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How Clinton's Tax Rate Increases on "Rich" Individuals Will Hurt Everyone

President Clinton has proposed a series of explicit and implicit marginal tax rate increases on upper income taxpayers. The rate hikes would seriously reduce incentives to work, save, and invest among the affected people. GDP, employment, and productivity would fall. Tax avoidance would increase. Taxable income would decline. Revenue from the rate hikes would fall far short of expectations.

Clinton's explicit marginal tax rate increases would take the form of a new top tax rate of 36% on taxable incomes above $140,000 for married couples filing jointly and on single filers with taxable incomes over $115,000. A 10% surtax would hit those with taxable income over $250,000. The basic Alternative Minimum Tax (AMT) rate would be increased, and a second AMT bracket at a higher rate would be added on AMT income over $175,000.

The hidden marginal tax rate hikes that Clinton proposes are to extend the present law's phase-outs of personal exemptions (PE) and up to 80% of itemized deductions (ID) for upper income taxpayers. PEs are phased out over adjusted gross incomes (AGI) of $108,450 - $230,950 for single individuals and $162,700 - $285,200 for married people filing jointly. IDs are gradually lost on AGIs above $108,450 for all filers, without upper limit. The phase-outs were scheduled to expire in 1996 (ID) and 1997 (PE).

These phase-outs were enacted as part of the 1990 budget deal to raise revenue from the upper income while saving face for President Bush, who had promised not to raise marginal income tax rates. Because of the phase-outs, however, an additional dollar of income raises taxable income by more than a dollar, effectively raising the marginal rates. For example, in 1993, a married couple in the 31% bracket, with two children, losing IDs and PEs faces an effective 34.3% marginal income tax rate. Under the proposed 36% tax rate, the phase-outs would boost the effective marginal tax rate to 39.8%. (The increase would become steeper over time as the PEs increase with inflation, because the phase-out ranges are not indexed.) Taxpayers affected by the ID phase-out and the proposed 10% surtax would face a marginal tax rate of 40.8%. (See table. Details are available upon request.) These proposed tax rates are far higher than the 31% rate that would apply under current law after expiration of the phase-outs.

Clinton also proposes to eliminate the current $135,000 wage cap on the 2.9% Medicare (HI, hospital insurance) portion of the payroll tax, which would then cover all wage and salary income. Because half of the HI tax is deductible against the income tax by the employer or the self-employed taxpayer, the net increase in the marginal tax rate on labor income over $135,000 would be 2.3 to 2.6 percentage points. High-salaried employees with a family of 4 could face a combined marginal federal income and HI tax rate of nearly 37% to more than 43%. (See table.)

Even higher marginal rates might apply at lower levels of wage and salary income under the proposals. Taxpayers with labor income below the cap for the retirement and disability portions of the payroll tax might face combined marginal federal income and payroll tax rates of up to 53%. This could occur if other income, from savings or earnings of a working spouse, pushed total taxable income and AGI to levels affected by the income tax hikes.

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Clinton would not only add a 36% tax bracket to the income tax schedule for estates and trusts, he would also lower the thresholds at which all lower tax rates become effective. He claims that the current 15% and 28% tax rates on small estate incomes constitute a "benefit" (as if all income should have been taxed at the top rate), and rationalizes that with a new top rate, even the old 31% rate would become an added "benefit". He would narrow the lower brackets of the estate income tax schedule to raise the tax and reduce the "benefit" back to current levels. This reasoning assumes that all income belongs to the government, and any income the taxpayer keeps is a loophole.

Clinton's effort to target the rich is misguided. Clinton claims that these tax increases would increase the fairness of the tax system by reversing the trend of the 1980s for the rich to pay a smaller share of the tax load. Clinton is wrong in asserting that the rich did not pay their fair share during the 1980s; indeed, they produced more output and paid a sharply higher share of the income tax burden during that decade than in the 1970s.

Top Federal Marginal Tax Rates, Current Law and Under Clinton Proposals, for a Family of 4

	Current Law	Proposed 36% tax rate	Proposed 36% rate and surtax
Marginal base income tax rate	31.0%	36.0%	39.6%
plus ID phase-out (and HI tax)*	31.9% (34.6%)	37.1% (39.5%)	40.8% (43.1%)
plus ID and PE phase-outs (and HI tax)*	34.3% (36.9%)	39.8% (42.2%)	**

* ID = Itemized Deductions; PE = Personal Exemptions; HI = Hospital insurance portion of payroll tax.
** Few taxpayers would encounter both the surtax and the phasing-out of PEs on the same dollar of incremental income. Most people with taxable income at the surtax levels have AGIs large enough to have lost all their PEs.

