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Simulating the Economic Effects of Obama's Tax Plan

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As a follow-up to the Tax Foundation's recent assessment of the macroeconomic effects of Governor Mitt Romney's tax plan, we now turn our attention to measuring the macroeconomic effects of President Barack Obama's tax proposals.

The first part of this paper discusses the economic and distributional effects of the president's proposals to sunset the Bush-era tax rates for high-income taxpayers. Next, we present the results of our modeling of the two largest tax increases in the Affordable Care Act (ACA), which will become effective in 2013. We then analyze the president's corporate tax proposals as outlined in the White House's *Framework for Business Tax Reform*.

The Economic Impact of Obama's Individual Income and Estate Tax Plan

We modeled the following elements of the president's individual income and estate tax proposals, as presented in his 2012 Budget documents, in the following manner:

- Retain the Bush tax cuts for taxpayers in the bottom four tax brackets. This includes keeping the current marginal tax rate levels of 10 percent, 15 percent, 25 percent, and 28 percent, and keeping the capital gains and dividend rate caps of 0 percent for people in the 10 percent and 15 percent brackets, and 15 percent for people in the 25 percent and 28 percent brackets.
- Increase the marginal tax rates in the top two tax brackets from 33 percent to 36 percent and from 35 percent to 39.6 percent.[1]
- Increase the capital gains top rate to 20 percent and let the tax rate on dividends revert to 39.6 percent for people in the top two brackets.[2]

[1] The top brackets for taxable income currently kick in at approximately the President's proposed thresholds of $250,000 in adjusted gross income for joint filers and $200,000 for single filers, at typical levels of itemized deductions. The equivalent dollar amounts for these brackets were lower in 2008 and were run at those levels.

[2] This was approximated by letting both rates rise to 24 percent, which is the weighted average of the two rates given the relative amounts of each realized in the base year.

- Restore the phase-outs of personal exemptions and itemized deductions (the PEP and Pease provisions) for taxpayers with more than $250,000 in AGI (joint filers) and $200,000 (single filers). These typically raise the effective marginal tax rates by about 1 to 4 percent for families of various sizes while their incomes are in the phase-out range, above which rates return to the normal statutory levels.
- Increase the federal estate tax from the current 35 percent top rate with a $5 million exempt amount to the 2009 levels of a 45 percent top rate and a $3.5 million exempt amount.

The simulation was run separately for each provision and for all provisions combined. The results are shown in Table 1. Because of interactions, the separate effects do not necessarily add up to the total effect of all provisions.

The Model Results

We find that President Obama's income and estate tax rate increases fall heavily on the earnings of capital. Capital is the input most sensitive to tax. The higher proposed tax rates render much potential capital formation unaffordable. The capital stock and the economy would experience a reduction in growth as the least profitable capital is either squeezed out of existence or out of the country. The most serious consequence would be slower economic growth, less job creation, and less wage growth. Secondarily, the smaller income gains would reflect back on federal revenues, offsetting much of the revenue growth the president hopes to achieve with the tax increases. State and local budgets would be adversely affected as well.

Table 1: Economic and Federal Budget Effects of Major Tax Proposals in President Obama's Budget

Percent or dollar changes* in:	Combined Obama Budget Tax Proposals	Raise Top Rates on Capital Gains and Dividend	Raise Top Two Tax Rates on High Incomes	Raise Estate Taxes to 2009 Levels	Restore PEP and Pease†
GDP (%)	-2.88%	-2.15%	-0.44%	-0.23%	-0.03%
Private business GDP (%)	-3.01%	-2.23%	-0.48%	-0.24%	-0.03%
Private business stocks (%)**	-7.46%	-5.81%	-0.99%	-0.65%	-0.07%
Wage rate (%)	-2.28%	-1.83%	-0.24%	-0.20%	-0.02%
Business hours worked (%)	-0.75%	-0.41%	-0.23%	-0.04%	-0.01%
Federal revenue (static est., $)	$136.1	$67.8	$37.3	$6.8	$19.1
Federal revenue (dynamic est., $)	$40.5	-$0.7	$23.1	-$0.4	$18.3
Federal spending ($)	-$14.9	-$11.6	-$1.9	-$1.3	-$0.1
Federal deficit (+ = lower deficit, $)	$55.5	$11.0	$25.0	$0.9	$18.4
% Dynamic revenue reflow vs. static est.***	-70.2%	-101.0%	-38.0%	-105.3%	-4.2%
GDP ($)	-$416.3	-$310.0	-$64.2	-$33.6	-$3.7
GDP/$ dynamic tax reduction****	-$10.27	N.A.	-$2.77	N.A.	-$0.20

