the economic damage would be more severe than what is estimated here.

Chart 1 Pre-2001 Tax Rates And A 5.4% AGI Surtax Reduce Capital And Labor Inputs, Causing GDP To Fall

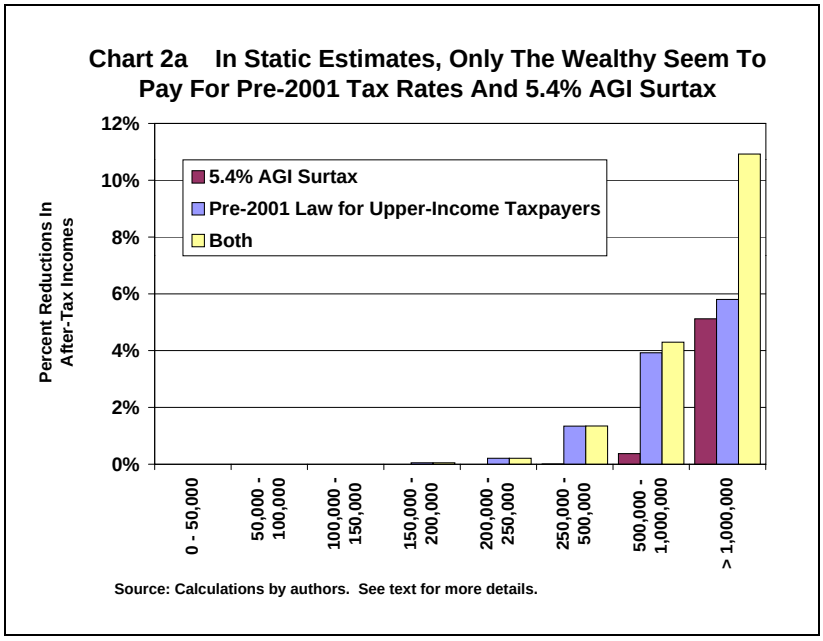


Source: Calculations by authors. See text for more details.

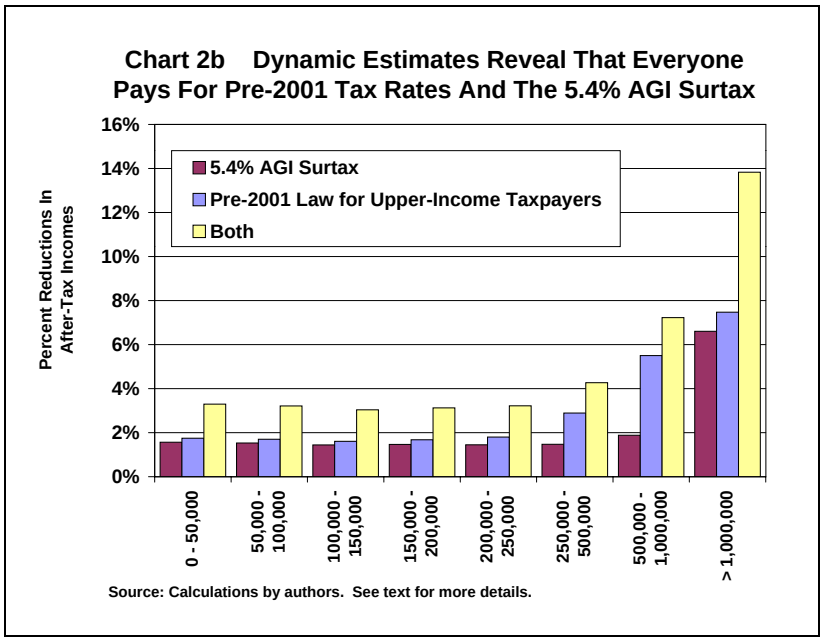
This study finds that the House surtax, on its own, would cause substantial drops in the capital stock, work hours, and gross domestic product (GDP). Chart 1 shows the results.[9] The capital stock would decline because upper-income individuals, who do a large amount of this nation's saving and investing, would save and invest less after the surtax reduced their after-tax rewards. This study estimates that the capital stock would ultimately be 3.4% smaller than otherwise. The full adjustment in

the capital stock would require about a decade, but about two-thirds would occur within five years.

