

# Background

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## Income Tax Will Become More Progressive Under Obama Tax Plan

*Curtis S. Dubay*

Today's federal income tax system is highly progressive, with taxpayers at the top of the income spectrum paying higher rates than those in the middle and bottom. The current tax code has six tax brackets with rates ranging from 10 percent (for taxable income up to \$16,700) to 35 percent (for taxable income above \$372,950 for married couples).

President Barack Obama's budget and the budget resolution adopted by Congress<sup>1</sup> would further increase progressivity by raising the tax rates of married couples who earn more than \$250,000 a year and singles who earn more than \$200,000.

Progressivity discourages hard work, savings, investing, and entrepreneurship. Discouraging these catalysts of economic growth is always counterproductive, but doing so during a severe economic recession is particularly irresponsible.

To make the tax code less progressive and encourage economic growth, Congress should scrap plans to increase tax rates on top earners and instead reduce the number of brackets and lower the rates on those that remain.

### Income Tax Highly Disproportionate

A decreasing number of high-income taxpayers are increasingly paying the entire income tax bill.<sup>2</sup> According to the Congressional Budget Office (CBO), the top 20 percent of all income earners paid 86.3 percent of all income taxes in 2006.<sup>3</sup> This was an all-time high and significantly higher than in 2000, before the 2001 and 2003 tax cuts went into effect.<sup>4</sup>

### Talking Points

- Today's progressive tax code has six brackets with rates ranging from 10 percent to 35 percent.
- President Obama's budget and Congress's budget resolution would further increase progressivity by raising tax rates for married couples who earn more than \$250,000 a year and singles who earn more than \$200,000.
- Discouraging hard work, savings, investment, and entrepreneurship is always counterproductive, but it is especially irresponsible during a severe economic recession.
- Increasing tax progressivity threatens to further stifle economic growth. A code more in line with the flat tax is necessary to remove the barriers to entrepreneurship and innovation.
- Under a flatter tax system, those who earn more still pay more in taxes than those who earn less, but that difference will be proportional to income.
- Instead of following liberal orthodoxy, President Obama and Congress should look to the flat tax for inspiration.

This paper, in its entirety, can be found at:  
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The drastically progressive income tax code means that high-income taxpayers pay disproportionately higher taxes compared to lower-income

taxpayers. Take the average family of four, which qualified for the top quintile of income earners if it earned at least \$142,000 in 2006 (the most recent year for which data are available). For 2006, the family paid income taxes of \$20,078, and its effective income tax rate—total income taxes paid after deductions and credits divided by income—was 14.1 percent. (See Chart 1.)

A family of four that earned the minimum amount to be included in the second-highest income quintile made \$94,800. Its effective income tax rate was 6.0 percent—less than half the top quintile's rate—and its tax bill was \$5,688.

Even though the family in the top quintile earned 50 percent more than the family in the second quintile, it paid 253 percent more in income taxes. (See Chart 2.)

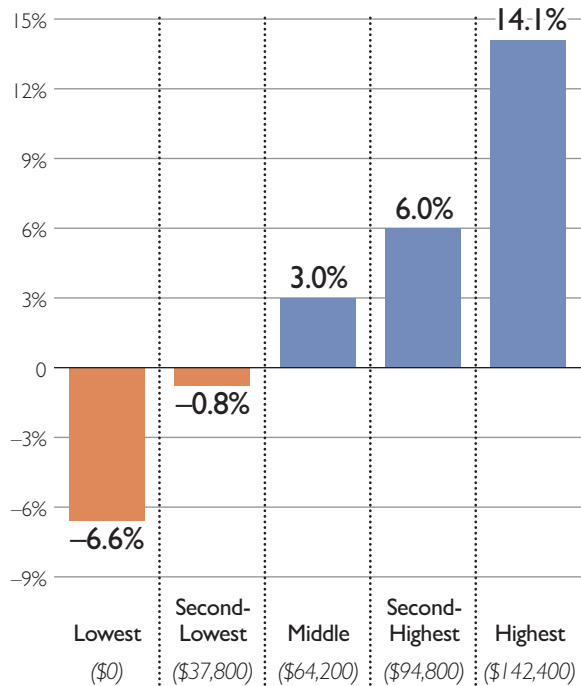
The statistics are even more astounding when one compares a family in the top quintile to families in the middle and lower quintiles. A family of four that earned \$64,200, the minimum amount to be classified as middle income, had an effective income tax rate of 3 percent—almost five times lower than the top quintile's rate—and paid \$1,926 in income taxes.

