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Top earners feel bite of U.S. tax increases

By John D. McKinnon

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The jump in federal tax rates that kicked in last year is causing sticker shock for many higher earners this tax season.

That, in turn, is rekindling a debate over a question likely to smolder for a long time: How much more could--or should--taxes go up on the well-to-do?

Higher earners' share of the overall federal tax burden has been climbing fairly steadily, even before lawmakers negotiated the fiscal-cliff deal at the end of 2012.

The latest tax-rate increases, passed at the start of 2013, have added to that burden, at least for the highest earners. Those changes included a bump in the top ordinary income rate to 39.6% from 35%, a limit on itemized deductions and an increase in the top rate on investment income. The Obama health-care overhaul also included some tax increases, including another boost in investment taxes.

Largely as a result, overall federal tax receipts from the top 1% of earners rose by 1.3 percentage points to 29.3% of all federal tax revenue, the nonpartisan Tax Policy Center estimates. The share of overall income for the top 1%, now at around 17%, according to the Tax Policy Center, has roughly doubled since the early 1980s, according to Congressional Budget Office figures.

It isn't just the super-rich who find their share of the burden growing. The increase in the individual income tax burden borne by the top 20%--including, say, couples with two children making more than $150,000--has gone from 65% in 1980 to more than 90% as of 2010, the most recent year available, according to the CBO.

Ahead of Tuesday's tax-filing deadline, higher-income people have been coming to grips with the new reality as they review their returns for 2013.

Rob Babek, partner in charge of Marcum LLP's Los Angeles office, said several of his clients have seen their tax bills increase by $100,000 or more. One business owner saw hers rise from around $600,000 in 2012 to more than $700,000, driven mainly by changes in investment-tax rates on the $2 million in dividends she received from her firm.

"She was really shocked by the increase," Mr. Babek said. "That one hit home."

The issue of how much to tax top earners is often debated now in political and economic circles. One camp, led by economists such as Emmanuel Saez of University of California at Berkeley, focuses on the rising gap in incomes between rich and poor. They advocate significantly higher tax rates on the rich.

"Higher-income people are the obvious target, because we have seen the trend of much higher incomes among [them]," said Peter Diamond, a Nobel Prize-winning MIT economist who has written with Mr. Saez on taxes. "Secondly we've seen a [long-term] trend of declining tax rates on higher income people." Mr. Diamond advocates going to a 50% top federal rate, for starters.

Others think the tax burden on high income people may already be too heavy. "Potentially it is too high," and could be causing economic distortions, said Jeffrey Miron, an economist at Harvard University and the libertarian Cato Institute. "That can have serious costs for economic activity," he added.

At the same time, a number of tax economists, including some on the right, advocate narrowing or closing many of the tax breaks that higher-income people use, including for investment and retirement savings. That would reduce some of the means for tax avoidance, and perhaps add to economic efficiency.

Another area where economists--and politicians--differ is on whether that winnowing of tax breaks should be accompanied by reductions in tax rates.

Rep. Dave Camp, the Republican chairman of the Ways and Means Committee, proposes a broad tax overhaul that would squeeze deductions--mainly for the wealthy--while also lowering rates significantly. The net tax burden would remain more or less where it is now.

President Barack Obama, on the other hand, wants to limit tax breaks, but would leave rates where they are. That would further increase the tax burden on the wealthy.

"The most efficient way to raise additional revenue would be to limit tax [breaks] for higher income households," said the White House's top economist, Jason Furman.

Neither Mr. Camp's proposal nor the president's policy preference has the political support to pass. And there are few signs of a big fiscal-policy deal in Congress anytime soon.

But if one does happen, it could well include some additional increase in the tax burden for the wealthy, most likely through limits on tax breaks coupled with rate cuts, and not through more rate increases.

In the U.S., "particularly for those in high-tax states, we might be pretty close to the revenue-maximizing tax rate," says Alan Auerbach, a tax economist at the University of California, Berkeley.

What is less clear is whether others lower down on the income spectrum would have to pony up a little more, too.