Note: All dollar figures are in billions of 2008 dollars. The simulation was run separately for each provision, and because of interactions the separate effects do not necessarily add up to the total effect of all provisions.

†PEP and Pease are the phase-outs of personal exemptions and up to 80 percent of itemized deductions for upper-income taxpayers that were in force before the Bush tax cuts.

*These changes represent the cumulative increase or decrease in the permanent *level* of GDP and other variables after all economic adjustments to the tax changes, taking five to ten years. They are not permanent changes in the annual *rates of growth* of the variables. The model and tax calculator were run at 2008 income levels; dollar figures are in 2008 dollars.

**Private business sector equipment, plant, other buildings and structures, inventory, etc.

***Percent of static tax cut recovered (+) due to faster economic growth, or percent of static tax increase lost (-) to slower economic growth.

****Negative numbers indicate the drop in GDP per dollar of increased federal revenue, after dynamic effects. N.A. indicates that the tax rate increase would actually lose revenue due to its adverse effects on the economy.

We estimate that President Obama's tax plan would gradually reduce the level of GDP by nearly 3 percent, relative to the baseline projection, over five to ten years. Labor income would be lower by a similar amount, driven down by fewer hours worked and lower wages per hour. The reduction in hours worked, about 0.75 percent, would be the equivalent of about a million jobs lost in today's economy, with those still employed earning roughly 2.28 percent lower wages. Alternatively, one could view the result as losing four million jobs at unchanged pay levels.

The plan would trim the capital stock by about 7.5 percent (or over $2 trillion in lost investment in plant, equipment, and buildings, things that drive productivity, wages, and hiring).

Three-quarters of the loss in GDP, labor income, and capital formation would come from the rise in the taxes on capital gains and dividends. These would trim GDP by a cumulative 2.2 percent over time, the

capital stock by 5.8 percent, and the wage rate by 1.8 percent.[3] Though of smaller total magnitude, the estate tax increase is equally destructive per dollar of initial tax increase.

After all adjustments, fully 70 percent of the expected static revenue gain from President Obama's plan would be lost due to the dynamic effects of slower economic growth. Revenue gains would be due entirely to the rise in the two top tax rates and the restoration of the PEP and Pease provisions.

Looking at the macroeconomic effects, the proposed increases in the top individual income tax rates would raise about 62 percent of their estimated static revenue gain. About 32 percent would be lost due to their contribution to a weaker economy, a 0.4 percent smaller GDP over the long run. PEP and Pease would lose less because of their weaker impact on production.[4]

The capital gains and dividend tax rate increases would be so economically harmful that they would eventually reduce revenues, when all types of federal taxes are considered. The same is true of the increase in the estate tax. (For more on capital gains, see below.)

The plan would lower the federal budget deficit by only about 40 percent of the estimated static revenue gains. There would be some saving in federal outlays due to lower economy-wide wages. Indeed, about a third of the net deficit decrease would be due to reduced wages and salaries of federal workers and lower costs of procurement. In the case of the capital gains and dividend tax rate hikes, which raise no revenue, all the reduction in the projected deficit is due to reduced federal wages and outlays. (Note, however, that the model does not cover the higher levels of Medicaid, welfare, and unemployment expenses. These items would tend to raise the deficit.)

Lawmakers should also be aware that each dollar of federal spending costs workers several dollars in lost wages and income from saving due to the economic damage from the taxes imposed. For the Obama tax plan as a whole, each $1 of increased government revenue it generates would reduce GDP by more than $10. Some elements of the Obama plan generate even higher costs to the public, reducing incomes and employment with no gain, and even some loss, to the federal budget.

