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FISCAL FACT

October 2009
No. 197

Can Income Tax Hikes Close the Deficit?

By William Ahern

For all but three years of the past 40, the federal government has run a deficit, and at the most basic level, the reason is simple. In their desire to be re-elected, congressmen are afraid not to spend more and more, and they're equally afraid to give voters the bill for those services, even though that bill must inevitably be paid.

During the fiscal year that's just beginning, fiscal year 2010, the federal government plans to spend $3.8 trillion dollars, the largest annual expenditure ever. On the revenue side, taxes will bring in about $2.3 trillion, so the federal government is creating a shortfall of approximately $1.5 trillion. That projected deficit will vary as the months pass, but it may well end up being even higher than the record-setting deficit in 2009 of $1.4 trillion. Those huge amounts translate into a federal government that will spend $33,000 on each household but that will raise only $19,000.

Although President Obama and the Congress do plan to raise taxes, which will cut into the deficit, they also have new spending plans, leaving the budget with historically huge deficits throughout the next decade. Those deficits will be financed by selling U.S. Treasury bonds to people all over the world and paying them back with interest in years to come. But instead of borrowing, could a congress willing to bring taxpayers the full bill for this year's spending erase the deficit by raising taxes this year?

Using the Tax Foundation's Microsimulation Model, we can project how much revenue a broad-based increase in federal income tax rates would generate. However, when the rates necessary are spelled out, it becomes apparent that deficits this large simply cannot be closed with higher federal income tax rates. This year and for several years to come, even if congressmen were willing to present the full bill to the taxpayers in the form of higher taxes to match their spending level, they could not do so.

About 40 percent of the federal government's revenue comes from payroll taxes at a rate of 15.3 percent of wages. After taking that chunk from the nation's paychecks, the federal government turns to the individual income tax for most of the rest. And the income tax is always the principal lever that Congress uses whenever it wants to adjust taxes up or down.

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Assuming deductions, exemptions and credits were kept the same as they are now, the government would have to nearly triple every tax rate. Table 1 shows the effect on statutory rates of such a hypothetical tax hike. Instead of taxing couples with rates that range from 10 percent to 35 percent, tax rates would have to start at 27.2 percent and range up to 95.2 percent.

Table 1
Federal Individual Income Tax Rates for Joint Tax Returns
Current Law Versus Rates Necessary to Erase Deficit
2010

Tax Brackets for Couples Filing Joint Returns	Current Law Tax Rates	Rates Needed to Close Deficit
$0 to $16,750	10%	27.2%
$16,751 to $68,000	15%	40.8%
$68,001 to $137,300	25%	68.0%
$137,301 to $209,200	28%	76.2%
$209,201 to $373,600	33%	89.8%
$373,601 and over	35%	95.2%

Note: The rates are the same for single taxpayers, but the brackets vary. For the bottom three brackets, the threshold amounts are exactly one-half what they are for couples. For the top bracket, the threshold is the same for singles as for couples. Brackets are shown for 2009; inflation adjustment for 2010 will be announced in the summer of 2010.
Source: IRS and Tax Foundation

Table 2 shows the effect on average tax payments, which would also rise precipitously, though not by exactly the same percentage as the tax rates.[1] Next year, the average tax return filed will be subject to a $7,169 tax bill. But if we wanted to close the deficit, the average tax bill would have to climb to $19,001. Low-income filers with adjusted gross incomes (AGIs) between $0 and $20,000 would see their tax burdens climb from $130 to $372; middle-income filers earning between $75,000 and $100,000 would see their $7,055 payments jump to $20,515; while taxpayers with AGIs over $1 million would see their tax bills climb from about $800,000 to almost $2 million.

Table 2
Estimated Average Federal Income Tax Payments Current Law Payments Compared to Payments Necessary to Erase Deficit
2010

Income Ranges	Average Payments Under Current Law	Average Payments Necessary to Close Deficit
All Returns	$ 7,169	$ 19,001
No AGI	$ 155	$ 444
$1 – $20,000	$ 130	$ 372

[1] Raising the statutory tax rates would proportionately raise the value of deductions, but fixed-dollar credits and exemptions would be comparatively less valuable. Therefore, each income group's average tax payment under the hypothetically high tax rates rises by a slightly different percentage, depending on which credits and exemptions are used the most at each income level.

