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## The Economic Cost of High Tax Rates

by Robert Carroll

### Introduction

President Obama appears intent on carrying out his campaign promise to raise tax rates on high-income households, but the surtax proposal that passed the Ways and Means Committee to finance health care expansion goes much further than most had anticipated. This is a policy to be wary of.

High tax rates come with a high economic cost, they raise less revenue than the casual observer might think, and they fall heavily on the entrepreneurial sector. Moreover, they do little to address the more fundamental explanation for the widening gap between rich and poor: the globalization of labor markets.

### How High Will Rates Go?

President Obama's budget will allow most of the Bush tax cuts for those earning over \$250,000 to expire on schedule in 2011, sending the top tax rate back up from 35 to 39.6 percent. Also, the so-called PEP and Pease<sup>1</sup> rules will be restored, increasing by several more percentage points the effective marginal tax rate (the tax people pay on the last dollar of their income).

These changes raise tax rates back to what they were during much of the 1990s, as the Obama campaign promised. House Ways and Means Committee Chairman Charles Rangel (D-NY), however, has proposed that tax rates be increased even further through a new high-income surtax. The surtax would increase the top tax rate for couples with more than \$1 million in adjusted gross income (AGI) by another 5.4 percent.<sup>2</sup>

Taken together, these changes would raise the top federal tax rate to above 46 percent, increasing tax rates to nearly what they were in the early 1980s (see table below).<sup>3</sup> Adding state income taxes—which average roughly 6 percent—means that some taxpayers would see the top tax rate rise above 50 percent.<sup>4</sup> With these tax hikes, the top tax rate increases by 27 percent, and the after-tax reward from earning income—what taxpayers get to keep after paying taxes—drops by 17 percent.

<b>Table 1</b>		
<b>Top Effective Marginal Tax Rate in 2011</b>		
	<b>Effect of Tax Rate Increase</b>	<b>Top Effective Marginal Tax Rate</b>
<b>With Extension of Bush Tax Cuts</b>		35.0%
Rolling Back Reduction in Top Tax Rate (Increasing Top Rate from 35% to 39.6%)	4.6%	
Restoring Limitation on Itemized Deductions for High-Income Taxpayers	1.2%	
<b>After Rolling Back Bush Tax Cuts</b>		40.8%
High-Income Surtax	5.4%	
<b>New Top Effective Marginal Tax Rate</b>		46.2%

Source: Computations by author

### **Economic Effects of High Tax Rates**

High tax rates discourage work, saving and entrepreneurship. They also encourage taxpayers to rearrange their tax affairs to receive more of their compensation in less heavily taxed forms and to take greater advantage of the myriad tax preferences in today's tax code. For example, taxpayers can reduce their tax bill by financing more of a home purchase, receiving more of their compensation as tax-free fringe benefits, or rebalancing their investment portfolios towards tax-exempt state and local government bonds.

It's important to remember that every time a taxpayer makes a decision based on tax considerations rather than economic merit, we all lose. It wastes resources by redirecting them to less productive uses. The cost of high tax rates is not trivial. Research on the major changes in tax rates over the last several decades—the lower tax rates enacted in 1981, 1986 and 2001 or the higher tax rates enacted in 1993—finds that the behavioral responses can be large. This research generally finds that for every 1 percent decrease in the after-tax reward from earning income, taxpayers reduce their reported income by about 0.4 percent.

This does not mean that tax cuts pay for themselves. Rather, tax rate changes can have a profound effect on the size of the tax base, with lower tax rates increasing the size of the tax base and higher tax rates, such as those proposed by President Obama, shrinking the tax base. A shrinking tax base is not only suggestive of the economic costs of high tax rates, but also means that the government will take in less revenue than the casual observer might assume.

### **High Tax Rates Will Shrink the Federal Income Tax Base**

Consider the combined effect of President Obama's proposal to raise the top tax rate from 35 percent to 39.6 percent and the new surtax. This means high-income households will receive 54 cents rather than 65 cents from every dollar they earn; that is, the after-tax reward from earning income falls by 17 percent. Based on the research mentioned above, with such large increases in tax rates, we can expect taxpayers facing the top tax rates to reduce their reported incomes by nearly 7 percent.

What is critically important from the government's perspective is that while it collects an extra 10 cents for every dollar subject to the higher rates, it loses over 45 cents for every dollar by which reported income falls due to taxpayers working less or otherwise reporting less income.

