American Enterprise Institute for Public Policy Research

No. 1 • January 2010

Tax Policy Outlook

Should Millionaires Pay for Health Care Reform?

By Alan D. Viard

By increasing marginal tax rates at high income levels, the millionaire surtax in the House health care reform bill would promote tax avoidance and impede saving and investment, reducing wages throughout the economy. Taxing a mere 0.3 percent of the population is not a sustainable way to pay for health care reform.

On November 7, 2009, the House of Representatives passed the Affordable Health Care for America Act. The bill would increase health coverage by expanding Medicaid, providing subsidies to moderate-income households, creating exchanges through which individuals may purchase health insurance, and other measures. To help pay for these new programs, the bill would impose a new 5.4 percent surtax on households with very high incomes, including married couples with incomes above $1 million.

The proposed millionaire surtax is politically attractive because its direct burden would fall on a small group—about 0.3 percent of the population—that is extremely wealthy and can easily afford an additional tax. For three reasons, however, the surtax would be bad tax policy.

First, significantly increasing marginal tax rates for the affected households would strengthen their incentives to reduce their taxable income through various avoidance strategies. As a result, the revenue raised by the surtax would be significantly smaller than the burden it would impose on the affected households.

Alan D. Viard (aviard@aei.org) is a resident scholar at AEI. A longer version of this *Outlook* appeared in *Tax Notes* on December 21, 2009.

Second, the surtax would increase tax rates on saving and investment for high-income households that account for a large portion of national saving. The resulting drag on capital accumulation would decrease real wages throughout the economy.

Third, the proposed surtax reflects an unsustainable approach to tax and fiscal policy. As commentators across the political spectrum have recognized, the existing fiscal imbalance cannot be addressed without imposing sacrifices on a broad segment of the population. New spending programs will impose additional burdens. By linking new programs to a tax imposed on 0.3 percent of the population, the House bill obscures that

Key points in this *Outlook*:

- The millionaire surtax in the House health care bill would raise marginal tax rates and encourage tax avoidance, limiting its revenue yield.
- The surtax would penalize saving and investment.
- The surtax is an unsustainable way to pay for major new spending programs because it would fall on only 0.3 percent of the population.

fiscal reality. If health care reform is worthwhile, it is worth paying for in a broad-based manner.

Proposed Surtax

Under the House bill, the surtax would take effect in 2011. It would equal 5.4 percent of any income a taxpayer earned above thresholds of $1 million for married couples filing joint returns and $500,000 for unmarried taxpayers. In computing income subject to the surtax, taxpayers would not be allowed to claim itemized deductions, except for investment interest expenses. (A household subject to the surtax that earned an additional $1,000 of income and spent all of it on deductible charitable contributions would still owe $54 surtax on that income.) The surtax would apply to capital gains and dividends, as well as ordinary income.

Internal Revenue Service data show that in 2007 roughly 0.35 percent of all income tax returns reported income exceeding the thresholds of the proposed surtax.[1] Because some households do not file tax returns, the group probably comprised about 0.3 percent of the overall population. Reflecting recent increases in income inequality, this small group earned a healthy 16.9 percent of the nation's income in 2007. Their share of the income tax burden was even greater; in 2007, they paid 29.2 percent of the nation's individual income taxes. Still, after paying $658,000 in income tax on an income of $2,971,000, the average household in this group cleared a tidy $2,313,000. It is safe to say that paying the surtax would not drive any of these households into destitution.

The House bill does not provide for inflation adjustments for the surtax thresholds. Unless Congress increased the thresholds in future years, the surtax would gradually spread to a somewhat larger and less affluent group. For the foreseeable future, though, the surtax would remain confined to a narrow group of wealthy taxpayers.

At first glance, it may seem desirable to target this small and wealthy group for additional taxes, but closer examination reveals the flaws in this approach. To begin, the revenue from the surtax would fall short of the burden that it would impose on the affected taxpayers.

> The proposed surtax reflects an unsustainable approach to tax and fiscal policy. The existing fiscal imbalance cannot be addressed without imposing sacrifices on a broad segment of the population.