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[3] To be clear, these percentage changes in GDP (and other variables) are the long run differences between the level of GDP in the baseline and the level the GDP will be at after all adjustments to the tax change are completed, about five years for equipment and ten years for buildings and other structures. They are not increases or decreases in the annual rate of growth of the variables. Thus, if the GDP is shown ultimately to be reduced by 2.9 percent by the policy change, the rate of growth of GDP would average about a quarter percentage point slower for about a decade (a bit more in the first half, a bit less in the second half) to build up to the final differential. Once the labor force and capital stock have finished their decline relative to the baseline, annual growth rates would presumably return to normal, but from a lower base.

[4] The adverse incentive effect of PEP and Pease is limited to the range of income over which the exemptions and deductions are phased out. Once a taxpayer has lost all personal exemptions and the full 80 percent of itemized deductions subject to phase-out, his or her effective marginal tax rate reverts to normal levels. Much of the income at these levels exceeds the phase-out ranges.

The lower levels of capital, GDP, and income would take time to develop. It takes about five years to lose all of the additional equipment made unaffordable by the tax increases and about ten years for the full decline in the stock of structures to be achieved. About two-thirds of the reductions in the capital stock would occur within five years. Job losses begin quite quickly, as fewer people are put to work producing machinery and buildings. The depression in employment and wages is sustained in the long term as workers must make do with the smaller amount of capital, and are left less productive on a permanent basis.

Distributional Affects: Losses in After-Tax Income Across the Board

The loss in GDP and incomes from the president's tax plan would be widely shared. Every income group would experience at least a 2.6 percent decrease in after-tax income from reduced wages and earnings on savings.

Regardless of the initial distribution of a tax change, the economic reactions to a tax increase distribute the economic losses (or gains in the event of a tax decrease) across the board. Tax increases on capital formation harm labor by reducing productivity, wages, and employment. Tax decreases on capital raise productivity, wages, and employment. The differences between the static and dynamic consequences of the Obama tax package are displayed below for all income classes.

Table 2: Distribution of Income Effects of the Obama Income and Estate Tax Plan

	Average Change per Return (in 2008 dollars)		Percent Changes	
Adjusted Gross Income Class (2008 dollars)	Static After-Tax Income	Dynamic After-Tax Income	Static After-Tax Income	Dynamic After-Tax Income
< 0	-6	2,606	0.01%	-2.95%
0 - 5,000	0	-75	0.00%	-2.73%
5,000 - 10,000	0	-212	0.00%	-2.64%
10,000 - 20,000	0	-410	0.00%	-2.62%
20,000 - 30,000	0	-665	0.00%	-2.70%
30,000 - 40,000	0	-917	0.00%	-2.76%
40,000 - 50,000	0	-1,148	0.00%	-2.71%
50,000 - 75,000	0	-1,566	0.00%	-2.72%
75,000 - 100,000	0	-2,200	0.00%	-2.73%
100,000 - 150,000	-1	-2,933	0.00%	-2.67%
150,000 - 200,000	-112	-3,837	-0.08%	-2.60%
200,000 - 250,000	-613	-5,161	-0.33%	-2.78%
250,000 - 500,000	-5,266	-11,670	-1.95%	-4.32%
500,000 - 1,000,000	-27,156	-39,941	-5.16%	-7.59%
> 1,000,000	-204,741	-269,723	-7.99%	-10.53%
TOTAL FOR ALL	-681	-1,983	-1.37%	-3.99%

The static changes in after-tax income are due solely to the average initial tax increase per tax return in the upper income classes. The post-economic adjustment decreases in after-tax incomes across-the-board are the sum of the tax increase plus the projected decrease in income due to the slower growth in the economy compared to the baseline (which will also affect the tax due to the government). Low-income taxpayers (those earning less than $50,000) are shown to suffer a roughly $75 to $1,100 decrease in after-tax income

as a result of the tax program, on a dynamic basis, even though these filers face no initial tax cuts on a static basis. For them, nearly all the reductions in income are due to a weaker economy and lower wages and hours worked.

Lawmakers must recognize that the economic impact of raising taxes on the "rich" extend well beyond those high-income taxpayers.