Similarly, people subject to the surtax would see their after-tax reward for labor service reduced, and they would respond by working less. Labor would not decline as sharply as capital because the labor supply curve is relatively inelastic. This study estimates that the quantity of labor would fall 0.3%. Because fewer capital and labor inputs would be supplied in production thanks to the surtax, GDP would also fall. The estimate here is that yearly GDP would ultimately be 1.7% smaller than otherwise. These tax-induced effects are starkly different from those of a static estimation model, where the changes in aggregate capital, labor, and output are – by assumption – all zero.



A return to pre-2001 law for upper-income taxpayers would have similarly deleterious effects, of slightly greater magnitude. They are also displayed in Chart 1. Upper-income individuals would respond to the larger tax bite by reducing their work, saving, and investment. The tax-induced contraction in production inputs would cause GDP to decline. The poor and middle-class would not bear the taxes explicitly, but much or the burden would be shifted to them as the economy contracted.



The strongest effects, by far, would be felt if Congress lets upper-income tax rates return to pre-2001 levels (which seems likely) and, in addition, imposes the upper-income surtax. After the economy has adjusted to these much higher marginal tax rates, the dynamic model estimates that the capital stock would be 7.0% smaller than otherwise, the quantity of labor would decrease by 0.6%, and yearly GDP would be 3.5% lower.

Charts 2a and 2b contrast the distributional consequences of the House surtax, the return to pre-2001 tax rates, and both together as they appear in static and dynamic analyses. Chart 2a shows static estimates based on running the tax changes through this study's tax calculator while (per static convention) holding macro-economic aggregates constant. In a static model, an income tax only burdens the people who pay it directly. Hence, Chart 2a portrays the taxes in the three scenarios as being shouldered entirely by upper-income taxpayers, with no impact on anyone else. The surtax would directly

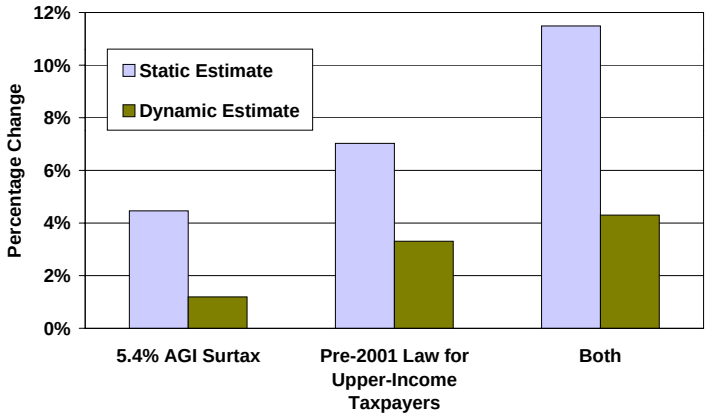
affect about 550,000 upper income tax returns, about 0.3% of the total. For those who want to redistribute income through the tax system and are not troubled by whether it is fair to place so much of the tax burden on upper-income individuals, a static analysis makes the surtax, the pre-2001 tax rates, or the two in combination seem appealing on distributional grounds.

Chart 2b is based on this study's dynamic analysis and reveals an entirely different story. One difference is that the burdens are much greater than in the static analysis, reflecting the tax-induced declines in capital, labor, output, and income. A second difference is that it is no longer only the wealthy who bear the tax increases; much of the economic burden shifts to lower- and middle-income people via lower wages and reduced job opportunities. Lower- and middle-income individuals would not pay the AGI surtax or the pre-2001 upper-income tax rates explicitly, and might (mistakenly) believe they escape them, but those tax increases would reduce their incomes nevertheless by discouraging capital formation and hiring.

For example, if the AGI surtax deterred a small-business owner from expanding and hiring more workers, most of the people losing job opportunities as a result would be lower- and middle-income workers. This is an especially worrisome concern because small businesses account for the majority of the nation's jobs and job growth. Or if the surtax caused a high-income individual to reduce saving and forgo a capital investment, much of the burden would be shifted to lower- and middle-income workers who would be less productive, and therefore earn less, because they would have less capital with which to work. (Historically, in the U.S. economy, about two-thirds of the returns from capital investments flow to labor because the added capital makes workers more productive and, hence, able to command higher compensation.)