Clinton ignores the depressing spill-over effect of increasing disincentives for productive activity imposed by raising marginal tax rates on upper incomes. Production of goods and services requires the cooperation of labor, capital, and entrepreneurial talent, as well as the availability of natural resources and energy. A reduced supply of any of these factors reduces the productivity and welfare of all of the others. Furthermore, all these factors of production are sensitive to taxes and regulations. Consequently, it is most unlikely that punitive taxes on one part of the population can improve the welfare of another part of the population. This is particularly true if the targeted group is unusually productive and unusually sensitive to the attack.

A given rate hike cuts the after-tax reward by a greater percentage if the tax rate was high to begin with than if it was low. For example, raising a tax rate from 50% to 55% lops 10% off the after-tax return; raising the rate from 15% to 20% cuts less than 6%. Rate hikes on the "rich" disproportionately reduce rewards for work, saving, investment, and entrepreneurial activity for the very individuals who do a disproportionately large amount of these activities, and who consequently produce a disproportionately large amount of the GDP. Upper-income taxpayers would save and invest less, and capital formation would slow. Reduction of human and other capital supplied by the rich would reduce productivity, compensation, and employment of the non-rich as well. People of all incomes would be hurt.

Because the affected taxpayers would change their economic behavior, and because the economy would suffer as a result, the revenue gain from these tax rate increases is overestimated. Upper-income people would reduce the amount of skilled labor and entrepreneurial talent they supply to the workplace. They would save and invest less, and divert income into less heavily taxed forms. Their taxable income would be less than otherwise. Less capital, and less entrepreneurial input, would result in reduced productivity and wages for all workers, further reducing the growth of income and payroll taxes.

Government revenue estimators assume, contrary to fact, that over-all economic activity is unchanged by changes in the tax law. This "static" method of tax revenue analysis always over-estimates the revenues to be gained from a tax rate increase, and over-estimates the revenue loss from a tax rate reduction. It biases fiscal policy in the direction of bigger government, and fails to warn policy-makers of the economic damage that tax increases generate.

Reduction of effort and investment by upper-income people need not be large to sharply reduce the revenue to the government from these tax rate increases. The rate hikes would add 7 to 13 percentage points of tax to each dollar the affected taxpayers continue to earn. But the government would lose all revenue, some 31 to 44 cents (including income tax and payroll tax where applicable) for every dollar that upper income individuals choose not to earn as a result of the tax rate increases. Each dollar of income not earned would wipe out the revenue gain on three to four dollars of income that continued to pay tax.

Consider a taxpayer in the current 31% federal tax bracket, with a state income tax of about 6% at the margin (after itemized deductions). After the scheduled expiration of the phase-outs, his combined marginal tax rate would be 37% on capital income; an extra dollar of capital income would net him only 63 cents, after-tax. Clinton would boost the combined marginal rates as high as 46%. The rate hike would cut the after-tax return on the taxpayer's saving to 57 cents, a decline of roughly 14%. (Factoring in corporate taxes would reveal an even greater decline. With payroll taxes, there could also be larger percentage declines in after-tax wage and salary income.) A drop in the after-tax return of that magnitude would significantly reduce investment, investment income, and the growth of productivity and wages. Much of the projected static revenue increase from the rate hikes would be lost.

Tracing all the adverse consequences of Clinton's income tax proposals is a daunting task, demonstrating that the tax code, post-Tax Reform, remains as complex and arbitrary as it ever was. Clinton would increase marginal tax rates by more than is apparent from a glance at the explicit tax rate changes alone. Determining the economic consequences of the rate hikes requires taking account of the drop in the after-tax returns to labor and capital services as the tax rates increase, and of the responses of the suppliers of these production services to the decrease in their rewards. The proposed tax rate hikes would discourage saving, investment, employment, and hours worked to a significant degree. The Btu tax and corporate tax rate increases would increase the economic damage. Clearly, the economy would be smaller and less efficient under the Clinton program than under current law.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.