The family in the top quintile's income was 122 percent higher than the middle-income family's, but they paid a staggering 943 percent more in income taxes.

Compared to the bottom 40 percent of income earners, taxpayers in the top quintile pay much higher taxes because taxpayers in the bottom two quintiles generally pay *no income taxes at all*. In fact, they receive payments through the tax code in the form of “refundable credits.”<sup>5</sup>

### Effective Income Tax Rates in 2006, by Income Group

Figures are for families of four.



Income Quintile, With Minimum Income to Qualify

Congressional Budget Office, “Data on the Distribution of Federal Taxes and Household Income,” April 2009, at <http://www.cbo.gov/publications/collections/taxdistribution.cfm> (May 27, 2009).

Chart 1 • B 2280  [heritage.org](http://heritage.org)

1. Curtis S. Dubay, “2010 Budget Resolution Raises Taxes and Hurts Economic Recovery,” Heritage Foundation *WebMemo* No. 2452, May 18, 2009, at <http://www.heritage.org/Research/Taxes/wm2452.cfm>.
2. “The Top 10 Percent of Income Earners Paid 71 Percent of Federal Income Tax,” 2009 *Federal Revenue and Spending Book of Charts*, The Heritage Foundation, at <http://www.heritage.org/research/features/BudgetChartBook/-Progressive-Taxes-Interactive-Chart.aspx>.
3. All data from Congressional Budget Office, “Data on the Distribution of Federal Taxes and Household Income,” April 2009, at <http://www.cbo.gov/publications/collections/taxdistribution.cfm> (May 8, 2009).
4. Curtis S. Dubay, “The Rich Pay More Taxes: Top 20 Percent Pay Record Share of Income Taxes,” Heritage Foundation *WebMemo* No. 2420, May 4, 2009, at <http://www.heritage.org/Research/Taxes/wm2420.cfm>.
5. Curtis S. Dubay, “Obama’s Stimulus Has ‘Spread the Wealth Around’: Are Tax Hikes Next?” Heritage Foundation *WebMemo* No. 2354, March 23, 2009, at <http://www.heritage.org/Research/Economy/wm2354.cfm>.

The effective income tax rate for a family of four in the bottom quintile that earned up to \$37,800 was -6.6 percent. This means that the average family in this quintile *received* almost \$1,300 in income through the tax code.

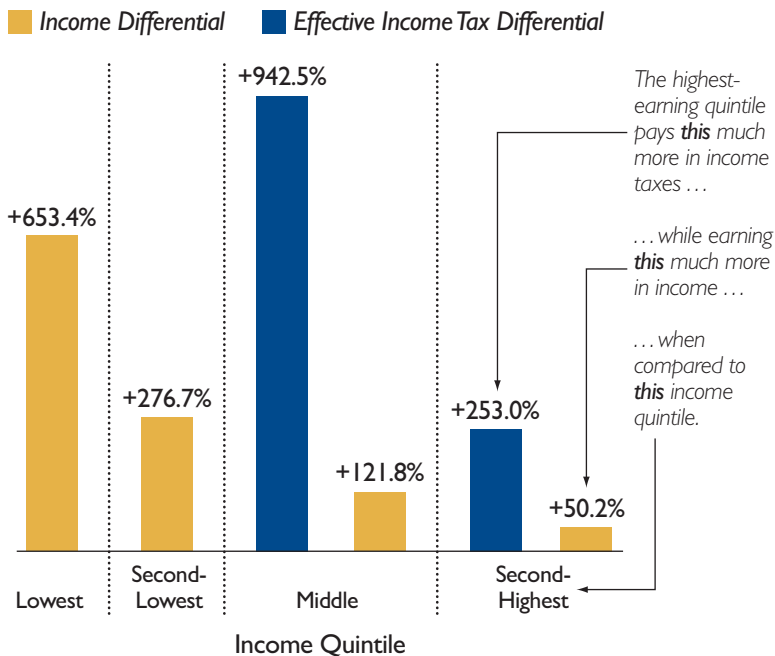
An average family of four in the second-lowest quintile had an effective income tax rate of -0.8 percent. This family earned up to \$64,200 and received an average of \$408 of income through the tax code.