Chart 2b shows, for example, that the AGI surtax lowers the after-tax income of someone making less than $50,000 by an estimated 1.6%. Although not as large as the after-tax income losses for wealthier individuals (estimated drops of 1.9% and 6.6%, respectively, for taxpayers with AGIs of $500,000 - $1 million and over $1 million), it is still an appreciable fall in income. The income losses would be greater across the income spectrum, of course, if the surtax comes on top of a return to pre-2001 tax rates for upper-income taxpayers. In that scenario, for instance, the estimated declines in after-tax income would be 3.3% for someone making less than $50,000, 7.2% for someone making $500,000 - $1 million, and 13.8% for someone with an AGI over $1 million.

Chart 3a Change In Federal Income Tax Collections: Static And Dynamic Revenue Estimates

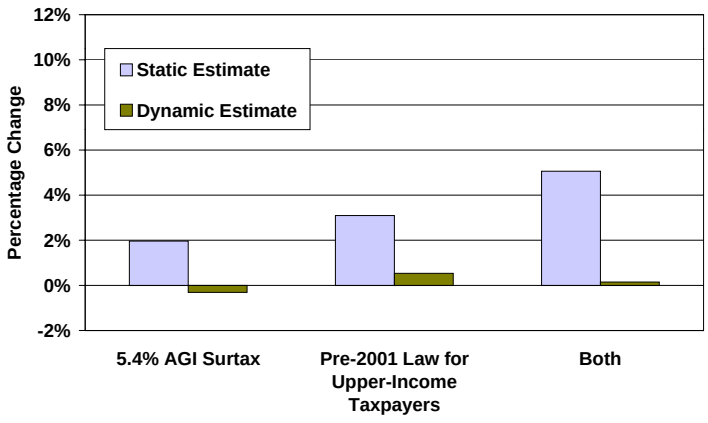


Source: Calculations by authors. See text for more details.

The core purpose of a tax is to collect revenue. How well would the 5.4% surcharge perform? Charts 3a and 3b show the results. Running the surtax through the tax calculator while holding macro-economic aggregates constant (a static analysis) produces an estimated 4.5% increase in federal individual income tax collections. In a more realistic dynamic analysis, however, the rise in income tax collections is only a bit over one-fourth as large, 1.2%. That is a loss of 73% of the expected static revenue. The reason is that the surtax depresses economic activity, and a smaller economy means less total income to tax.

In other words, the surtax would be a potent revenue raiser – if it did not reduce macroeconomic aggregates. However, because it hurts the economy, it is a weak revenue raiser. Even this figure is too optimistic because it omits the surtax's negative feedback effects on other federal receipts. As the surtax weakens the economy, other federal taxes and non-tax receipts, which are dependent to varying degrees on economic activity, would decline relative to their baselines. The model estimates that non-income-tax federal revenue would fall by 1.5% and total federal revenue would actually decline slightly (by 0.3%). That means that 115% of the expected static revenue gain is lost to the reduction in GDP.

Chart 3b Change In Total Federal Revenue: Static And Dynamic Revenue Estimates



Source: Calculations by authors. See text for more details.

Funding expensive new government spending programs with the surtax is a recipe for further deepening the already threateningly large federal budget deficit. The model further predicts that the surtax's negative economic feedbacks would depress state and local government revenues by 1.8%.

The study's dynamic analysis estimates that a return to pre-2001 tax rates for upper-income taxpayers would gain less than half the income tax revenue that a static model predicts (3.3% versus 7.0%). The dynamic model predicts that total federal receipts would rise, but by only 0.5% due to negative macroeconomic feedbacks on non-income-tax receipts. State and local governments would unambiguously suffer, losing close to 2% of their receipts.

If Congress allows pre-2001 tax rates to return for upper-income taxpayers and, in addition, enacts the House bill's 5.4% AGI surtax, the static revenue gain would be 11.5%. However, the more realistic dynamic estimate of the increase in individual income tax collections would be only about one-third as much, at 4.3%. The model estimates that total federal revenue would rise, but just barely (by 0.1%). Meanwhile, the dynamic model estimates that the losses of capital, labor, output, and income attributable to the surtax and the other upper-income tax hikes would slash state and local receipts by 3.7%.

Dynamic estimation results for the Senate bill's 0.9% wage and self-employment surtax

The Senate version of the health care bill includes a 0.9 percent surtax on wages, salaries, and self-employment income in excess of $200,000 ($250,000 for joint filers).[10] The Senate bill calls its surtax an "additional hospital insurance tax on high-income taxpayers".[11] In fact, the surtax has nothing to do with Medicare's HI program, nor would the revenues be dedicated to covering some of HI's impending deficits.[12] It is an add-on labor income surtax to be dumped into general federal revenue to help fund the new health care bill. Like the House surtax, this one would be in addition to the regular income tax, the AMT, and regular payroll taxes; it would not offer any relief to people with high itemized deductions; and it would not be indexed for inflation, which means it would begin at ever lower real incomes over time, and hit increasing numbers of taxpayers. Further, the small difference in the exempt amounts for joint filers and others constitutes a marriage penalty.