Overall, simulating the effect of the higher tax rates in 2011 shows that the federal government can expect to raise at most only 60 cents on the dollar. While "large" is always in the eye of the beholder, losing 40 cents on a dollar should cause us all to question this policy. Moreover, this is a cautious estimate. It is based on the behavioral response estimated for the overall taxpaying population, even though high-income households are likely to be much more responsive. Thus, we might expect an even faster shrinkage of the federal tax base from these tax increases.

### **Effect of High Tax Rates on the Entrepreneurial Sector**

The impact of the higher tax rates on the entrepreneurial sector is also particularly troubling. An often underappreciated feature of our tax system is that roughly one-third of all business taxes are paid by owners of flow-through businesses—the sole proprietorships, partnerships, and S corporations that are often small in size and entrepreneurial—when they file their individual tax returns. These businesses are an important source of innovation and risk taking. The relatively large size of this sector also distinguishes the U.S. from other developed nations and adds to the flexibility and dynamism of the U.S. economy as these businesses are highly capable of bringing new ideas and products to market.

Despite the importance of these businesses to the U.S. economy, they will bear a substantial portion of the higher tax rates. About one-quarter of taxpayers who derive at least 50 percent of their income from a flow-through business will be subject to the higher tax rates (see below table). Moreover, a substantial share of the new revenue—40 percent for the increase in the top two tax rates and 29 percent for the high-income surtax—can be attributed directly to the income reported for flow-through businesses by their owners.<sup>5</sup>

**Table 2**  
**Effect of Tax Rate Increases on Owners of Flow-Through Businesses**

	<b>Taxpayers Paying Higher Taxes with Substantial Flow-Through Income (a)</b>		<b>New Revenue Attributable to Flow-Through Income</b>
	Thousands	Percentage	
Increasing the Top Two Tax Rates	600	25%	40%
High-Income Surtax	500	25%	29%

(a) Includes taxpayers who receive more than 50 percent of their income from a flow-through business, such as a partnership, S corporation, sole proprietorship, or farm proprietorship, or active rental activity.

Source: Computations by author

### **The Widening Gap between the Rich and Poor**

An often cited goal of higher tax rates is to make sure that those who have benefitted the most

during the past decade pay their fair share. But even this premise for higher tax rates is flawed. The widening gap between the rich and poor is a trend that began several decades ago, not with the enactment of the tax policies of the prior Administration.

The trends also have little to do with tax policy. The globalization of labor markets over the past several decades has meant that less-skilled labor in the developing world now competes more directly with less-skilled labor in the United States. This has put downward pressure on earnings growth for at least the lower half of the wage distribution in the U.S. Highly skilled labor and those who have made investments in advanced degrees—what economists would call investment in human capital—continue to earn high returns.

### **Conclusion**

High tax rates carry economic consequences. They cause taxpayers to base decisions more on tax considerations and less on economic merit. They also can be expected to shrink the size of the tax base and raise less revenue than the casual observer might assume. Another important consideration is the substantial effect the higher tax rates will have on the entrepreneurial sector, whose business income tends to be subject primarily to the individual income tax.

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### **Notes**

1. In 2011, high-income individuals will once again lose the tax benefit of the personal exemption when it phases out. Similarly, they will lose most of the tax benefit of itemized deductions.
2. For joint filers, the surtax would be 1 percent for taxpayers with AGI between \$350,000 and \$500,000, 1.5 percent for AGI between \$500,000 and \$1,000,000 and 5.4 percent for AGI over \$1 million. AGI used for computing the surtax would be adjusted by adding back investment interest expenses.
3. The effective marginal tax rate rises to 46.19 percent. This is calculated by adding \$100 to a high-income taxpayer and computing the change in the taxpayer's income tax liability. The tax rate increases by 4.6 percent when the top tax rate rises back to 39.6 percent, 1.19 percent when the limitation on itemized deductions (the so-called "Pease" provision) is restored, and 5.4 percent through the new surtax.
4. The top income tax rates would rise over 50 percent in 39 states. See *Tax Foundation Fiscal Fact*, No. 178, "If Health Surtax is 5.4 Percent, Taxpayers in 39 States Would Pay a Top Tax Rate Over 50 Percent," July 14, 2009, (<http://www.taxfoundation.org/publications/show/24863.html>).
5. The share of new revenue attributable to flow-through income under the surtax is substantially smaller because the surtax also applies to capital gain and dividends, while the increase in the top two tax rates only applies to ordinary income. The Obama Administration has also proposed to increase the tax rates on capital gains and dividends for higher-income taxpayers.

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