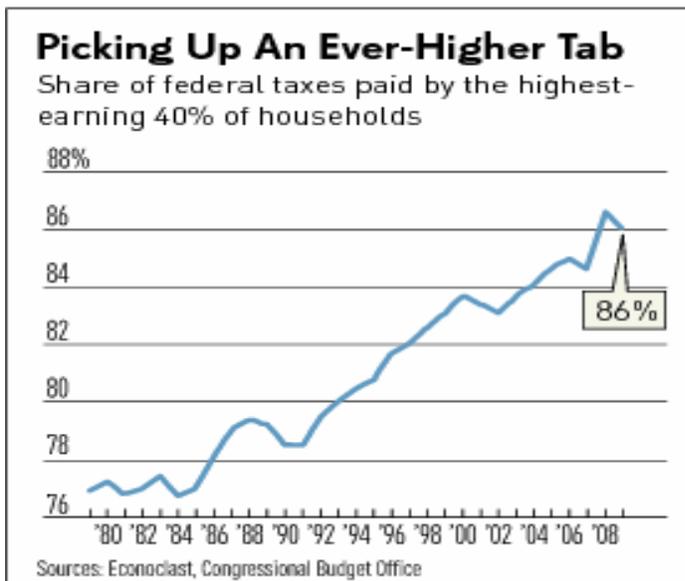


The Cost of Higher Rates Paid by Fewer Taxpayers

By MIKE COSGROVE

Forty percent of U.S. households paid 86.2% of all federal taxes — personal, corporate, Social Security and excise — in 2009, according to the Congressional Budget Office. That leaves 60% of the nearly 118 million U.S. households — the majority of the country — paying only 13.8%.



The proportion of federal taxes paid by the 40% of U.S. households has increased about 10 percentage points since the Reagan years, and the proportion paid by the larger group of households has, of course, fallen by that much.

Under the current federal tax code (Bush tax code) and entitlement structure, the proportion of all federal taxes paid by the 40% will rise in the years ahead. President Obama wants the proportion of all federal taxes paid by the 40% to increase at a faster pace by implementing higher marginal tax rates on higher-income households and new taxes to help pay for ObamaCare.

Should Obama's vision of higher tax rates be implemented, it may turn out that 40% of U.S. households will be paying 90% to 95% or more of all federal taxes. That, of course, will not close the federal deficit as the higher federal tax burden on the 40% acts as a tax on economic growth and capital formation. Obama's vision has already had the effect of slowing trend economic growth and job creation.

The U.S. comprehensive entitlement system of cash payments and in-kind benefits evolved over many decades, and major tax reforms have had the combined effect of decreasing the proportion

of households that effectively pay federal taxes and increasing cash transfers and in-kind benefits received by many households.

Obama has large constituencies in that 60% who pay only a small proportion of federal taxes, and those constituencies may want to re-elect him for another four years.

Forty percent of U.S. households effectively subsidize the benefits that the other 60% of U.S. households are able to enjoy by living in America. However, it might be safe to say that the majority of Americans still view this country as a place with upward income mobility. At one point in their life cycle household members may be low-income but over time enjoy becoming higher income while bearing a larger federal tax burden.

If that is the case, cash payments and in-kind benefits for lower-income households can be viewed in a positive light. But the adverse incentives created by U.S. entitlements and the tax structure may dull the incentive to move up the income ladder for many.

Transfers received (cash payments and in-kind benefits) came to about \$23,000, \$15,000 and \$10,000 for the three household segments that make up the 60% of U.S. households that pay about 14% of all federal taxes. The lower the reported household income, the larger in general will be the stream of government cash payments and in-kind benefits received.

This system can encourage households to engage in activities that keep their reported income low to avoid paying federal taxes.

This system of entitlements and tax code was, of course, already in place when Obama took office. Both Republicans and Democrats evolved this complex entitlement and tax system over many decades with its adverse impact on incentives.

Mitt Romney's proposal to lower marginal income-tax rates encourages more: (1) capital formation, (2) hours worked and (3) higher labor force participation so that trend economic growth and income could increase. Faster trend economic growth means more households with higher income to pay more federal taxes to help close the deficit.

Romney's proposal of eliminating or reducing the value of deductions also shifts more of the federal tax burden onto higher-income households. But his proposal to lower tax rates and broaden the tax base acknowledges that the U.S. is part of a global economy and that the U.S. economy needs a competitive tax system.

Obama's vision, in contrast, appears to assume the U.S. economy is an island — with no global economy — as his regulatory and proposed tax policies would work to create a slower-growing, less competitive U.S. economy.

To be clear, the list of federal taxes that the CBO uses to arrive at 40% of U.S. households paying 86.2% of all federal taxes includes: the individual income tax, payroll tax, corporate income tax and excise taxes.

The CBO assumes "as do most economists," the CBO said, that households pay all taxes either directly or indirectly. That means both the employee and employer share of payroll taxes is allocated to households. Likewise the corporate income tax is also allocated to households. The CBO prepared its report at the request of the chairman of the Senate Finance Committee, Max Baucus.

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