The JCT estimates the provision would collect $86.8 billion over the period 2113-2019.[13] The JCT thinks the "HI" surtax would collect much less than

the House bill's surtax, despite having a lower exempt amount and hitting more tax returns (about 2.2 million versus 550,000), because it would be assessed at a lower rate and apply to only the labor income portion of AGI. Our dynamic analysis concludes that the employment surtax would collect even less than the JCT predicts, because the higher marginal tax rate on labor income would reduce the quantity of labor supplied, resulting in less income and output.

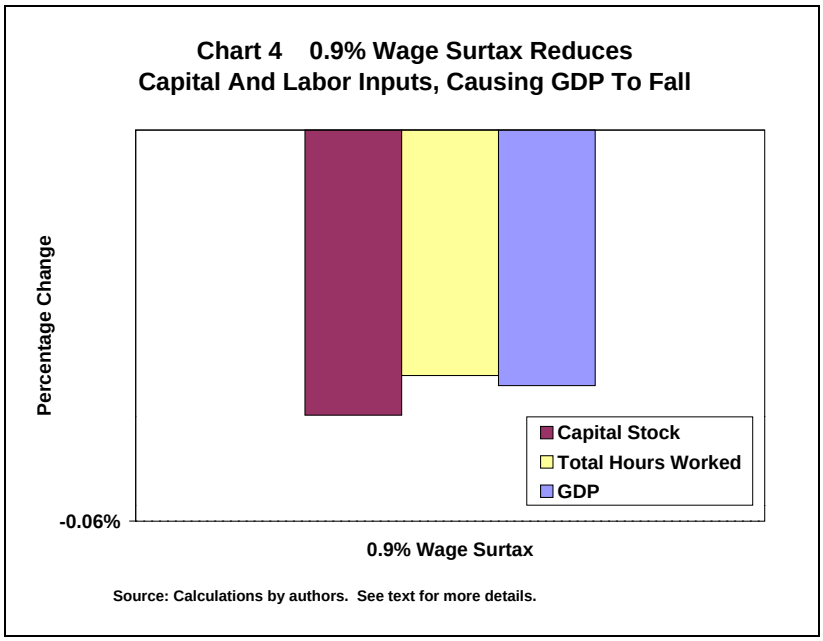


Chart 4 0.9% Wage Surtax Reduces Capital And Labor Inputs, Causing GDP To Fall

Source: Calculations by authors. See text for more details.

The dynamic model indicates that the wage surtax would slightly reduce the labor and capital inputs supplied in production, causing a small drop in GDP, as shown in Chart 4. The dynamic effect is less dramatic here than in the case of the AGI surtax because the wage surtax is imposed only on labor income, and the labor supply curve is much less sensitive to prices than the capital supply curve. (The impact of the wage surtax is shown on separate charts from the AGI surtax or the return of pre-2001 income tax rates for upper-income taxpayers because it is much smaller in scale. The impact may be added to that of the return of the pre-2001 rates is one assumes that both would be implemented.)