Revenue and Burden

A central tenet of public finance economics is that a tax usually imposes a greater dollar burden on a taxpayer than the government raises in revenue. The additional burden on the taxpayer, beyond the revenue collected, is referred to as excess burden. Excess burden arises when taxpayers change their behavior to avoid the tax. Although the change in behavior burdens taxpayers, it does not result in revenue for the government.[2]

For example, consider a consumer who, in the absence of tax, buys one hundred widgets for $10 each. When a $2 tax raises the price to $12, the consumer buys only eighty widgets, so tax revenue is $160. That $160 payment is clearly a burden on the consumer. However, the consumer suffers an additional burden because she purchases twenty fewer widgets. To the consumer, each of those widgets was worth at least $10 (because she purchased them at the $10 price), but no more than $12 (because she did not purchase them at the $12 price). In the no-tax situation, therefore, the consumer received a net gain of at least zero but no more than $2, by buying each of the twenty widgets at the $10 price. Assuming a $1 average net gain, the loss of the twenty widgets imposes a $20 excess burden above and beyond the $160 tax payment.

Excess burden is greater when the taxpayer's behavior is more sensitive to incentives. If a taxpayer does not change behavior at all in response to the incentives created by a tax, the tax has no excess burden. The excess burden from income taxes, including the surtax, depends on the extent to which income tax incentives change behavior.

To measure the excess burden of income taxation properly, it is necessary to look at all of the behavioral changes the tax may cause. Some analysts focus on the fact that income taxation reduces the incentive to work additional hours and attempt to measure the excess burden that arises when people respond to that disincentive. They often find that income taxation has only a modest effect on hours worked and therefore conclude that income taxes have little excess burden. As Martin S. Feldstein has observed, however, income taxes give people incentives to reduce their taxable

income through many means other than a reduction in hours worked. For example, income taxes give people incentives to hold tax-exempt municipal bonds rather than taxable bonds, to receive fringe benefits rather than cash wages, and to engage in tax shelters. Even if income taxes have little effect on hours worked, they may still create a substantial excess burden by changing behavior in other ways.[3]

Recent statistical studies have focused on estimating the overall responsiveness of taxable income to changes in income tax rates. Although estimates vary widely, many studies find significant responsiveness to tax rates among high-income taxpayers.[4] I chose a middle-ground value of the estimated responsiveness from these studies to construct a simple example illustrating the excess burden and revenue gained from the surtax.[5]

The surtax would reduce investment incentives for firms throughout the economy, whether big or small, corporate or noncorporate.

I consider a married couple that, in the absence of the surtax, would have an income of $3.5 million in 2011, including $1.5 million of capital gains and dividends. (These are average values for married couples with incomes above $1 million in 2007.) If there were no behavioral changes, the surtax would raise $135,000 in revenue, which is 5.4 percent of the $2.5 million of income that exceeds the threshold.

Without the surtax, the couple would face a marginal tax rate of 43.8 percent on ordinary income, where the rate includes state income taxes and the effects of a provision that phases out itemized deductions at high income levels. They would also face a 24.2 percent tax rate on capital gains and dividends.[6] The 5.4 percent surtax would increase these tax rates to 49.2 percent and 29.6 percent, respectively.

Based on the aforementioned middle-ground estimate, the surtax would prompt the household to reduce its ordinary income by 4.93 percent and its capital gains and dividends by 3.63 percent. As a result, the surtax would yield a net (federal and state) revenue gain of only $70,425, a mere 52 percent of the $135,000 revenue gain that would have occurred with no behavioral changes. Because the surtax would impose a total burden of $130,902 on the couple (when both the tax payment and the cost of the income reduction are taken into account), the couple incurs an excess burden of $60,477, which is almost as large as the revenue gain.[7]

The ratio of excess burden to revenue would be higher for the surtax than for broader tax increases for three reasons. First, the taxpayers subject to the surtax already face a high marginal tax rate (on ordinary income), which magnifies the excess burden from any further increase. Second, the surtax would apply only to income above a threshold, which diminishes the revenue gain. Third, the high-income taxpayers subject to the surtax are more likely than other taxpayers to change their behavior in response to tax incentives.

