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Towards Understanding the Full Burden of High Tax Rates

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Introduction

When it comes to tax policy, the emphasis in Washington, DC, has once again turned to how to split up the economic pie rather than the effect of tax policy on its size. During the 2008 Presidential campaign, the focus on equity took the form of rolling back the Bush tax cuts—increasing the top tax rates—for those with incomes above $250,000. Now it is clear that some policymakers want to go even further by adding a high-income surtax to partially finance health care reform, which would raise the top tax rate to more than 46 percent.

While we ought to expect the distribution of the tax burden to be adjusted periodically with changes in the political winds, it is important that the Congress and the Obama Administration not lose sight of the economic consequences of these policies. A recent *Tax Foundation Special Report*, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," estimates that the current income tax system already costs the economy between $1.10 and $1.15 for every dollar the government collects in tax revenues. The new tax proposals under consideration will add significantly more to this excess burden.

An Additional Burden of Taxes: The Excess Burden

When most people think of the burden associated with taxes, what comes to mind is the revenue that is transferred to the government. Taxes reduce peoples' disposable incomes. But taxes also result in a burden beyond what households transfer to the government as revenue, what economists call the *excess burden* or *deadweight loss* of taxes.

Virtually every tax creates an excess burden.[1] Taxes distort choices and steer resources away from their best and highest use based purely on economic merit. When decisions are, in part, made for tax reasons, economic resources are wasted. The excess burden can be thought of as a measure of the income that would need to be given to people to compensate them for the resources lost due to the distorting effect of taxes.

The crucial point is that the revenue the government collects understates how much worse off an individual is because of a tax. Also, not all taxes are created equal. Two tax changes that raise the same revenue can have very different economic effects and excess burdens.

Estimates of the excess burden and the total burden of the individual income tax are presented in a recent *Tax Foundation Special Report*, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," In 2009, the excess burden of the current individual income tax was estimated to be $105 billion. This increases the total burden of the individual income tax by 11.4 percent, from the $921 billion in income tax revenue to the total burden of $1,025 trillion. That is, the total burden of the individual income tax is 11.4 percent higher than what the government collects in revenue.

The collective impact of the higher tax rates in 2011 is even more significant. In the absence of the higher rates, the excess burden of the income tax system is estimated to be $169 billion above the amount the government actually collects in revenues. This increases the total economic cost of the income tax system by 15.6 percent, from $1.086 trillion to $1.255 trillion. However, the increase in the top two tax rates raises the total excess burden of the income tax by an additional $39 billion to more than $208 billion. This increases the total excess burden of the individual income tax from 15.6 percent to 18.5 percent of individual income tax revenues. Thus, the actual cost of the tax increase to the economy is $1.333 trillion, not just the $1.125 trillion raised by the government.

The health care surtax adds yet another layer of economic costs beyond what the government collects in revenues. As Table 1 shows, the health care surtax adds an additional $37 billion to the excess burden, bringing the total to $245 billion overall, or 20.9 percent of individual income tax collections. Added together, the total cost to the economy is $1.419 trillion, not just the $1.174 trillion the government intended to collect.

Table 1
Excess Burden of the Individual Income Tax Assuming Responsiveness to Tax Rates Rises with Income