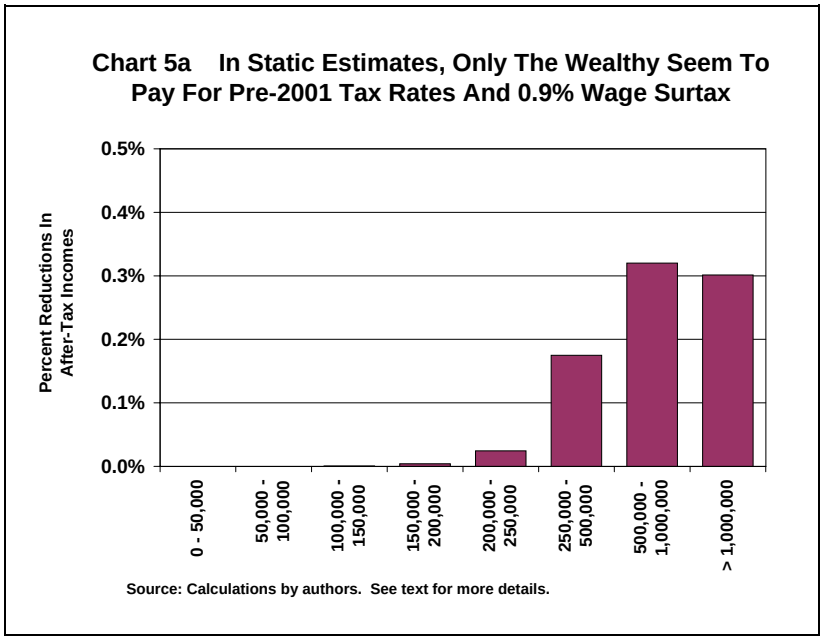


Chart 5a In Static Estimates, Only The Wealthy Seem To Pay For Pre-2001 Tax Rates And 0.9% Wage Surtax

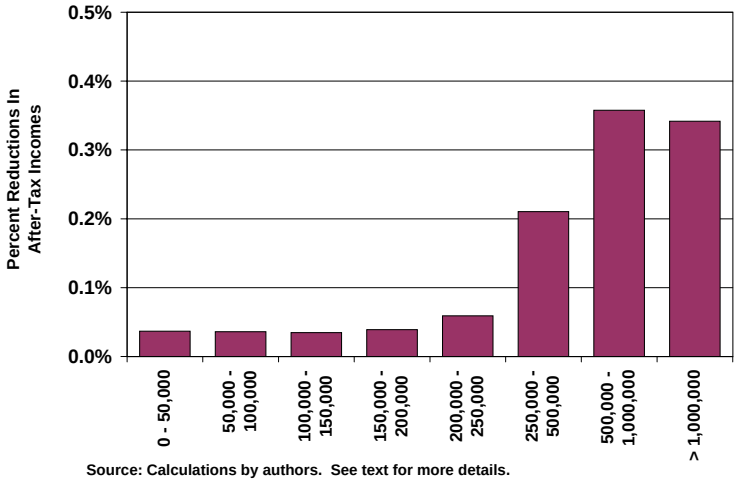
Source: Calculations by authors. See text for more details.

People would not pay the wage surtax explicitly until they reached the upper-middle class. It would directly affect about 2.2 million tax returns, or about 1.2% of filers. This is shown in Chart 5a, which is based on running the 0.9% wage surtax through this study's tax calculator while holding all macro-economic aggregates constant.[14] However, such static distributional results are misleading because macro-economic aggregates do vary. Chart 5b displays the dynamic distributional results. Due to negative macroeconomic feedbacks (drops in labor, capital, output, and real income), people at all income levels would bear some of the tax burden, and the loss of income would be greater at every income level than in the static analysis. To be sure, the surtax's burden would be much larger at high incomes than low ones, but no income group would entirely escape.

In this case, the difference between the static and dynamic estimates would not be as sharp as with the AGI surtax, because the wage surtax falls only on labor income, and the supply of labor is relatively inelastic. When the 0.9% wage and self-employment surtax is run through the tax calculator while holding

macroeconomic aggregates constant, it generates tax receipts equal to 0.47% of federal individual income tax collections. (See Chart 6.) In a dynamic analysis that incorporates economic feedbacks, however, the added income tax revenue is about 84% of a static estimate (an offset of about 16%). The dynamic model also predicts that the net gain to the U.S. Treasury would be only about 73% of the static estimate (an offset of about 27%) because other federal receipts would decrease due to the weaker economy.

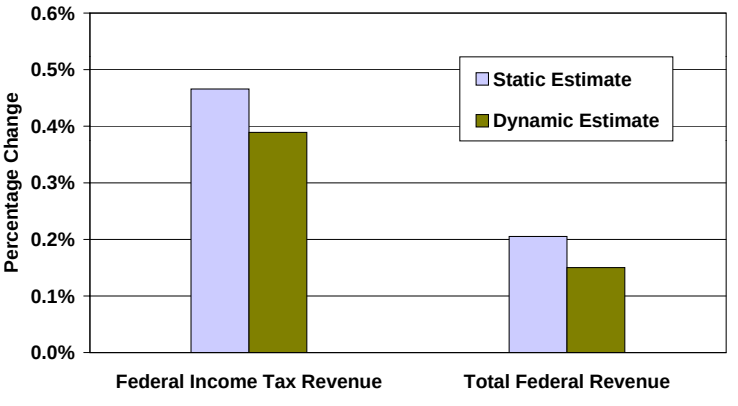
Chart 5b Dynamic Estimates Reveal That People At All Income Levels Pay For 0.9% Wage Surtax



Source: Calculations by authors. See text for more details.

