Regressive, Proportional, and Progressive Taxes: What's the Difference?

You likely pay a version of each on income or goods

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Regressive, Proportional and Progressive Taxes: An Overview

Tax systems in the U.S. fall into three main categories: Regressive, proportional, and progressive. Two of these systems impact high- and low-income earners differently. Regressive taxes have a greater impact on lower-income individuals than the wealthy.
Proportional tax, also referred to as a flat tax, affects low-, middle-, and high-income earners relatively equally. They all pay the same tax rate, regardless of income. A progressive tax has more of a financial impact on higher-income individuals than on low-income earners.

KEY TAKEAWAYS

- A regressive tax system levies the same percentage on products or goods purchased regardless of the buyer's income and is thought to be disproportionately difficult on low earners.
- A proportional tax applies the same tax rate to all individuals regardless of income.
- A progressive tax imposes a greater percentage of taxation on higher income levels, operating on the theory that high-income earners can afford to pay more.

Regressive Taxes

Low-income individuals pay a higher amount of taxes compared to high-income earners under a regressive tax system. That's because the government assesses tax as a percentage of the value of the asset that a taxpayer purchases or owns. This type of tax has no correlation with an individual's earnings or income level.[1]

Regressive taxes include property taxes, sales taxes on goods, and excise taxes on consumables, such as gasoline or airfare. Excise taxes are fixed and they're included in the price of the product or service.

Sin taxes, a subset of excise taxes, are imposed on commodities or activities that are perceived to be unhealthy or have a negative effect on society, such as cigarettes, gambling, and alcohol. They're levied in an effort to deter individuals from purchasing these products. Sin tax critics argue that these disproportionately affect those who are less well off.

Many also consider Social Security to be a regressive tax. Social Security tax obligations are capped at a certain level of income called a wage base—$142,800 for the 2021 tax year and 147,000 in 2022.[2] An individual's earnings above this base are not subject to the 6.2% Social Security tax.

The annual maximum that you can pay in Social Security tax is capped at $9,114.00 in 2021, whether you earn $147,001 or $1 million. Employers pay an additional 6.2% on behalf of their workers, and self-employed individuals must pay both halves on earnings up to the wage base.[3] Higher-income employees effectively pay a lower proportion of their overall pay into the Social Security system than lower-income employees because it's a flat rate for everyone and because of this cap.

Just as Social Security can be considered a regressive tax, it's also a proportional tax because everyone pays the same rate, at least up to the wage base.

Proportional Taxes

A proportional or flat tax system assesses the same tax rate on everyone regardless of income or wealth. This system is meant to create equality between marginal tax rates and average tax rates paid. Nine states use this income tax system as of January 2021: Colorado, Illinois, Indiana, Kentucky, Massachusetts, Michigan, North Carolina, Pennsylvania, and Utah.[4] Other examples of proportional taxes include per capita taxes, gross receipts taxes, and occupational taxes.[5]

Proponents of proportional taxes believe they stimulate the economy by encouraging people to work more because there is no tax penalty for earning more. They also believe that businesses are likely to spend and invest more under a flat tax system, putting more dollars into the economy.[5]

Progressive Taxes

Taxes assessed under a progressive system are based on the taxable amount of an individual's income. They follow an accelerating schedule, so high-income earners pay more than low-income earners. Tax rate, along with tax liability, increases as an individual's wealth increases. The overall outcome is that higher earners pay a higher percentage of taxes and more money in taxes than do lower-income earners.[6]

This sort of system is meant to affect higher-income people more than low- or middle-class earners to reflect the presumption that they can afford to pay more.

The U.S. federal income tax is a progressive tax system. Its schedule of marginal tax rates imposes a higher income tax rate on people with higher incomes, and a lower income tax rate on people with lower incomes. The percentage rate increases at intervals as taxable income increases. Each dollar the individual earns places him into a bracket or category, resulting in a higher tax rate once the dollar amount hits a new threshold.

