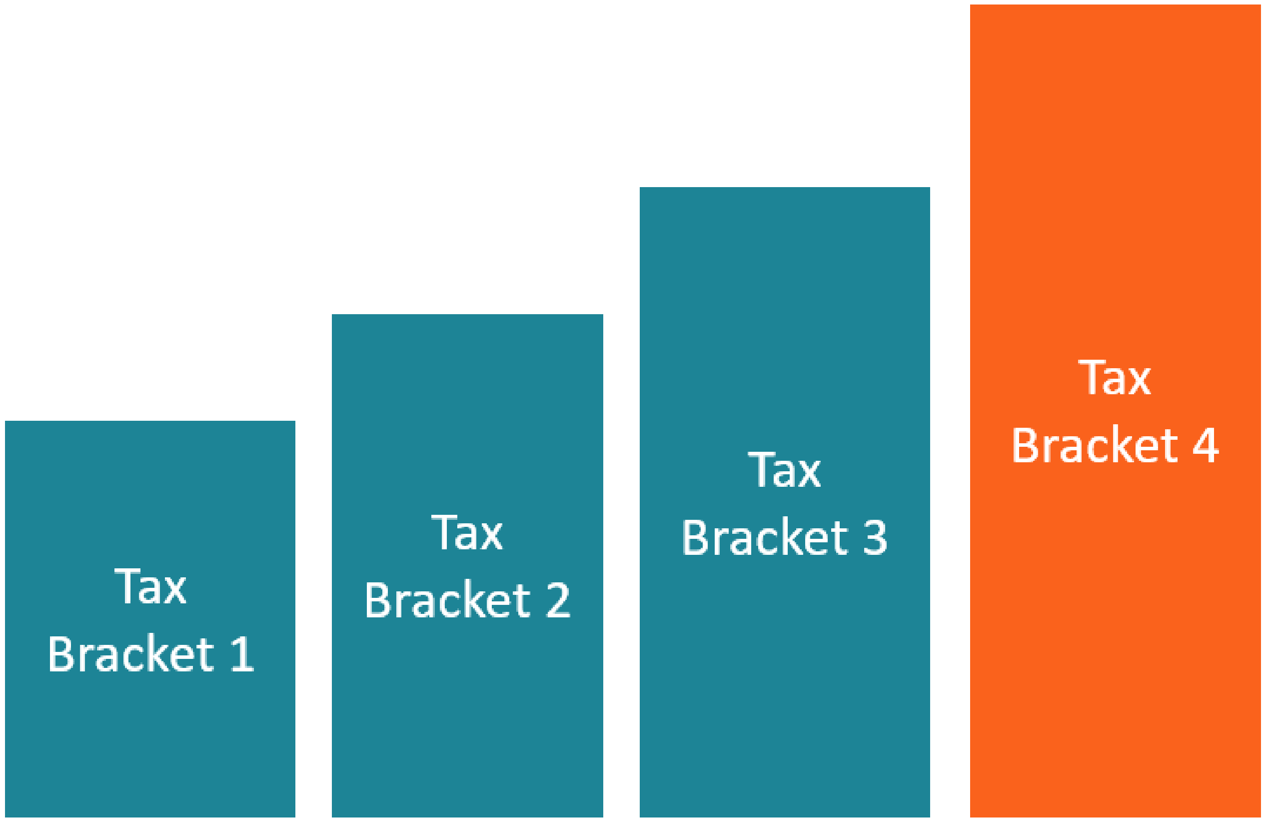
Progressive Tax

A tax system wherein the tax burden increases as the taxable income increases

What is Progressive Tax?

A progressive tax is a tax system that increases rates as the taxable income goes up. It is usually segmented into tax brackets that progress to successively higher rates. For example, a progressive tax rate may move from 0% to 45%, from the lowest and highest brackets, as the taxable amount increases. In a progressive tax system, a taxpayer's marginal tax rate is higher than their average tax rate.



Various tax methods that governments may use include progressive, regressive, digressive, or proportional. The Progressive Tax System is one where the tax burden increases as taxable income increases. In some instances, there is a minimum tax-free amount where individuals earning less than the stated minimum taxable amount are not liable for any payments to tax authorities.

Summary

- **A progressive tax is a tax system that increases rates as the taxable income goes up.**
- **Examples of progressive tax include investment income taxes, tax on interest earned, rental earnings, estate tax, and tax credits.**
- **The opposite of the progressive system is the regressive tax rate where tax liability reduces as the taxable amount increases.**

Examples of Progressive Tax

Investment income taxes: These are taxes on investment income-generating activities. They tend to impact those with excess money that save and engage in investment.