This analysis illustrates the perennial trade-off between efficiency and distributional concerns. Although the surtax would impose a high burden per dollar of revenue, that burden would fall on a very wealthy group. One could make the case that the surtax is appropriate on distributional grounds, despite its economic inefficiency, but such a conclusion would be premature without considering the impact the surtax would have on saving and capital accumulation.

Saving and Capital Accumulation

The above analysis would be essentially complete if the surtax applied only to labor income or consumption because in that scenario there would not be an increase in taxation of returns to saving. The health care reform bill passed by the Senate on December 24, 2009, would increase the Medicare tax by 0.9 percentage points for single workers with earnings above $200,000 and married couples with earnings above $250,000; the above analysis would generally apply to that proposal because the Medicare tax is largely confined to labor income.[8]

In contrast, the proposed surtax in the House bill would apply to capital income as well as labor income. Because taxpayers subject to the surtax earn a large part of the nation's capital income, the surtax would have significant implications for capital accumulation.

It is sometimes argued that tax rates on high-income taxpayers have little impact on noncorporate investment because relatively few owners of noncorporate firms have high incomes.[9] The relevant factor, however, is the volume of investment and income, not the number of firms or owners. In 2007, tax returns from households with incomes greater than $1 million reported 29 percent of all interest income, 35 percent of all dividends, 37 percent of all net noncorporate business income, and 64 percent of all net capital gains. Including unmarried taxpayers with incomes between $500,000 and

$1 million (who would also be subject to the surtax) would further boost these percentages. The surtax would, therefore, be levied on a large fraction of saving and investment.

Political rhetoric has tended to focus on how the surtax would affect investment by small noncorporate businesses. When the surtax was proposed, the president of the U.S. Chamber of Commerce complained that the "real victims would be America's small business owners," and a leading House Republican commented that the surtax would fall on the "small business men and women we are counting on to start hiring workers again."[10] As Amy Roden and I noted in a previous *Tax Policy Outlook*, political rhetoric and policy initiatives often focus on small business to the exclusion of big business, although firms of all sizes contribute to the prosperity of the American economy.[11]

In reality, the surtax would reduce investment incentives for firms throughout the economy, whether big or small, corporate or noncorporate. The effects would be far-reaching because the surtax would apply to all forms of capital income, including dividends, interest, capital gains, and noncorporate business income. Regardless of whether a corporate or noncorporate firm made an investment and regardless of whether it was financed by issuing stock, retaining earnings, or issuing debt, the investment payoff would give rise to some type of capital income subject to the surtax.

Taxing capital income is distortionary because it imposes a penalty on future consumption relative to current consumption. Economic analysis suggests that the optimal tax rate on capital income, even taking distributional and revenue concerns into account, is probably close to zero.[12] The surtax would, therefore, move the tax system further away from the optimum.

Any saving reduction caused by the surtax would have ramifications throughout the economy. Although part of the reduction would take the form of reduced holdings of foreign assets, much of it would show up as a smaller U.S. capital stock, which would make workers less productive and drive down real wages. Statistical estimation of the impact of tax rates on saving is difficult, but simulations suggest that the impact could be significant. For example, simulations reported by the Treasury Department Office of Tax Analysis in 2006 found that extending the 2003 dividend and capital gains tax cuts would increase long-run real gross national product by 0.2 to 0.5 percent, depending on the economic assumptions and how the extension was financed.[13] As I noted in a previous *Tax Policy Outlook*, the estimates in the Treasury study imply that real wages would rise by as much as, or more than, the revenue loss from extending the tax cuts.[14] The effects of raising the tax rate on dividends and gains, as the surtax would do, obviously go in the opposite direction.

A financing mechanism that is broader and less distortionary than the surtax is necessary on both political and economic grounds.

Given the effects on saving and capital accumulation, it is hard to defend the surtax as good policy. Other considerations provide further grounds for opposition.

Limits of Taxing the Wealthy

As I have noted elsewhere, the amount of revenue that can be raised from taxing only the top 2 or 3 or 5 percent of the income distribution is limited.[15] The point applies all the more strongly to the even smaller group targeted by the proposed surtax.

