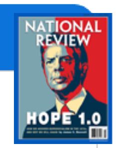

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SEPTEMBER 21, 2010 4:00 A.M.

Foolhardy Tax Hikes

Overtaxing the top 2 percent can't cover even nine days' worth of deficit.

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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: It's based on the assumption that higher tax rates do 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 such as homes and cars. They account for 25 percent of consumer spending, as Mark Zandi points out.

And even if we assume the proposed tax hikes would have no harmful effects on the economy, the $34 billion estimate would still be wildly optimistic. Why? Because it's also based on the assumption that high-income taxpayers would make no effort to avoid the added burden. Evidence from past changes in the highest tax rates suggests that affected taxpayers would be able to conceal almost enough incremental income (above the $250,000 threshold) to offset the added taxes 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, it fails to take into account how taxpayers would react. To make matters much worse, if there are any adverse effects on the economy at all, the net effect would 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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