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TAX INCREASES WOULD DAMAGE THE ECONOMY

Introduction. Federal policymakers have recently floated a number of proposals to levy new taxes or to increase existing taxes. These include:

- higher individual income tax rates,
- higher tax rates on capital gains and dividends,
- an income tax surcharge on upper income households,
- removal of the earnings cap on payroll taxes for OASDI benefits (i.e., Social Security pensions),
- eliminating the tax treatment of carried interests as capital gains,
- higher motor vehicle fuel taxes, and
- a new tax on the carbon content of energy.

However, these tax proposals are not paired with significant spending reductions. Instead, many are combined with plans for new spending. It is doubtful whether these proposals should be considered as deficit reduction measures.

Moreover, the tax relief provisions enacted in 2001 and 2003 are currently scheduled to expire on December 31, 2010. These include:

- the reduction in individual income tax rates from a range of 15 percent to 39.6 percent to a range of 10 percent to 36 percent,
- the $1,000 per child tax credit,
- the 15 percent tax rate on long-term capital gains and dividends,
- marriage tax penalty relief, and
- the "death" tax phase-out.

Imposing tax increases at this time, whether through legislation or the failure to renew expiring tax relief provisions, may slow real GDP growth in an economy that has already been weakened by the bursting of housing bubble, the meltdown of the subprime residential mortgage loan market, and high oil prices. Over the next several quarters, real investment in housing may decrease, and a negative wealth effect due to declining housing prices may dampen real growth in consumer spending.

Any significant increase in the marginal tax rates for either households or businesses at this time may slow the growth of business investment in new structures, equipment, and software and may exacerbate any weakness in consumer spending. Hence, tax increases at this time would counteract the monetary easing by the Federal Reserve and could push the U.S. economy into an otherwise avoidable recession.

Macroeconomic effects of higher taxes in the aggregate. Recent research has found that higher federal taxes may significantly reduce real GDP during the following three years. Christina Romer and David Romer (2007) examined the macroeconomic effects of all U.S. tax changes from 1947 to 2006.[1] Using official records, the authors classified all tax changes by their primary purpose into two categories: endogenous and exogenous. Endogenous changes were intended to maintain or restore normal economic growth. These include tax increases to pay for specific programs[2] and short-term countercyclical tax changes.[3]

In contrast, exogenous tax changes were intended to stimulate long-term economic growth or to reduce inherited federal budget deficits.[4] By separating tax changes into endogenous and exogenous categories, Romer and Romer obtained a more accurate estimate of the macroeconomic effects of any given tax change expressed as a percent of GDP. The authors found:

- "[Exogenous] tax increases appear to have a very large, sustained, and highly significant negative impact on output … [exogenous] tax cuts have very large and persistent positive effects on output."[5] An exogenous tax increase equal to one percent of GDP caused a decline in GDP over the next ten quarters to a maximum of 3 percent below the baseline before leveling out.[6]
- Most of this reduction in GDP occurs because of a decline in investment. "In response to a tax

increase of one percent of GDP, the maximum fall in personal consumption expenditures is 2.6 percent, just slightly less than the maximum fall in GDP. The maximum fall in gross private investment is 12.6 percent."[7]

Romer and Romer subdivided exogenous changes into tax reductions to stimulate long-term growth and tax increases to reduce an inherited budget deficit. Tax reductions for long-term stimulation have similar effects to exogenous changes as a whole. In contrast, "output does not fall at all following deficit-driven tax increases."[8] However, there were too few examples of tax increases for deficit reduction to calculate their effects precisely.

"Deficit reduction packages … often include at least some small cuts in spending."[9] Accompanying spending reductions may signal that additional tax receipts will actually be used to reduce budget deficits rather than to boost spending. Thus, deficit reduction packages may have beneficial effects on output through expectations concerning long-term real interest rates that can offset the negative effects that higher taxes and lower spending would otherwise have on output.

Tax increases for deficit reduction raise gross private investment over the first three quarters, but this effect declines over the next seven quarters. Housing investment is more responsive than business investment. Consumer spending on durable goods increases, while consumer spending on non-durable goods and services declines. This pattern suggests that household expectations may improve and real long-term interest rates (to which housing investment is particularly sensitive) may fall in response to tax increases for deficit reduction.[10]

High economic costs from existing federal taxes. Existing federal taxes already impose a large burden on the U.S. economy. In fiscal year 2006, federal revenues were $2.4 trillion (equal to 18.4 percent of GDP). However, the federal tax system imposes other costs on the U.S. economy above and beyond the amount of federal tax receipts collected. These costs arise from three sources:

1. **Administrative costs** are the expenses that the U.S. government incurs in devising, administering, and enforcing its tax laws. In fiscal year 2006, the Internal Revenue Service spent $10.7 billion, or 0.5 percent of federal tax receipts.
2. **Compliance costs** are the value of time and the out-of-pocket expenses that individuals and businesses must shoulder to learn tax requirements, keep records, and prepare returns, including accounting and legal fees. In 1999, compliance costs were estimated to be $100 billion, or about 9.4 percent of federal income tax receipts.[11]
3. **Excess burden of taxation**. Excess burden or deadweight loss is the reduction in potential output or economic welfare that occurs when taxes distort behavior. High marginal tax rates:
   - discourage individuals from working and businesses from undertaking investments that would increase GDP;
   - cause individuals and businesses to arrange their transactions in ways that minimize tax payments even though these arrangements may reduce GDP; and
   - prompt individuals to increase their consumption of less valuable goods and services that are tax-preferred instead of more valuable goods and services that are taxed.