It should be cautioned that this study's dynamic estimates regarding the wage and self-employment surtax may be too optimistic. One concern is that the analysis assumes a labor elasticity of 0.2, which is not unreasonable for the general population but may be too low for the successful small business owners, professionals, and others who would be subject to the surtax. Those people often have considerable flexibility in the hours they work and the forms in which they receive compensation. If those highly productive people reduce their hours more than a labor supply elasticity of 0.2 implies, the loss in economic output and other negative feedbacks would be greater than the model's estimates. If they shift more compensation into lightly taxed or nontaxed forms, production might not suffer, but tax revenues would be lower than the model predicts. Another concern is that the model assumes the surtax applies only to labor income. However, some self-employment income is actually a return to capital, and capital is much more sensitive to after-tax rewards than labor. To the extent that returns to capital fall within the ambit of the wage and self-employment surtax, the negative feedbacks will be stronger than estimated here.

Chart 6 Federal Revenue From 0.9% Surtax On Wage And Self-Employment Income Static Versus Dynamic Estimates



Source: Calculations by authors. See text for more details.

Conclusion

This study has used a dynamic economic model to estimate the effects on the economy and government revenues if the largest new tax in the House health care bill, a 5.4% surtax on AGI for upper-income taxpayers, becomes law. The analysis finds that, in contrast to the government's static revenue estimate, the AGI surtax would significantly damage the economy and raise little (if any) revenue. If the surtax remains a revenue linchpin in the final bill, a severe budget

shortfall is highly likely. This would be in addition to concerns that the health care bill would prove far more costly than predicted, which would create its own budget hole. There are also concerns that the bill would erode the quality of care for many Americans.

The Senate version of the health care bill also contains a surtax, a 0.9% surcharge on the wage and self-employment income of upper-income taxpayers. Although the wage surtax is large when measured in dollars, it is small in comparison to the AGI surtax. In addition, because the wage surtax would apply to labor income, it would do far less damage than the AGI surtax, since hours worked are far less sensitive to taxation than capital formation. Therefore, this study does not find as sharp a difference between static and dynamic revenue estimates for the HI surtax as for the AGI surtax. Nevertheless, the wage surtax would cause some damage to aggregate output and income, and the dynamic estimate would be lower than the static estimate.

Any upper-income surtax would be in addition to the probable return of pre-2001 tax rates for upper-income individuals. Not surprisingly, the combination would produce still larger drops in capital inputs, labor inputs, GDP, and national income. Again, the dynamic revenue estimate is much lower than the static estimate.

These damaging tax increases and the massive increase in federal outlays that would result from the health bill both point in the direction of slow growth for the U.S. economy and gigantic government budget deficits.

Our focus on the macroeconomic consequences of these bills's upper-income surtaxes is not meant to slight other major flaws with the bills' revenue provisions. Some provisions, such as the surtaxes, fall explicitly on a small fraction of the population (although they affect everyone by reducing GDP), which raises equity questions. Many provisions are hidden from citizen/voters, which violates the principle of transparency. The penalties in the bill for businesses that do not offer insurance, and on taxpayers who do not buy insurance, would further increase the money owed to Washington, and increase the paperwork burden on taxpayers. Moreover, several of the revenue raisers would raise push up medical costs and lower the quality of care, which directly contradict two of the health bills' stated goals. The medical devices tax would raise their cost for consumers, including the federal government, which pays for over half of the nations' health care.

There are also other problems with the bills. They fail to address the tax subsidies that distort the health care market and encourage over-consumption. They do not effectively address excessive malpractice suits. They contain provisions that would reduce compensation and discourage the supply of medical services, and retard research into life-saving new drugs, devices, and techniques. There would be drastic restrictions on the freedom of choice of consumers, not only among medical plans, but whether or not to purchase insurance at all. The young would be overcharged to subsidize the middle aged. The added demand for health care would drive up the price as the system struggles to attract additional resources, raising unit costs for everyone, including the federal government, which, as noted, is the largest health care spender in the country. Clearly, this entire exercise needs to be sent back to the drawing board.