$20,000 – $25,000	$ 667	$ 1,963
$25,000 – $30,000	$ 1,091	$ 3,217
$30,000 – $40,000	$ 1,702	$ 5,010
$40,000 – $50,000	$ 2,525	$ 7,507
$50,000 – $75,000	$ 4,208	$ 12,537
$75,000 – $100,000	$ 7,055	$ 20,515
$100,000 – $200,000	$ 15,502	$ 42,641
$200,000 – $500,000	$ 55,740	$ 139,392
$500,000 – $1,000,000	$ 172,143	$ 431,427
$1,000,000 and Over	$ 793,842	$ 1,964,052
Source: Tax Foundation microsimulation model		

This analysis assumes that individuals would not change their income-earning or tax-planning behavior in response to higher tax rates. That is, they would earn the same amounts as they would with current tax rates, and they would fill out their tax returns in the same way they do now. But of course they would alter their behavior. With high-income people paying a federal tax rate over 90 percent, and most states adding on about 8 percent, plus local income taxes and payroll taxes, tax rates would be over 100 percent for many households. In other words, beyond some point government would be taxing away all earnings and there would be no incentive to work.

Are 2009 and 2010 an Anomaly?

The federal deficit is projected to be larger in 2009 and 2010 than in any future year, and it could be argued that the impossibility of raising enough revenue now to match federal spending is not so alarming because those two years are an anomaly caused partly by the TARP bailout and the fiscal stimulus legislation. Those two federal actions account for roughly one quarter of 2009's $1.4 trillion deficit, according to Secretary Geithner.[2]

However, in subsequent years, according to the President's Budget, the deficits are still huge by historical standards, never falling below $700 billion and rising back above $1 trillion as 2020 nears. As a result, in all likelihood it is true for every foreseeable year that the income tax system would be unable to raise as much revenue as the government plans to spend, absent major changes in our tax code or spending patterns.

In 2011 tax rates would have to be increased by a factor of 2.23 to close the deficit, and even in 2012 and 2013, when projected deficits are the lowest, according to the Administration, tax rates would have to be levied at prohibitively high levels to erase the deficit. For example, in 2012, even after the top two tax rates have been raised from 33% to 36% and from 35% to 39.6%, all the rates would have to be multiplied by 1.87 to raise enough to erase the deficit (see Table 3).

[2] Jackie Calmes, "$1.4 Trillion Deficit Complicates Stimulus Plans," *New York Times,* October 16, 2009, at http://www.nytimes.com/2009/10/17/us/17deficit.html?hp

Table 3 Federal Individual Income Tax Rates Current Law Versus Rates Necessary to Erase Deficit 2012		
Tax Brackets for Couples Filing Joint Returns	Current Law Tax Rates	Rates Needed to Close Deficit
$0 to $17,150	10%	18.7%
$17,151 to $69,600	15%	28.1%
$69,601 to $140,500	25%	46.8%
$140,501 to $214,100	28%	52.4%
$214,101 to $382,300	36%	67.3%
$382,301 and over	39.6%	74.1%
Source: Internal Revenue Service and Tax Foundation		

Average tax payments would rise precipitously in 2012 if that were the year targeted for eradicating the deficit, though not as steeply as in 2010.

Table 4 shows the effect on average tax payments in 2012 if the congress decided to close the deficit that year. Low-income filers (AGI between $0 and $20,000) would pay $248 instead of $129; middle-income filers (AGI between $75,000 and $100,000) would pay about $13,700 instead of $7,000; and the highest-earning filers (AGIs over $1 million) would pay about $1,650,000 instead of $935,000.

Table 4 Estimated Average Federal Income Tax Payments Current Law Payments Compared to Payments Necessary to Erase Deficit 2012		
Income Ranges	Average Payments Under Current Law	Average Payments Necessary to Close Deficit
All Returns	$ 8,831	$ 16,178
No AGI	$ 151	$ 292
$1 – $20,000	$ 129	$ 248
$20,000 – $25,000	$ 660	$ 1,289
$25,000 – $30,000	$ 1,006	$ 1,986
$30,000 – $40,000	$ 1,670	$ 3,280
$40,000 – $50,000	$ 2,488	$ 4,904
$50,000 – $75,000	$ 4,162	$ 8,265
$75,000 – $100,000	$ 6,992	$ 13,708
$100,000 – $200,000	$ 15,757	$ 29,609
$200,000 – $500,000	$ 57,692	$ 103,074
$500,000 – $1,000,000	$ 195,687	$ 347,765
$1,000,000 and over	$ 935,425	$ 1,644,460
Source: Tax Foundation microsimulation model		

While much debate rages over the effect of modest tax rate changes – do they persuade workers to work less and entrepreneurs to risk less? – there can be little doubt that the high tax rates necessary to balance the budget in any of the next several years would discourage all manner of income-producing endeavors. Consequently, even when the deficit is projected to be as "low" as it is in 2012 and 2013, it is probably not possible to close the deficit with personal income tax hikes.