Impact of the Affordable Care Act Tax Increases

The ACA tax increases would further dampen economic activity. The most damaging is the additional 3.8 percent tax on income from savings and investment imposed on taxpayers with AGI in excess of $250,000 (joint returns) and $200,000 (single filers). It would raise the service price of capital and reduce investment. Also damaging would be the introduction of a second tax bracket on the HI (Medicare Part A) tax, adding 0.9 percent to the tax rate on wages and salaries in excess of the same thresholds. That tax would reduce hours worked and entrepreneurial activity.

Table 3: Economic and Budget Changes due to Obama Individual and Estate Tax Proposals and Pending HI and Savings Income Surtax Provisions of the Patient Protection and Affordable Care Act (PPACA)

Percent or dollar changes* in:	Combined	Tax Proposals	PPACA
GDP (%)	-4.10%	-2.88%	-1.23%
Private business GDP (%)	-4.28%	-3.01%	-1.28%
Capital stock (%)**	-10.57%	-7.46%	-3.29%
Wage rate (%)	-3.29%	-2.28%	-1.01%
Business hours worked (%)	-1.03%	-0.75%	-0.27%
Federal revenue (static est., $)	$199.9	$136.1	$63.8
Federal revenue (dynamic est., $)	$60.5	$40.5	$24.6
Federal spending ($)	-$21.4	-$14.9	-$6.5
Federal deficit (+ = lower deficit, $)	$81.9	$55.5	$31.1
% Dynamic revenue reflow vs. static est.***	-69.7%	-70.2%	-61.5%
GDP ($)	-$592.3	-$416.3	-$177.5
GDP/$tax dynamic reduction	-$9.79	-$10.27	-$7.23

Note: All dollar figures are in billions of 2008 dollars. The simulation was run separately for each provision, and because of interactions the separate effects do not necessarily add up to the total effect of all provisions.
*These changes represent the cumulative increase or decrease in the permanent level of GDP and other variables after all economic adjustments to the tax changes, taking five to ten years. They are not permanent changes in the annual rates of growth of the variables. The model and tax calculator were run at 2008 income levels; dollar figures are in 2008 dollars.
**Private business sector equipment, plant, other buildings and structures, inventory, etc.
***Percent of static tax cut recovered (+) due to faster economic growth, or percent of static tax increase lost (-) to slower economic growth.

Table 3 shows the separate and combined effects of the income tax and ACA tax increases on the economy. The ACA taxes would reduce economic output and labor income by an additional 1.3 percent, and would reduce the stock of capital by an additional 3.3 percent. The combined losses would be 4.1 percent of GDP and wages, and 10.6 percent for capital formation. Table 4 shows the distributional effects. After economic adjustments, all income groups would share in the income losses.

Table 4: Distribution of Income Effects of Obama Income and Estate Tax Proposals and PPACA Surtaxes on Wages and Investment Income

	Average Change per Return (in 2008 dollars)		Percent Changes	
Adjusted Gross Income Class (2008 dollars)	Static After-Tax Income	Dynamic After-Tax Income	Static After-Tax Income	Dynamic After-Tax Income
< 0	-11	3,701	0.01%	-4.18%
0 - 5,000	0	-106	0.00%	-3.89%
5,000 - 10,000	0	-302	0.00%	-3.76%
10,000 - 20,000	0	-583	0.00%	-3.74%
20,000 - 30,000	0	-946	0.00%	-3.84%
30,000 - 40,000	0	-1,306	0.00%	-3.92%
40,000 - 50,000	0	-1,636	0.00%	-3.87%
50,000 - 75,000	0	-2,229	0.00%	-3.88%
75,000 - 100,000	0	-3,134	0.00%	-3.89%
100,000 - 150,000	-2	-4,175	0.00%	-3.79%
150,000 - 200,000	-116	-5,422	-0.08%	-3.68%
200,000 - 250,000	-1,145	-7,501	-0.62%	-4.04%
250,000 - 500,000	-9,959	-18,606	-3.69%	-6.90%
500,000 - 1,000,000	-40,218	-57,805	-7.64%	-10.98%
> 1,000,000	-294,775	-383,276	-11.50%	-14.96%
TOTAL FOR ALL	-1,016	-2,852	-2.05%	-5.74%

Assessing the President's Framework for Business Tax Reform

In February, the Obama administration presented a *Framework for Business Tax Reform* that envisioned lowering the corporate tax rate to 28 percent while staying revenue neutral by raising business income taxes in other ways.[5] This study cannot estimate the dynamic effects of the full *Framework* because, although the revenue raisers would probably have large negative effects, their magnitude can only be guessed at since the administration has not specified which ones would actually be in the package and has not provided details on how each would operate. (See below.)

