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Soaking the rich

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The 2001 and 2003 tax cuts are scheduled to expire at the end of this year, which means a big tax hike in 2011. Tax rates for all brackets will increase, the double tax on dividends will skyrocket from 15 percent to 39.6 percent, the child credit will shrink, the death tax will be reinstated (at 55 percent!), the marriage penalty will get worse and the capital-gains tax rate will jump to 20 percent.

Higher taxes in 2011 will be unwelcome news for taxpayers. But equally troubling are the indirect costs to the economy.

The direct cost of the tax system is the amount of money the government takes from you, which means unpleasant things, like less take-home pay and a smaller bank account or mutual fund. These costs are significant, and they tend to dominate the political debate, but they're just part of the story.

Indirect costs can be even more critical, especially in the long run. The most important indirect costs are lost economic growth and reduced competitiveness. You don't have to be a radical supply-sider to recognize that higher tax rates -- particularly steeper penalties on investors and entrepreneurs -- are likely to slow economic growth.

Even if growth only slows a bit, perhaps from 2.7 percent to 2.5 percent, the long-term impact can be big. After 25 years, a worker making $50,000 will make about $5,000 more a year if economic growth is at the slightly higher rate.

So if this worker gets hit next year with a $1,000 tax hike, he or she understandably will be upset. In the long run, however, that worker may be hurt even more by weaker growth.

Competitiveness also is important. The global economy makes it much easier for jobs and investment to cross borders. So if America becomes less attractive because of higher tax rates, it becomes more profitable for companies to build factories in places like China and for entrepreneurs to create jobs in such nations as India.

If we lose jobs to other nations because of smarter management or more industrious workers, that would be unfortunate but understandable. But if we lose jobs because greedy politicians are punishing success and hard work, that calls for a tax revolt.

The Obama administration's approach is to look at tax policy mainly through the prism of class warfare. This means that some of the 2001 and 2003 tax cuts can be extended, but only if there is no direct benefit to anybody making more than $200,000 or $250,000 per year.

That's bad news for the so-called rich, but what about the rest of us? This is why the analysis about direct and indirect costs is so important. The folks at the White House presumably hope that we'll be happy to have dodged a tax bullet because only upper-income taxpayers will face higher direct costs.

But it's the rest of us who are most likely to suffer indirect costs when higher tax rates on work, saving, investment and entrepreneurship slow economic growth. When the economy slows, that's bad news for the middle class -- and it can create genuine hardship for the working class and poor. Indeed, punitive taxation of the "rich" is one reason why middle-class people in high-tax European welfare states have lost ground in recent decades compared to Americans.

The White House may be playing smart politics by engaging in class warfare, especially if President Obama succeeds in blaming the recession on tax cuts that took place five years before the downturn began. But for those who care about prosperity more than politics, what really matters is that the economy is soon going to be hit with higher tax rates on productive behavior.

The key lesson is that higher tax rates on entrepreneurs and investors are misguided. The economy will suffer collateral damage for every dollar the government collects from such soak-the-rich provisions as higher capital-gains and dividend taxes, a renewed death tax and raises in the top tax rates. It's unclear whether that's good for the president's poll numbers, but it's definitely bad for America.

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