Examining data before and after the Tax Reform Act of 1986, Feldstein calculated the economic effects of a 1-percentage point increase in all federal income tax rates. Under static modeling, this hypothetical tax increase would generate $7.5 billion in federal revenue. However, Feldstein estimated that it would net only $4.6 billion, or 57 percent of the static amount, after taking into account the excess burden of this tax increase on the economy. The marginal increase in the excess burden is $3.5 billion, or 76 percent of the $4.6 billion net gain in tax revenue. Thus, the actual cost of a new dollar of federal spending in this example is $1.76 ($4.6 billion of additional spending financed by an equal amount of new taxes really costs the economy $8.1 billion in taxes and lost potential GDP).[12]

Effects of different types of tax increases. Whether endogenous or exogenous, previous research has found that the elasticity of labor, investment, saving, and consumption with respect to after-tax return (cost) varies widely. Thus, the

marginal excess burden of each type of tax differs substantially.[13] Alternative tax increases designed to raise the same amount of receipts can have significantly different effects on output. For example:

- Private business investment in non-residential fixed assets is very responsive to expected after-tax returns. The after-tax return is affected by the marginal individual income tax rates, the marginal corporate income tax rate, tax depreciation schedules, investment tax credits, and marginal tax rates on dividends and capital gains.[14]
- Households may choose when to sell their assets. The realization of capital gains is very responsive to changes in the marginal tax rate on capital gains.

If the goal of the federal tax system is to raise a given amount of receipts with the smallest negative effect on output (i.e., minimize the excess burden of taxation given the desired level of revenue), then policymakers should concentrate taxes on economic activities that have a low responsiveness with respect to their after-tax rate of return. Of course, policymakers may have other objectives in designing taxes. These include the "ability to pay" principle, the desire to link certain benefits and taxes, simplicity and ease of collection, and concerns about the after-tax distribution of income and wealth among households.

However, many of the proposed tax increases that have been recently floated are precisely those types of tax changes that previous research suggests are the most damaging to future economic growth by increasing the marginal tax rate on economic activities that are the most responsive to changes in the after-tax rate of return. These include:

- higher individual income tax rates,
- higher tax rates on capital gains and dividends,
- an income tax surcharge on upper income households, and
- removal of the earnings cap on payroll taxes for OASDI benefits.

Conclusion. The bursting of the housing bubble and the meltdown in the subprime residential mortgage loan market may weaken real GDP growth over the next several quarters. Some policymakers have recent floated proposals to levy new taxes or increase existing taxes.

Recent research suggests that exogenous tax increases are very damaging to economic growth. Moreover, many of the ideas floated for raising taxes are precisely the types of tax increases that are likely to have most damaging effects on GDP for each dollar in new receipts.

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[1] Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," National Bureau of Economic Research Working Paper 13264 (July 2007). Found at: http://www.nber.org/papers/w13264.

[2] For example, enactment of the motor vehicle fuel tax to pay for the interstate highway system and a number of increases in payroll taxes to pay higher OASDI benefits before they were indexed for inflation.

[3] For example, the surtax in 1968 and the tax rebate in 1975.

[4] The pro-growth tax reductions include the Kennedy-Johnson Revenue Act of 1964, the Reagan Economic Recovery Tax Act of 1981, the Bush (43) Economic Growth and Tax Relief Reconciliation Act of 2001, and Jobs and Growth Tax Relief Reconciliation Act of 2003. The deficit reduction tax increases include the Bush (41) Omnibus Budget Reconciliation Act of 1990 and the Clinton Omnibus Budget Reconciliation Act of 1993.

[5] Romer and Romer, 20.

[6] Ibid., 19.

[7] Ibid., 38.

[8] Ibid., 22.

[9] Ibid., 23.

[10] Ibid., 40-41.

[11] Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform* (Cambridge, Massachusetts: MIT Press, 2000): 137.

[12] Martin Feldstein, *The Effect of Taxes on Growth and Efficiency*, NBER Working Paper 12201 (May 2006).

[13] Charles Ballard, John B. Shoven, and John Whalley (1985) found that while the average excess burden across all taxes of raising extra revenue was 33.2 percent, the marginal excess burden from specific taxes ranged from 11.5 percent to 46.3 percent. Charles Ballard, John B. Shoven and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review* 75 (March 1985).

[14] For a discussion, see: Robert P. O'Quinn, *Federal Individual Income Taxes and Investment: Examining the Empirical Evidence*, prepared for the Joint Economic Committee, 107th Cong., 2nd sess. (June 2002).