Nonetheless, we offer the following estimate of the effect of including a reduction in the corporate tax rate to 28 percent if it were enacted without the revenue offsets suggested in the *Framework*—that is, if it were a straightforward tax cut. This is the most generous treatment we can give the President's proposals inclusive of the business tax reform.

[5]The White House & Department of the Treasury, *The President's Framework for Business Tax Reform* (Feb. 2012), http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf.

Table 5: Comparison of the Economic and Budget Effects of Obama Tax Proposals With and Without Business Tax Reform

Percent or dollar changes* in:	Obama Individual (a)	Obama indiv. & corp. (b)	Cut Corporate Rate to 28% (c)
GDP (%)	-2.9%	-1.3%	1.6%
Private business GDP (%)	-3.0%	-1.4%	1.7%
Capital stock (%)**	-7.5%	-3.3%	4.5%
Wage rate (%)	-2.3%	-0.9%	1.4%
Business hours worked (%)	-0.7%	-0.4%	0.3%
Federal revenue (static est., $)	$136	$100	-$36
Federal revenue (dynamic est., $)	$41	$57	$14
Federal spending ($)	-$15	-$6	$9
Deficit (+ = reduction, - = increase, $)	$55	$63	$5
% Dynamic revenue reflow vs. static est.***	-70%	-43%	139%
GDP ($)	-$416	-$188	$233
GDP / $ dynamic tax change****	-$10.27	-$3.32	N.A.

Note: All dollar figures are in billions of 2008 dollars. The simulation was run separately for each provision, and because of interactions the separate effects do not necessarily add up to the total effect of all provisions.
(a) The first Obama column displays effects of his proposed increases in individual and estate taxes as presented in the 2012 Federal Budget.
(b) The second Obama column includes the reduction in the corporate tax rate to 28% proposed in the February White House/Treasury Framework For Business Tax Reform, but without the suggested revenue offsets. The offsets, if enacted, would negate the bulk of these benefits from the rate cut. The corprate tax eventually recovers its static revenue cost due to added growth. The economy and the budget would be better served by omitting the offsets.
(c) The effect of the cut in the corporate rate by itself.
*These changes represent the cumulative increase or decrease in the permanent level of GDP and other variables after all economic adjustments to the tax changes, taking five to ten years. They are not permanent changes in the annual rates of growth of the variables. The model and tax calculator were run at 2008 income levels; dollar figures are in 2008 dollars.
**Private business sector equipment, plant, other buildings and structures, inventory, etc.
***Percent of static tax cut recovered (+) due to faster economic growth, or percent of static tax increase lost (-) to slower economic growth.
****Negative numbers indicate the drop in GDP per dollar of increased federal revenue, after dynamic effects. N.A. in the last column indicates that the corporate tax rate cut, by itself, would actually gain revenue due to its positive effects on the economy.

The corporate rate cut would add over 1.6 percent to the GDP and recover its static revenue loss with room to spare. It would reduce the economic damage from the president's individual and estate tax proposals by about 56 percent, while increasing revenues and providing a larger reduction in the deficit. GDP would fall by 1.3 percent off the baseline instead of nearly 3 percent. The deficit would be reduced by $63 billion instead of $55 billion.[6]

[6] The model overstates the impact of corporate tax rate changes and understates the impact of individual tax rate changes due to the inclusion in the corporate sector of the so-called pass-through entities. In the context of the Obama tax plan, it understates the damage done by the individual tax provisions and overstates the offsetting benefits available from reducing the corporate tax rate.