## Top Income Earners Pay a Disproportionate Amount of Taxes

The U.S. tax code is highly progressive, meaning higher income earners lose a higher proportion of their incomes to taxes. In fact, a family in the top quintile earned 50 percent more in 2006 than a family in the second quintile, but it paid 253 percent more in income taxes. The chart below shows how much more the highest-income quintile earns in income and pays in taxes compared to the other income groups.

Comparing the differences in effective tax rates as percentages between the highest-earning quintile and the two lowest-income quintiles is not possible because the two lowest-income quintiles have negative effective tax rates, meaning they receive more funds from their tax returns than they pay in taxes. Figures are for families of four.

### Comparing the Highest-Earning Quintile to the Other Four Quintiles



**Note:** Calculations for the lowest quintile were based on income of \$18,900—the midway point between \$0 and the low end of the range for the second-lowest quintile, \$37,800.

**Source:** Heritage Foundation calculations using data from the Congressional Budget Office, "Data on the Distribution of Federal Taxes and Household Income," April 2009, at <http://www.cbo.gov/publications/collections/taxdistribution.cfm> (May 27, 2009).

Chart 2 • B 2280 [heritage.org](http://heritage.org)

## Progressivity Knows No End

It is obvious that high-income families pay substantially higher taxes than low and middle-income families pay, but the tax code is also highly progressive among high earners because rates continue to rise. In 2006, the top 35 percent rate kicked in at \$336,550, which is above the threshold for a family of four to qualify for the top 5 percent of earners. As taxpayers move into higher income brackets, they lose the ability to take certain deductions, and the alternative minimum tax (AMT) reduces the value of other deductions.

A family of four that earned enough to be in the top 1 percent of all income earners made \$664,600 in 2006 and paid an effective income tax rate of 19 percent. Its tax bill for the year was \$126,274.

A family that made enough to qualify for the top 5 percent of income earners made \$268,800 and paid an effective income tax rate of 17.5 percent. Its tax bill was \$47,040.

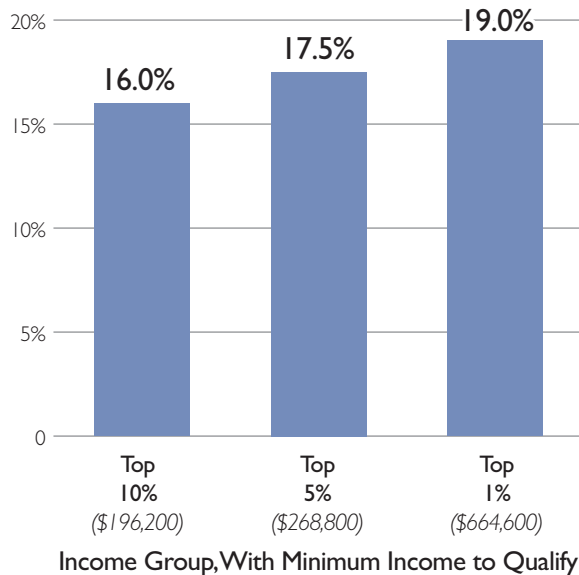
The family in the top 1 percent earned 147 percent more than the family in the top 5 percent but paid 168 percent more in taxes. (See Chart 3.)

