# The Corner



## Nine Days' Deficit

By Alan Reynolds
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"Raising taxes on the top 2% of households, as Mr. Obama proposes, would bring in $34 billion next year: enough to cover nine days' worth of the deficit," notes *The Economist*. So *that* is what all the political fuss about extending the Bush tax cuts for another year is all about. Does this make any sense? After all, errors in estimating next year's revenues are typically much larger than $34 billion.

The arithmetic is even more absurd than it appears, because the alleged $34 billion of extra revenue is a *static* estimate. That means the number assumes higher tax rates do literally *no damage at all* to the affected taxpayers, and therefore no damage to consumer spending, business investment, employment, stock prices, housing prices, new car sales, etc.

In an economy producing a GDP of $15 trillion a year, even the slightest ill effect from Obama's punitive tax hikes would quickly turn that hypothetical $34 billion revenue gain into a big revenue loss. Even if one could somehow believe there would be no harmful effects on small businesses' hiring, or on decisions of second earners to cut back or retire early, upper-income families in the president's target zone are nevertheless very important prospective buyers of big-ticket items like homes and cars. They account for 25 percent of consumer spending, as Mark Zandi points out.

If anyone could really believe the proposed tax hikes could possibly have no harmful effects on the economy, the $34 billion revenue estimate would still be *wildly optimistic*. Why? Because it also assumes high-income taxpayers make *no effort* to avoid the added burden. In economic jargon that means assuming an "elasticity of taxable income" of zero, although recent studies put the actual elasticity closer to one. Evidence from past changes in the highest tax rates suggests affected taxpayers will be able to conceal almost enough incremental income (above the $250,000 threshold) to offset the steep surtaxes tax on such income, leaving even the IRS no better off.

For example: More professional and small business income would be sheltered as retained earnings inside new corporations. More managerial income would be deferred, or received as perks. More investors would maximize contributions to tax-favored savings plans, or switch to tax-exempt bonds. The academic evidence is especially clear that a higher tax rate on dividends would dampen investors' appetite for dividend-paying stocks, and that a higher tax rate on capital gains would reduce the frequency with which investors sell assets and therefore have to pay the tax.

As puny as it is, the official $34 billion estimate of the revenue from Obama's crusade against high incomes is wildly optimistic to begin with, because it fails to take into account how taxpayers will react. To make mattes much worse, if there are *any* adverse effects on the economy at all, however slight, the net effect must be to *reduce* rather than increase federal, state, and local tax receipts in 2011. Are these risks worth taking in the foolhardy hope of paying for nine days' worth of deficit?

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