Tax on interest earned: Interest is earned from savings or investments, and is considered passive income.

Rental earnings: Although there is a chance to deduct all the costs associated with building operations, once they are done, this is a very progressive kind of tax since it targets those who invest in rental property.

Estate tax: This is a form of tax levied against the assets of those who have deceased. It typically applies where the value of the estate of the deceased is above a certain amount as set by the government.

Tax credits: These are benefits and perks awarded to less fortunate citizens by the government to save them some cash. They are many and might include earned income tax credit, elderly and disabled tax credit, child tax credit, or retirement savings contribution credit.

Advantages of Progressive Tax

- There is a proper distribution of the tax burden. Those with broader financial shoulders carry the heaviest burden.
- There is a reduction in tax amounts for the less fortunate in society to ensure their tax burden is not crippling.
- The government collects more tax revenue, as compared to a proportional tax system.

Progressive vs Regressive Tax System

The opposite of the progressive system is the regressive tax rate where tax liability reduces as the taxable amount increases. Regardless of the rate used, the government aims to collect money from citizens. After pooling all the money together, it can provide public goods and services such as infrastructure and healthcare.

Example

Taxable Amount ($)	Proportional Tax (%)	Progressive Tax (%)	Regressive Tax (%)	Digressive Tax (%)
10,000	14	10	20	10
20,000	14	15	18	12
30,000	14	20	16	14
40,000	14	25	12	16
50,000	14	30	10	16
>50,000	14	35	9	16

From the above example, it can be seen that under the progressive tax system, the tax liability increases with income. If we take an example of a person earning $70,000 per annum, then his/her tax liability will be computed as follows under the progressive tax system:

The first $10,000 at 10% = $1,000

The second $10,000 at 15% = $1,500

The third $10,000 at 20% = $2,000

The forth $10,000 at 25% = $2,500

The fifth $10,000 at 30% = $3,000

The excess of $20,000 at 35% = $7,000

The total tax liability will be $(1,000+1,500+2,000+2,500+3,000+7,000) = $17,000

Note: Any amount in excess of $50,000 is taxed at a flat rate of 35%.

Among the tax rate systems used to calculate the taxable liability of an individual or a corporation, the progressive tax rate is considered by many to be the best since it puts more burden on those with the highest incomes. Under this system, the average tax less than the marginal tax rate. It can be explained further by referring to the same example:

The total tax liability is $17,000 on a taxable income of $70,000. This implies that the average tax rate will be $(17,000/70,000) = 24.3%. From the calculations, it is evident that the average tax rate of 24.3% is less than the marginal rate of 35%.

Remember the progressive tax system aims to get more money from high income earners. The government also uses other progressive measures to try and reduce income inequality as much as possible. Some of the progressive measures the government can put in place include imposing a property tax or even taxing luxury commodities heavily while exempting essential products from taxation.

The Economists' View on Progressive Tax Rates

The economy of a country is developed through investments. Most of the time, the remainder of income after consumption is what is invested. In an efficient economy, savings are supposed to equal investments. What this means is that after a person consumes part of their income, rather than keeping the balance in an unproductive state, it can be put in an income-generating activity.

The case might not be exactly like this in a progressive tax system since those with more are taxed heavier. **It leaves them with less disposable income** and they might also not have the incentive to optimize their productivity since the marginal income is taxed at an extremely high marginal rate. This may lead to a reduced level of investment, which can have a detrimental effect on the overall economy in the long-term.

From the point of view of those who benefit from progressive taxes, their purchasing power becomes stronger. Also, the demand for certain commodities that are either subsidized or are part of the basic commodities increases. These two factors can promote growth and development in areas that may have otherwise been difficult to stimulate.

The effect of a progressive tax on economic growth can have two interpretations, depending on your school of thought. Classical economists believe that economic growth should take a natural course without government intervention while the Keynesians believe in government expenditures to stimulate economic growth.

Impact of Inflation on a Progressive Tax System

Inflation is a state where the price levels of goods and services keep on increasing without a corresponding positive change in standards of living. It reduces the purchasing power of money and also the value of investments. Thus, during inflation, those affected by progressive tax rates pay higher than the proper value initially set for them.

Related Readings

Thank you for reading CFI's guide to Progressive Tax. To continue learning and advancing your career, the following additional CFI resources will be helpful:

- Accounting for Income Taxes
- Tax Shield
- Cash Flow Statement
- Three Financial Statements

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