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Senior Economist

Stephen J. Entin
President and
Executive Director

Appendix: The Dynamic Model

The dynamic analysis used a tax calculator developed by Gary Robbins at the Heritage Foundation Center for Data Analysis Macroeconomic Working Group. Across a large sample of tax returns that is based on microdata from an IRS public use file, the calculator gauged the impact that the proposed tax changes would have on people's marginal tax rates. The calculator determined how the proposed tax changes would alter individuals' marginal tax rates on labor income, weighted by the incomes of the earners. It also calculated the changes in the income-weighted marginal tax rates on dividends, capital gains, and non-corporate business income. The results for investment income, together with data on depreciation schedules, the corporate income tax rate, and the estate and gift tax rate, were used to determine the effect of the proposed tax changes on the "service price" of capital. The service price is the rate of return that capital must earn to cover its economic obsolescence, pay taxes, and yield a normal after-tax return to its owners.

Because people respond to after-tax rewards, a larger tax bite at the margin on labor income will reduce labor inputs. (Conversely, a smaller marginal tax bite would increase the quantity of labor that people supply.) Based on the literature, this study used a labor supply elasticity of 0.2. (A 1% drop in the after-tax wage would cause a 0.2% decline in the supply of labor.) The 0.2 elasticity reflects evidence that, in deciding how much labor they are willing to supply, people do not respond strongly to changes in after-tax compensation, but they do respond. (More realistically, the labor elasticity of primary earners would be lower than this, and the labor elasticity of secondary earners much higher.)

Similarly, if a new tax pushes up the service price of capital, people will forgo investments that cannot earn enough to clear the hurdle, which will reduce the supply of capital. (Conversely, a lower service price would encourage additional capital formation.) Empirically, the stock of capital is highly responsive to changes in its service price. This study assumes that the quantity of capital adjusts to changes in the marginal tax rate by enough to restore its after-tax, risk-adjusted returns to their long-run level of a bit under three percent.[15] While the full capital-stock adjustment requires about five years for equipment and about ten years for structures, almost two-thirds of the total adjustment occurs within the first five years.

Next, the changes in labor and capital inputs were related to changes in the economy's aggregate output and income using a Cobb-Douglas production function.[16] The Cobb-Douglas production function is mathematically tractable, and it produces results that are in line with historical evidence; empirically, the U.S. economic seems to be close to Cobb-Douglas.[17] The income changes were then fed back through the tax calculator, which produced further changes in marginal tax rates, labor and capital inputs, and output, until a new equilibrium was reached.

In a dynamic analysis, tax changes do not have their full effects immediately because it takes time for people to respond to new incentives. However, historical evidence indicates that people react quickly. In that sense, this study's analysis is long run, but most of the long run will arrive within several years.

Endnotes

1. For cost and revenue estimates for the House bill, see Congressional Budget Office, Revised Cost Estimate for H.R. 3962, Affordable Health Care for America Act, November 20, 2009, accessed at http://www.cbo.gov/doc.cfm?index=10741&type=1; and Joint Committee on Taxation, "Estimated Revenue Effects Of The Revenue Provisions Contained In H.R. 3962, 'The Affordable Health Care For America Act'," JCX-53-09, November 6, 2009, accessed at http://www.jct.gov/publications.html?func=startdown&id=3633. For cost and revenue estimates for the Senate bill, see Congressional Budget Office, Cost Estimate for H.R. 3590, Patient Protection and Affordable Care Act, November 18, 2009, accessed at http://www.cbo.gov/doc.cfm?index=10731&type=1; and Joint Committee on Taxation, "Estimated Revenue Effects Of The Manager's Amendment To The Revenue Provisions Contained In The 'Patient Protection And Affordable Care Act'," JCX-61-09, December 19, 2009, accessed at http://www.jct.gov/publications.html?func=download&id=3641&chk=061befb80affef034ba90756bb1a4516&no_html=1.

2. See Stephen J. Entin, "CBO Underestimates Cost Of The Senate Finance Health Bill," *IRET Congressional Advisory*, No. 259, October 12, 2009, available at http://iret.org/pub/ADVS-259.PDF.

3. See Michael Schuyler,"Health Bills' Tax Increases Would Harm Health Care And The Economy," *IRET Congressional Advisory*, No. 260, December 11, 2009, available at http://iret.org/pub/ADVS-260.PDF.

