Notations

Robin Hood Tax Policy

Bruce Bartlett, 07.17.09, 12:00 AM ET

This week, House Democrats proposed that most of the funding for their health reform plan should come from an income tax surcharge of 1% on those earning between $350,000 and $500,000; 1.5% on those with incomes between $500,000 and $1 million; and 5.4% on those making more than $1 million. Since the surtax is levied on adjusted gross income, it applies to dividends and capital gains even though they are taxed at a lower rate than ordinary income.

Former Labor Secretary Robert Reich calls this "the most blatant form of Robin Hood economics ever proposed." An outspoken liberal, Reich meant this as praise.

The Tax Policy Center estimates that about two million taxpayers will have to pay higher taxes under the proposal and that most of the burden will fall on the ultrawealthy. Those in the top 1% of the income distribution would pay 98% of the higher taxes, and 77% of the increased burden would be paid by just the top 0.1% of taxpayers.

Those in the top one percent would see an average tax increase of $35,939 per year, but those in the top one tenth of one percent would pay $279,493 more per year on average. (Those with incomes above $556,929 make up the top one percent; the income threshold for the top 0.1% is $2,359,664.)

According to the Joint Committee on Taxation, the surtax would raise $543.9 billion over 10 years. With the Congressional Budget Office estimating the cost of the health plan at $1,042 billion, this means that taxes on the rich will contribute 52% of the financing. Other taxes included in the proposal raise the total tax contribution to 56%.

The true tax contribution will probably come closer to 100% in the long run because Democrats expect the balance of financing to come from reduced spending on Medicare and Medicaid. The experience of various budget deals of the 1980s and 1990s, however, is that projected spending cuts seldom emerged and the bulk of deficit reduction came from higher taxes. The legislation even anticipates this likelihood by automatically raising the surtax on those with incomes between $350,000 and $1 million in the event that savings targets are not achieved.

A Cato Institute study also points out that projections of spending for Medicare have been chronically low. So even if the proposed savings are actually achieved they will probably be overwhelmed by unexpected health cost increases.

Finally, it should be noted that CBO's estimate greatly understates the true cost of the health plan because it isn't fully effective until 2015. Spending in the first three years of the 10-year forecast window is close to nil but rises very rapidly after 2014, with 20% of the total cost coming in just 2019, the last year estimated.

It's important to remember that the 5.4% surtax will come on top of the already scheduled rise in the top federal income tax rate to 39.6% from 35% at the end of next year. This will result from expiration of the Bush tax cut, which neither he nor the Republican-controlled Congress made any effort to enact permanently. Republicans legislated this tax rate increase back in 2001, and Democrats are simply allowing it to go into effect.

Thus, beginning in 2011, the top federal income tax rate will be 45% if the Democratic proposal is enacted. Many conservatives are predicting economic disaster. The rich, they say, will go on strike as they did in Ayn Rand's apocalyptic novel, *Atlas Shrugged*. But they said the same thing when Bill Clinton raised the top rate to 39.6% from 31% in 1993, just before the economy took off. Conservatives should also remember that the top rate was 50% as recently as 1986, which didn't prevent the economy from booming in the 1980s.

The truth is that rich people aren't going to suddenly stop working in protest or move to some lower-taxed nation, and the economy isn't going to collapse if they are forced to pay a bit more in taxes. The real problem is that higher tax rates will encourage the wealthy to spend more of their time and resources engaging in tax avoidance rather than making money.

The critical dividing line is 50%. When tax rates are higher than that saving a dollar in taxes is worth more than earning a dollar of income. Although the top rate will still be below that even if the surtax is enacted, when one includes the Medicare tax, which applies to all wages, and state income taxes, the top rate will be well above 50% for many high-income taxpayers. According to the Tax Foundation, the top rate in 39 states plus the District of Columbia will be above 50% in 2011 if the surtax is enacted. Taxpayers in New York City, which has its own income tax, will face a top rate of 58.6%.

When the top federal income tax rate went as high as 70% back in the 1970s, it led to a vast amount of tax sheltering activity. And while some of the more blatant shelters were curtailed in the 1976 and 1986 tax reform bills, many still remain. The reason one doesn't hear about them from one's tax adviser isn't because they disappeared but because they aren't economically viable when the top rate is as low as it has been since 1987.

One technique that will certainly become more popular will be to incorporate oneself. With a corporate tax rate of just 35%, wealthy persons can cut their tax by 10% and have many more opportunities for sheltering income through pensions and the conversion of ordinary income into capital gains or dividends. Although Barack Obama plans to raise the top rate on dividends and capital gains from 15% to 20% (24.5% with the surtax), that is still far better than 45% (47.9% including the Medicare tax).

Unearned income, such as capital gains and dividends, is also free of the Medicare tax, which only applies to wages. People may remember that in 2004 former senator and vice presidential nominee John Edwards was found to have used incorporation to save close to $600,000 in Medicare taxes alone by paying himself a small wage and taking most of his income in the form of untaxed dividends.

Of course, higher tax rates will raise the value of deductions, such as that for mortgage interest. One bright side of this is that it may encourage rich people to overinvest in housing, which could drive up the prices of high-end homes. Companies that sell tax-free municipal bonds can also expect more business in the future.

It almost goes without saying that tax sheltering is socially and economically wasteful. It does nothing to increase the size of the economic pie and is essentially parasitic. It is far better for people with the talent and skill to earn large incomes to concentrate their efforts on ways to earn more by starting new businesses, revitalizing old ones, finding investment opportunities and so on. Spending more time with their accountants and tax lawyers trying to figure out how to keep their money away from the tax collector does nothing to enrich anyone except the accountants and tax lawyers.

As the top rate rises we can expect Congress to create new tax loopholes for their wealthy campaign contributors. No doubt, they will be justified on the grounds of meeting some critical social need, but their effect will be to lower the effective tax rate--the rate that is actually paid--well below the statutory rate. The result will be to further complicate the tax code and bias investment decisions, which will reduce growth.

In the end, it is highly unlikely that the surtax will bring in anything close to the projected revenue. This is almost inevitable because the models used to project the revenue effects of tax increases are largely static and assume that they don't significantly impact on economic behavior.

For example, back in 1989 the Joint Committee on Taxation (JCT) was asked to estimate the revenue effect of raising the top rate to 100% on all incomes over $200,000. It dutifully calculated that this measure would raise $204 billion in 1990, $232 billion in 1991, $263 billion in 1992, and $299 billion in 1993. Of course, the true revenue yield would have been closer to zero since no one would have realized any taxable income over $200,000 if they didn't have to.

I remain convinced that just down the road major tax increases will be needed to avoid national bankruptcy. When that day comes, it will be harder for Democrats to go back to the same well and demand that all the burden fall upon the wealthy, especially if it is clear by then that the surtax didn't raise nearly as much revenue as expected. Congress will have no choice except to look for ways to tax people who have much more limited opportunities for tax avoidance: those who have only wage income, which means the middle class.

Historically, increases in the top rate have tended to pave the way for higher rates on the middle class. Holding down the top rate in effect places a cap on how high tax rates on the middle class can go. If the top rate rises, higher rates on the middle class probably won't be too far behind.

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