The difference is even larger when comparing a family in the top 10 percent to the family in the top 1 percent. A family in the top 10 percent earned \$196,200 in 2006 and paid \$31,392 in taxes for an effective income tax rate of 16 percent. The family in the top 1 percent earned 239 percent more than this family—and paid more than 300 percent more in taxes.

## Progressive Tax Rates Increase With Higher Incomes

Figures are for families of four.

Effective Income Tax Rate, 2006



Source: Congressional Budget Office, "Data on the Distribution of Federal Taxes and Household Income," April 2009, at <http://www.cbo.gov/publications/collections/taxdistribution.cfm> (May 27, 2009).

Chart 3 • B 2280 heritage.org

## Stifling Growth

Progressive taxation dampens economic growth because it lessens the incentives of investors, savers, and entrepreneurs to take on new risk and reduces incentives for workers to put in longer hours. People work longer hours and extra days to earn additional income, and progressive taxation means they keep less of what they earn as their income rises. Not surprisingly, many workers decide that the extra effort is not worth it.

Savers and investors forgo spending their income today for the chance to earn high returns in the future, but progressive taxation means that as their

returns increase, they pay higher tax rates and their after-tax returns decline. This makes spending their income now more attractive, and both investment and savings decline.

The risks of starting a new business are high, but the rewards often outweigh those risks—and not just for entrepreneurs. Workers and the economy as a whole benefit when entrepreneurs take on new risk, because the small businesses they create provide jobs for millions of Americans and often grow into larger businesses that create even more jobs.

Small businesses rely heavily on the profits they earn in the early stages of their development to fund growth and expansion. Progressivity takes more and more of these much-needed profits as businesses grow. This creates an entry barrier for many would-be entrepreneurs, discouraging many of them from taking risks to bring their ideas to market.<sup>6</sup>

## Stop Progressivity Now by Making Taxes Flat

Even though the tax code is already steeply progressive, President Obama proposed in his budget, and Congress adopted in its budget resolution, a measure to make it even more punitive by raising the income tax rates for couples earning over \$250,000 a year (\$200,000 for singles) back to levels that applied before the 2001 and 2003 tax cuts. Under this plan, the top two rates will be 36 percent and 39.6 percent, compared to today's 33 percent and 35 percent.

To avoid increasing the damage that tax progressivity has already done to the economy, Congress should:

- **Abandon** the plan to raise tax rates on top earners and extend the 2001 and 2003 tax cuts for all taxpayers, and
- **Reduce** the progressivity of the tax code by eliminating several brackets and lowering the rates on those that remain.

Congress should aim for a tax code that treats taxpayers more equally: one that more closely

6. William M. Gentry and R. Glenn Hubbard, "Success Taxes, Entrepreneurial Entry, and Innovation," National Bureau of Economic Research *Working Paper* No. 10551, June 2004, at <http://www.nber.org/tmp/69279-w10551.pdf> (May 27, 2009).

resembles a flat tax. A tax code that has fewer tax brackets and lower rates would not punish success as a progressive taxation scheme does. It would tax all income similarly, so there would be no impediment to earning more.

Under a flatter tax system, those who earn more income still pay more taxes than those who earn less, but that difference will be more proportional to income. Under a flat tax that taxes all income at one rate, a family that earned 100 percent more than another family would pay 100 percent more in taxes<sup>7</sup>—not nearly 1,000 percent more, as is the case under the current tax code.

## Conclusion

Increasing the progressivity of the tax code threatens to further stifle economic growth. A code more in line with the flat tax is necessary to remove the barriers that block entrepreneurship and innovation. Regrettably, President Obama and Congress have chosen to follow liberal orthodoxy and put up more road blocks to economic growth by increasing the progressivity of the tax code through higher rates on top earners. They should look to the flat tax for inspiration instead.

—Curtis S. Dubay is a Senior Analyst in Tax Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

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7. Daniel J. Mitchell, "A Brief Guide to the Flat Tax," Heritage Foundation *Background* No. 1866, July 7, 2005, at <http://www.heritage.org/Research/Taxes/bg1866.cfm>.