4. The model is described in the appendix.

5. Government estimators point out that, although they keep macroeconomic totals fixed, they sometimes allow for adjustments of "microeconomic" behavior that affect revenues without altering total GDP. Allowing for such microeconomic changes in behavior is a step in the correct direction but, unfortunately, does not go far enough.

For example, the revenue estimators are aware that higher gasoline or tobacco tax rates may lead to less production and consumption of gasoline and cigarettes. They take the drop in consumption into account in estimating the excise tax revenues. They may even take into account the deduction of the higher excise taxes from business income, and count the associated reduction in corporate and business income taxes as part of their revenue estimate. However, the JCT assumes that the people working in these industries shift to some other activity with no loss in total income and output, so that other revenues from the individual income tax, corporate income tax, and payroll tax are not changed.

The JCT may assume that an increase in tax rates will lead to increased efforts at tax avoidance or tax evasion at any given level of income and GDP, and alter the revenue estimate of the tax rate change accordingly. However, they do not assume that people choose to work, save, or invest less, and therefore earn less, as a result of the higher tax rates. The estimators ignore any "macroeconomic" feedback on revenues from reduced economic production.

In the specific case of the health care bills, the JCT assumes that the proposed tax on high value health care plans will cause some workers to trade them down for increased cash wages, which will increase payroll and income tax receipts. It assumes no effect on total compensation (wages plus fringes), hours worked, and total output. The JCT assumes that people will try to beat the first year of the wage surtax by shifting wages into calendar year 2012 from 2013, but that the surtax has no lasting effect on total hours worked. It is unrealistic to hold total economic activity constant when making changes in major taxes that affect total hours worked, saving, and investment.

6. H.R. 3962, sec. 551. For its surtax provision, H.R. 3962 defines modified AGI as AGI minus qualified investment interest expenses plus certain income that citizens and residents living abroad can exclude from income under tax code section 911.

7. JCT, Revenue Estimate for H.R. 3962, *op. cit.*

8. Dividends were taxed as ordinary income before 2001, at statutory rates of up to 39.6%. However, the Obama Administration has suggested that it may keep the capital gains and dividend rates equal, somewhere between 20% and 28%. This paper assumes a 20% rate for both.

9. Our baseline is 2008 income levels and tax law, with the Bush tax cuts still in place. Our changes in GDP, hours worked, the capital stock, and federal revenues are all in percentage terms relative to the baseline. We have adjusted

the thresholds at which the surtaxes are imposed for CBO's projected inflation through 2016, the mid-point of its budget forecast and scoring of the bills. This allows us to apply the surtaxes to the income levels in the 2008 baseline tax calculator. Our calculations of percentage increases in income tax and federal revenues due to the surtaxes are measured against 2008 revenues. If they were measured against 2016 income tax law, in which the Bush tax rate cuts are scheduled to be repealed, the percentage changes for the surtaxes alone would all look slightly smaller, but their relative dynamic outcomes would be the same as the ones we show in our charts.

10. H.R. 3590, secs. 9015 and 10906. The bill's authors originally set the surtax rate at 0.5 percent (sec. 9015), but they upped it at the last minute to 0.9 percent (sec. 10906).

11. *Ibid*.

12. Even if the revenues were dedicated to the HI trust fund, it should be noted that upper income wage and salary workers and the self-employed already pay more HI tax, and hence pay more for the same HI coverage, than lower income workers.

13. JCT, Revenue Estimate for H.R. 3590, *op. cit.*

14. It might be noticed that a few taxpayers with AGIs below $200,000 would have to pay the surtax. The explanation is that the surtax is based on wage and self-employment income. A person with wage and self-employment income above the surtax's threshold may, nevertheless, have an AGI below $200,000 due to losses on other types of income.

15. See Gary Robbins and Aldona Robbins, "Capital Taxes and Growth," National Center for Policy Analysis, *Policy Report*, No. 169, January 1992; and Gary Robbins and Aldona Robbins, "Eating Out Our Substance (II): How Taxation Affects Investment," Institute for Policy Innovation, *TaxAction Analysis Policy Report*, No. 134, November 1995.

16. The production function is described in greater detail in Stephen J. Entin, "Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?" *IRET Policy Bulletin*, No. 88, September 10, 2004, Appendix A, available at http://iret.org/pub/BLTN-88.PDF.

17. *Ibid.*