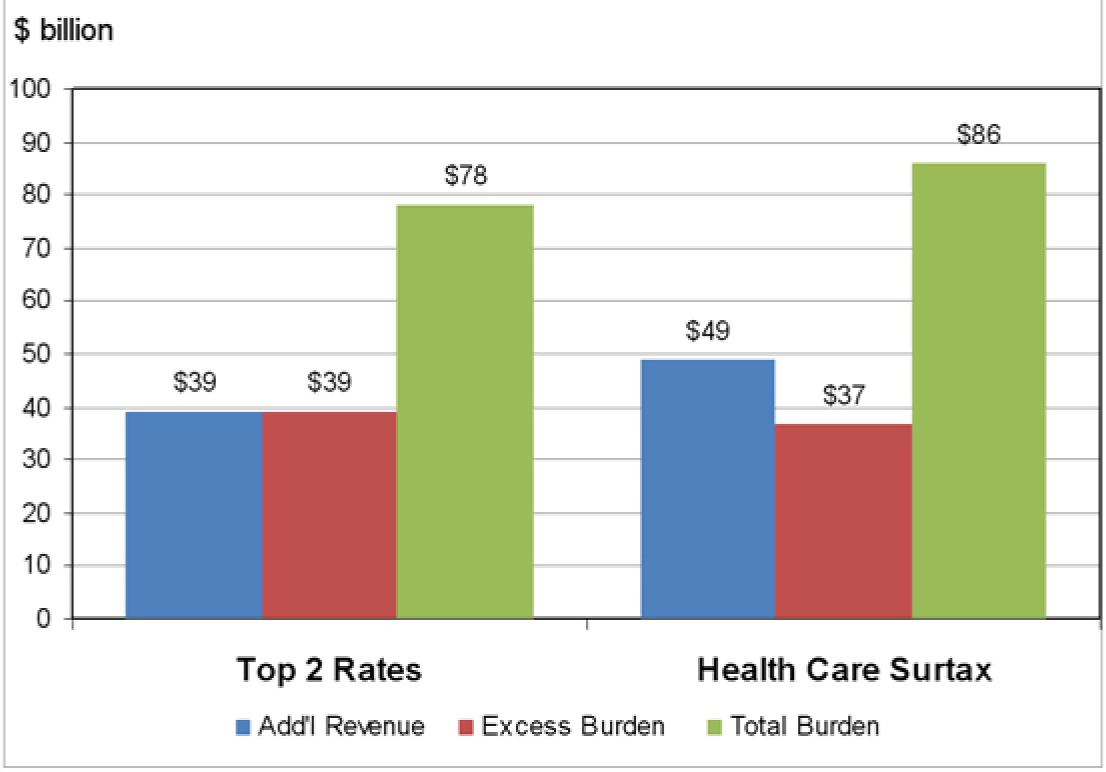
	Income Tax Liability ($billions)	Excess Burden Estimates (a)			
		Total ($billions)	As Percentage of Total Income Tax Liability	As Percentage of Additional Revenue	Total Burden ($billions)
Top two tax rates kept at 33% and 35%	$1,086	$169	15.5%		$1,254
Increase top two tax rates to 36% and 39.5%	$1,125	$208	18.5%		$1,332
Effect of rate increase (without behavior)	$39	$39	2.9%	100%	$7
Add high-income surtax	$1,174	$245	20.8%		$1,418
Effect of surtax (without behavior)	$49	$37	2.4%	75%	$86
Combined effect of rate increase and surtax	$88	$76	5.3%	86%	$164
(a) Estimates for the excess burden assume a taxable income elasticity with respect to the net-of-tax rate of 0.6 for those with incomes of $100,000 and above, and 0.2 for other taxpayers.					
Source: Tax Foundation calculations					

What should be particularly troublesome, however, is comparing the increase in the excess burden to the revenue that these two tax increases yield. This provides a sense of the revenue efficiency of these policies—that is, just how burdensome these higher tax rates are. If the excess burden is large relative to the revenue collected from the tax increases, one might conclude that the policies are relatively inefficient means for collecting revenue. Why? Because they impose a large cost to households and the economy for each dollar raised.

By this metric, these policies do very poorly. As shown in Figure 1 (and Table 1) the excess burden is nearly as much as the revenue collected. The increase in the top two tax rates raises $39 billion in 2011, but imposes an extra burden-the excess burden-of another $39 billion. Thus, the total burden of this tax increase is twice the revenue collected!

The health care surtax is estimated to raise $49 billion, but imposes an excess burden of $37 billion. For this tax increase, the excess burden is 75 percent of the revenue collected. When these two policies are considered together, the total burden is 175 percent of the revenue raised.[2]

Figure 1: Total Burden of Higher Tax Rates is Nearly Twice the Additional Revenue Raised



Conclusion

The emphasis in tax policy has taken a turn towards redistribution and increasing progressivity through higher tax rates. Absent from most policy discussions, however, is recognition that the full cost of these policies exceeds the revenue raised. Virtually all taxes involve what economists call the "excess burden" of a tax and this additional burden can be substantial.

While the current income tax may raise roughly $1 trillion, the actual cost to the economy is between $114 billion and $150 billion more. But, more relevant to the current policy debate is the effect of allowing the top two tax rates to increase in 2011 when the tax cuts enacted in 2001 and 2003 sunset and the recent proposal for a new high income surtax to help finance health care reform.

These tax increases will push the top marginal tax rate from roughly 36 percent to over 46 percent and increase the excess burden of the income tax to over 20 percent. Moreover, the excess burden of the higher rates nearly exceeds the revenue raised; that is, the full burden of these taxes may well be nearly twice the revenue they raise.

Some wariness would seem appropriate for policies that are purported to make higher income taxpayers "pay their fair share," but that impose such substantial burdens on *all* taxpayers - nearly twice the revenue that is raised.

Notes

1. One exception is a lump-sum tax, which has no effect on the price of one good or activity relative to another.

2. These estimates understate the burden per dollar of revenue because the estimate of the revenue raised does not include the effect of any behavioral response on the revenue raised from the higher tax rates. The government can probably expect to collect 40 percent less than the static estimates reported on Table 1 indicate.

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