A wide range of analysts across the political spectrum have reached similar conclusions.[16] There is a broad consensus that taxes cannot be raised *solely* on the very rich, even among those who believe that taxes should be raised on that group. Fiscal burdens will eventually have to be imposed on the middle class, and any new spending program will ultimately add to that burden. Linking a major spending program, such as health care reform, to taxes on a small group of wealthy people hides that reality.

A number of commentators have recognized the need for broader financing for health care reform. Leonard Burman, former director of the Urban-Brookings Tax Policy Center, recently noted that Social Security and Medicare Part A are financed by broad-based payroll and self-employment taxes, giving all Americans a vested interest in the programs, and urged that the same philosophy apply to health care reform.[17] *Tax Notes* columnist Joseph J. Thorndike recently commented, "When you ask a small minority to pick up the tab for the vast majority, you implicitly devalue the program. . . . If Congress decides to finance a mass program with a class tax, it will have built a grand edifice on a shaky political foundation."[18]

Although the surtax is bad policy, this failing should be placed in perspective. This would not be the first time the federal government has expanded health care spending without proper attention to financing. In 2003, Congress

and President George W. Bush enacted a Medicare prescription drug benefit without any offsetting spending cuts or tax increases, adding to the deficit and burdening future taxpayers. By providing budgetary offsets, however imperfect, President Barack Obama and congressional Democrats have chosen a more courageous and responsible path than their predecessors, and they deserve considerable credit for doing so. Nevertheless, a financing mechanism that is broader and less distortionary than the surtax is necessary on both political and economic grounds.

Conclusion

The millionaire surtax in the House health care bill is politically attractive because it would apply to only a small group of very wealthy households. Unfortunately, it would raise marginal tax rates, spur tax avoidance, hamper saving and investment, and reduce real wages throughout the economy.

Attempting to impose the costs of a major new federal program on a mere 0.3 percent of the population is ill-conceived and unsustainable. If we decide that health care reform is worth doing, we should decide to pay for it in a broad-based manner.

Notes

1. The data can be found at Internal Revenue Service, "Individual Tax Statistics," available at www.irs.gov/taxstats/indtaxstats (accessed January 8, 2010). These data are summarized by Justin Bryan, "Individual Income Tax Returns, 2007," *Statistics of Income Bulletin* (Fall 2009): 5–69. The income data refer to adjusted gross income.

2. Excess burden is a staple of public finance textbooks. See, for example, Harvey S. Rosen and Ted Gayer, *Public Finance*, 9th ed. (New York: McGraw-Hill, Irwin, 2010), 329–41.

3. Martin S. Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *Review of Economics and Statistics* 81, no. 4 (November 1999): 674–80.

4. I discuss the evidence at somewhat greater length in the longer version of this *Outlook*. See Alan D. Viard, "The Case against the Millionaire Surtax," *Tax Notes* (December 21, 2009): 1355–62, available at www.aei.org/article/101464. I draw primarily on two recent surveys of the evidence: Seth H. Giertz, "The Elasticity of Taxable Income: Influences on Economic Efficiency and Tax Revenues, and Implications for Tax Policy," in *Tax Policy Lessons from the 2000s*, ed. Alan D. Viard (Washington, DC: AEI Press, 2009), 101–36, available at www.aei.org/book/975; and Emmanuel Saez, Joel B. Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review" (Working Paper 15012, National Bureau of Economic Research, Cambridge, MA, May 2009).

5. I assume that reported income has an elasticity of 0.5 with respect to one minus the tax rate. For further discussion, see the longer version of this *Outlook*, Alan D. Viard, "The Case against the Millionaire Surtax."

6. I assume that, in 2011 and thereafter, without the surtax, the dividend tax rate will be 20 percent, as proposed by President Barack Obama, rather than the 39.6 percent rate scheduled to take effect under current law. Further details about the tax rates may be found in the longer version of this *Outlook*, Alan D. Viard, "The Case against the Millionaire Surtax."