The model uses capital stock data provided by the Bureau of Economic Analysis. BEA combines capital stock and other data for all corporations, lumping together C corporations, S corporations, REITs, and RICs. Only the C corporations are subject to the additional corporate tax rate. The rest are pass-through entities whose earnings are subject only to the individual income tax. The model captures the individual income taxes imposed on the pass-through income, but its service price changes, weighted by the capital stock, are too large in the corporate sector and too small in the non-corporate sector. The pass-throughs have grown as a share of the economy and need to be modeled explicitly. The BEA expects to devote some resources to splitting the pass-through data from the C corporation data in 2014.

The irony is that if the president had merely offered to reduce the corporate tax rate to 28 percent without the offsets and without insisting on revenue neutrality, his plan would have recovered most if not all of the lost revenue. By restricting the offsets to increases in the taxes on capital formation, he ensures that the reform will achieve nothing. A look at the proposed offsets explains why.

The administration has offered a long menu of potential revenue raisers and described them only in general terms. While the lower corporate rate would encourage business investment and entrepreneurial activity, which would positively impact tax revenue, many of the business tax increases on the administration's menu would have negative feedbacks.

The *Framework* insists that the proposals be at least revenue neutral. Indeed, they suggest that certain expiring tax provisions that have been renewed on a temporary basis for some years (such as the R&D tax credit) should be paid for this time around, suggesting a possible $250 billion tax increase. It is very hard to imagine how a static revenue-neutral tax change on capital formation can reduce the cost of adding to the capital stock and improve the economy, let alone a tax increase.

Consider three of the possible business tax increases. Noting that many forms of businesses organization, such as S corporations, partnerships, and sole proprietorships, are not subject to the corporate income tax (income from those businesses is immediately passed through to owners' tax forms, where it is subject to the individual income tax), the administration suggests imposing both the corporate income tax and the individual income tax on some pass-through income. That would certainly broaden the corporate income tax base, but subjecting more business income to two separate income taxes would raise the cost of capital and discourage business activity. It would take a larger reduction in the corporate and individual tax rates than the administration has offered to offset that sort of base broadening.

Another option is not allowing businesses to deduct all their interest costs. That would expand the income tax base by forcing some businesses to understate their expenses and, thereby, overstate their income. That would hurt business activity by raising the cost of debt-financed investment. Business people would demand a higher minimum pretax return before undertaking new business investments in order to compensate for having to pay income tax on phantom income.

A third possibility on the administration's long list is heavier taxation of oil and gas producers and royalty owners, coupled with tax incentives for clean energy. Oil and gas production has been one of the few genuinely bright spots for the U.S. economy in recent years, as people in petroleum producing states like North Dakota can attest. Meanwhile, heavily government-subsidized clean energy projects have been plagued by unmet technological promises, broken job-creation promises, bankruptcies, and charges of government-business cronyism. Forcing capital to move from the development of profitable, traditional energy sources to uneconomical alternative energy sources is value-destroying, not value-adding.

More information would be needed from the administration in order to estimate whether the net impact of the statutory corporate rate cut and the offsetting business tax hikes would be negative, a wash, or positive. We suspect that the outcome would be negative.

Previous Increases in the Taxation of Capital Prove Harmful

Many types of tax changes move revenues in the normal direction predicted by static analysis. Tax rate increases raise revenues; tax rate reductions reduce revenues. They do not alter economic growth and incomes enough to completely offset their projected revenue gains or losses. For example, across-the-board income tax rate reductions recover only about a third of their static revenue losses with additional growth (while adding more than $2 to people's pre-tax incomes for each dollar of revenue loss to the government). Likewise, excise taxes, sales taxes, and payroll taxes are generally not over the revenue-maximizing hump of the Laffer curve.

Nonetheless, some tax reductions (or increases) are unusually effective in raising (lowering) incomes and recovering (losing) revenues. Capital formation is highly sensitive to after-tax earnings. Some tax changes that aim directly at capital formation can trigger enough of a change in the stock of buildings, the amount of equipment, and the hiring of workers to utilize them to come close to, or even more than offset, the initial revenue change. These include reductions in the estate tax and steps that offset some of the double taxation of corporate income, including lower corporate tax rates and lower taxes on capital gains (which hit retained after-tax corporate earnings) and dividends (which are paid out of after-tax corporate earnings). Raising these taxes can often be entirely counter-productive.

