IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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March 1, 2010 **Advisory No. 263**

THE OBAMA ADMINISTRATION'S PROPOSED 2.9% "HI" SURTAX WOULD HARM THE ECONOMY AND LOSE REVENUE

President Obama has recommended imposing a 2.9% "HI" surtax on "passive income" (income from saving and investment) to help fund his health insurance overhaul. Social Security taxes for retirement and medical programs for the elderly taxes have always been levied on wages, as a form of social insurance. Extending the Hospital Insurance tax to income from savings would be a sharp departure from previous practice and very bad economics.

Economic consequences of the 2.9% rate hike

On a static basis, our preliminary estimate is that the Obama plan's 2.9% surtax on the capital gains, dividends, interest, and certain other income of upper-middle class and wealthy taxpayers would:

- Raise approximately $39 billion yearly (at 2009 income levels);
- Affect only a small number of upper-income individuals.

In reality, on a dynamic basis, the 2.9% surtax would, after the economy has adjusted to it:

- Depress GDP by about 1.3%;
- Reduce private-sector capital formation by about 3.4%;
- Cut the wage rate by about 1.1%, and hours worked by about 0.2%;
- Reduce the after-tax incomes of the people in the income ranges supposedly not touched by the proposed 2.9% surtax by 1.1% - 1.2%;
- Lose about 70% of its anticipated income tax revenue gain due to lower GDP and incomes across-the-board;
- Decrease other federal tax revenues, causing total federal receipts actually to fall by about $5 billion yearly (at 2009 income levels).

Discussion

Capital formation is very sensitive to taxes on capital income, and reduced capital formation reduces labor productivity and wages across the board. We estimate that the proposed surtax will depress capital formation, GDP, and wages. The resulting loss of income, payroll, corporate, excise, and other taxes will offset the assumed revenue gains. The wage depression will affect all income levels, and the tax burden will not be confined to the top income earners.

The 2.9% passive income surtax (equal to the Medicare Part A – or Hospital Insurance – payroll tax rate) would be imposed on dividends, interest, capital gains, rents, royalties, and other income from saving and investing. The tax would hit couples with more than $250,000 in adjusted gross income ($200,000 trigger for singles and heads of households). The tax would be triggered by earning even a single dollar above the thresholds, after which all of the taxpayers' passive income would be immediately subject to the tax. This creates a huge tax rate spike or "cliff" at the thresholds. It would be imposed on AGI instead of taxable income, taking no consideration of itemized deductions and the differing circumstances of families which the deductions reveal.

The surtax would depress capital formation and wages, and fail to bring in the expected revenue. The numbers below are for the 2.9% rate hike in isolation. The Administration's proposal to raise the top tax rates on capital gains and dividends would produce additional losses. Further losses would result from the Administration's proposal that the Bush tax cuts expire for upper-income taxpayers, which would increase the top two tax rates on interest income and other "passive" income to 36% and 39.6%. The return of the itemized deduction limitation and the personal exemption phase-out would raise upper-income individuals' marginal rates even higher and add more economic damage. (The rise in the top two rates would also apply to labor income, and the Administration's health care proposal, taking a page from the health care bill that the Senate passed on Christmas Eve, would pile on a 0.9% surtax on wages and self-employment income.)

The House health bill has a 5.4% surtax on AGI. The Senate considered that but dropped it as ill-advised and instead opted for a 0.9% surtax on wage and self-employment income only, building on the existing payroll tax. Any surtax is undesirable, but a surtax on capital income would be especially damaging, and the "cliff" in the Obama Administration's plan would compound the harm and is especially inept.

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