7. As implied by economic principles, the total burden is close to, but a little smaller than, the $135,000 revenue gain that would occur if taxpayers did not change their behavior in response to the tax. Further details of the computation are in the longer version of this *Outlook* and are available from the author upon request. See Alan D. Viard, "The Case against the Millionaire Surtax."

8. The Medicare tax applies to some capital income of the self-employed.

9. Senate Finance Committee, "Testimony of Robert Greenstein, Executive Director, Center on Budget and Policy Priorities," 111th Cong., 1st sess., March 26, 2009, 6, available at http://finance.senate.gov/hearings/testimony/2009test/032609bgtest.pdf (accessed January 8, 2010). In his testimony, Greenstein notes that only 2.2 percent of small business owners are in the top two brackets.

10. Thomas Donohue of the Chamber of Commerce and Representative Eric Cantor (R-Va.) in Ryan J. Donmoyer and Kristin Jensen, "House Plans to Tax Millionaires to Fund Health Care (Update 1)," Bloomberg.com, July 15, 2009, available at www.bloomberg.com/apps/news?pid=20601087&sid=aUVZeh_GVBYM (accessed January 8, 2010).

11. Alan D. Viard and Amy Roden, "Big Business: The Other Engine of Economic Growth," AEI *Tax Policy Outlook*, no. 1 (June 2009), available at www.aei.org/outlook/100051.

12. See N. Gregory Mankiw, Matthew N. Weinzerel, and Danny Yagan, "Optimal Taxation in Theory and Practice," *Journal of Economic Perspectives* 23, no. 4 (Fall 2009): 167–68; David Weisbach, "Comment," in *Taxing Capital Income*, ed. Henry J. Aaron, Leonard J. Burman, and C. Eugene Steuerle (Washington, DC: Urban Institute Press, 2007), 143–51; Louis Kaplow, *The Theory of Taxation and Public Economics* (Princeton: Princeton University Press, 2008), 221–35; and Joseph Bankman

and David A. Weisbach, “The Superiority of an Ideal Consumption Tax over an Ideal Income Tax,” *Stanford Law Review* 58, no. 5 (March 2006): 1413–56.

13. Office of Tax Analysis, U.S. Department of the Treasury, *A Dynamic Analysis of Permanent Extension of the President's Tax Relief*, 109th Cong., 2nd sess. (Washington, DC, July 25, 2006), available at http://treasury.gov/press/releases/reports/treasurydynamicanalysisreporjjuly252006.pdf (accessed January 8, 2010).

14. Alan D. Viard, “The Trouble with Taxing Those at the Top,” AEI *Tax Policy Outlook*, no. 2 (June 2007): 6–7, available at www.aei.org/outlook/26354.

15. Alan D. Viard, “Four Long-Term Fiscal Realities,” *Business Economics* 44, no. 3 (July 2009): 146, available at www.aei.org/article/100962; and Alan D. Viard, “Denying the Obvious: The Limits of Taxing the Top 3 Percent,” Enterprise Blog, September 8, 2009, available at http://blog.american.com/?p=4619.

16. Henry J. Aaron and Isabel V. Sawhill, “Bend the Revenue Curve; Health Reform Alone Won't End Deficits,” *Washington Post*, October 13, 2009; “Once and Future Taxes,” *New York Times*, September 4, 2009; “The Deep-Pockets Mirage: House Democrats Would Have Us Believe That the Rich Can Pay for It All,” *Washington Post*, July 15, 2009; Paul Krugman, “Climate of Change,” *New York Times*, February 27, 2009; Steven Pearlstein, “Tax Fantasies of the Right and Left,” *Washington Post*, April 17, 2009; David Leonhardt, “The Upside of Paying More Taxes,” *New York Times*, February 25, 2009; and Joseph J. Thorndike, “What You Can't See Might Hurt You,” *Tax Notes* 122, no. 13 (March 30, 2009): 1527.

17. Leonard Burman in Jackie Calmes, “Obama's Pledge to Tax Only the Rich Can't Pay for Everything, Analysts Say,” *New York Times*, August 11, 2009.

18. Quoted in “The Tragedy of the Move to a Surtax,” *Tax Notes* 124, no. 5 (August 3, 2009): 418.