Insight

Why Marginal Tax Rates Matter

DOUGLAS HOLTZ-EAKIN | DECEMBER 17, 2012

A central aspect of the policy debate underneath both the impending fiscal cliff and taming the federal debt is the role of higher marginal tax rates in raising revenue. This short paper reviews the logic showing the damage from high marginal tax rates.

There are four basic lessons:

- Higher marginal tax rates make the economy progressively less productive;
- Higher marginal tax rates trump consumers ability to send market signals;
- Unequal and high marginal tax rates harm lead to the misuse of workers, capital, and technologies; and
- Revenue is best raised with the lowest rates and broadest base possible.

High Marginal Tax Rates Make the Economy Less Productive

Higher marginal tax rates stop productive investments. Suppose that in the absence of taxes, it takes a 10 percent return to cover maintenance, depreciation, and the cost of raising funds. A 10 percent tax rate would require a pre-tax return of 11.1 percent in order to pay tax, and then meet the other investment factors. However, as the marginal tax rate rises, the impact becomes progressively larger as shown below.

Pre-Tax Return Required to Yield

10 Percent After Tax

Marginal Tax Rate	Pre-Tax Return
0%	10.0%
10%	11.1%
20%	12.5%

30%	14.3%
40%	16.7%
50%	20.0%
60%	25.0%
70%	33.3%
80%	50.0%
90%	100.0%