Part of what makes the U.S. federal income tax progressive is the standard deduction that lets individuals avoid paying taxes on the first portion of the income they earn each year. The amount of the standard deduction changes from year to year to keep pace with inflation. Taxpayers can elect to itemize deductions instead if this option results in a greater overall deduction. Many low-income Americans pay no federal income tax at all because of tax deductions.[7]

Estate taxes are another example of progressive taxes as they mainly affect high-net-worth individuals (HNWIs) and they increase with the size of the estate. Only estates valued at $11.58 million or more are liable for federal estate taxes for 2021, although many states have lower thresholds.[8]

As with any government policy, progressive tax rates have critics. Some say progressive taxation is a form of inequality and amounts to a redistribution of wealth as higher earners pay more to a nation that supports more lower-income earners. Those who oppose progressive taxes often point to a flat tax rate as the most appropriate alternative.

43.8% is the percent of U.S. citizens who did not pay income taxes in 2019 because their earnings weren't sufficient to reach the lowest tax rate, according to the Tax Policy Center.[9]

Examples of Regressive, Proportional, and Progressive Taxes

The following examples of regressive, proportional, and progressive taxes show how they work in practice:

Regressive Tax

If shoppers pay a 6% sales tax on their groceries whether they earn $30,000 or $130,000 annually, those with lesser incomes end up paying a greater portion of total income than those who earn more. If someone makes $20,000 a year and pays $1,000 in sales taxes on consumer goods, 5% of their annual income goes to sales tax. But if they earn $100,000 a year and pay the same $1,000 in sales taxes, this represents only 1% of their income.

Proportional Tax

Under a proportional income-tax system, individual taxpayers pay a set percentage of annual income regardless of how much they earn. The fixed rate doesn't increase or decrease as income rises or falls. An individual who earns $25,000 annually would pay $1,250 at a 5% rate, whereas someone who earns $250,000 each year would pay $12,500 at that same rate.

Progressive Tax

In the U.S. federal taxes operate under a progressive system. In 2021, federal progressive tax rates are 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The first tax rate of 10% applies to incomes of less than $9,950 for single individuals and $19,900 for married couples filing joint tax returns. The highest tax rate of 37% applies to incomes over $523,600 for single taxpayers and $1,047,200 for joint married filers.[8]

A single taxpayer who has a taxable income of $50,000 in 2021, for example, would not pay the third rate of 22% on their income. Instead, they would owe 10% on the first $9,950 of income, 12% on income from $9,951 to $40,525, and 22% for the amount over $40,525. This taxpayer would owe a total of $6,748.50—the 10% rate on the first $9,950 is $995, 12% on the $9,950 to $40,525 is $3,669, and 22% on the amount over $40,525 is $2,084.50. This puts the effective tax rate at just below 13.5%.

Are Income Taxes Progressive Taxes?

Income taxes can be both progressive or proportional. Progressive taxes impose low tax rates on low-income earners and higher rates on those with higher incomes, while individuals are charged the same tax rate regardless of how much income they earn.

Is the Federal Income Tax Proportional?

No, the federal income tax in the United States is progressive.

Are Regressive Taxes Fair?

Regressive taxes may seem fair because they are imposed on everyone regardless of income, but they hurt low-income earners more than others. That's because they spend a larger portion of their income on regressive taxes than people who earn more.

What Taxes Are Considered Regressive?

Regressive taxes are those that are paid regardless of income, such as sales taxes, sin taxes, and property taxes.

How Do You Calculate Progressive Tax?

Progressive tax systems don't charge taxpayers a flat rate. Instead, your tax liability is based on the marginal tax rates set by the IRS. Let's say you earn $50,000, here's how you'd calculate your tax bill for 2021. Under a progressive system, you are charged 10% on the first $9,950. The amount above $9,950 and below $40,520 is taxed at 12%, while the amount over $40,520 is taxed at 22% for a tax bill of $6,748.50.

The Bottom Line

Paying taxes is inevitable. But how much of an impact they have depends on the tax system used and how much you make. Regressive taxes—sales taxes, property taxes, and sin taxes—and proportional taxes have a greater impact on low earners because they spend more of their income on taxation than other taxpayers. But progressive taxes—the federal tax system used in the United States—usually impact high-income earners more than anyone else.

Source: https://www.investopedia.com/ask/answers/042415/what-are-differences-between-regressive-proportional-and-progressive-taxes.asp