One must count revenue from all sources to determine the revenue effect of a particular tax change. For instance, a modestly higher tax rate in the top two tax brackets would probably raise revenue from those taxpayers, although not as much as the static revenue estimates would suggest. (That might not be the case if the rate increases were truly outrageous, as with the recent French rate hike to 75 percent, and if the U.S. were a relatively small nation in a larger economic community to which the afflicted minority could readily flee.) However, the higher tax rates of top earning savers and investors would reduce capital formation and hiring, and would lower wages across-the-board. Federal revenues from payroll and income taxes, corporate taxes, excise taxes, and tariffs would fall as well, adding to the total revenue offset. State and local governments would see as drop in their sales and income tax receipts.

By contrast, the lowering of the capital gains tax rate in 1978, 1981, and 1997 may not only have raised incomes and general revenues, it may also have raised revenues from the capital gains tax itself. The then-existing rates were above the revenue maximizing capital gains tax rate, which appears to be a bit under 10 percent (looking only at capital gains revenues).[7] The reduced rate raised the value of capital (boosting the amount of gains to be reported) and encouraged people to take gains earlier than otherwise. Such a rate cut is one of the few cases where the tax's own revenue may rise with a rate cut.

In the other direction, the increase in the capital gains tax rate in the Tax Reform Act of 1986 resulted in a sharp collapse in realizations. Revenues from the tax plunged both in dollars and as a share of GDP. They

[7] Paul Evans, *The Relationship between Realized Capital Gains and Their Marginal Rate of Taxation, 1976-2004*, IRET DYNAMIC TAX ANALYSIS SERIES: CAPITAL GAINS (Oct. 9, 2009), http://iret.org/pub/CapitalGains-2.pdf.

did not regain their share of GDP until the rate was reduced again in 1997. That is not counting the damage done to capital formation and other revenues. In the Obama plan, the proposed increase in the rate to 20 percent for the top brackets would reduce capital gains collections due to reduced realizations. It would also lower the value of assets, cutting the amount of gains available to be taken. We do not model these effects. They would be in addition to the reduction in other revenues due to reduced economic activity and income, which we do model.

The 1986 Tax Reform Act was designed to be revenue neutral, with many base broadeners that raised taxes on capital income. These base broadeners offset the benefits of the reduction in the corporate tax rate. Taxes on capital income rose to pay for the lower tax rates on labor income and to provide tax credits to address social issues. The result was a slower rate of economic growth in the last third of the decade, damaging revenue collections from many sources in addition to the collapse in tax revenues from capital gains.

Conclusion

Tax Foundation economists measured the economic and distributional effects of all of President Obama's tax proposals: his plan to sunset the Bush-era tax rates for high-income taxpayers; his corporate tax plan; and, the tax changes contained in the Affordable Care Act beginning in 2013. We found that these proposals would lower economic growth while substantially lowering workers' wages and incomes. Ultimately, these tax plans would be very harmful for the nation's long-term economic outlook.

Appendix

The Model

The model is keyed to 2008 levels of income and GDP to utilize an actual set of tax and economic data for the baseline and to produce a picture of the likely effects once we are past the statistical distortions of the recent recession. This model produces a simulation of what the policy change would do to the economy, incomes, and tax revenues after all economic adjustments are given time to work, which is roughly five to ten years. It does not show the annual progression, year by year, from the starting point to the final outcome, but most of the effects occur within five years.

The model is neo-classical; its projections are derived from tax-driven changes in the quantity of capital and labor offered to the market and used to produce output within the United States. They do not include any additional behavior changes to avoid the higher taxes, such as a slowdown in the rate of realization of capital gains or reductions in dividend payments, nor any reduction in R&D or the rate of technological advance as a result of the initial reduction in the after-tax returns to investment.[8]

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[8] The model is described in more detail in our paper on the Romney tax proposals. *See* Stephen Entin & William McBride, *Simulating the Economic Effects of Romney's Tax Plan*, TAX FOUNDATION FISCAL FACT NO. 330 (Oct. 3, 2012), http://taxfoundation.org/article/simulating-economic-effects-romneys-tax-plan.