Income Tax Alternatives: What Is a Fair Income Tax?

- A tax that takes an increasingly larger percentage as income rises?
- A tax that takes the same percentage of income from every taxpayer?
- A tax that is levied only on consumption?
    - A tax on final consumption?
    - A tax on value added?

A Short History of the Personal Income Tax in the US

The 16th amendment to the Constitution, ratified in 1913, permanently established the ability of the Federal Government to tax personal income. Income was defined in the amendment in basically the same way it is now. The Federal tax structure, however, has varied widely since 1913. The number of income brackets has ranged from a low of two in 1988 to a high of 55 in 1932. Today there are seven income brackets with marginal rates ranging from 10% to 39.6%. The latter rate kicks in at an income of $403K. However, the tax code contains a multitude of exemptions and adjustments often called “tax expenditures.” The net result is that actual tax rates are far below what pre-tax income would suggest.

The Current System

From its origins, the US income tax system has been progressive: as income rises an increasing proportion is taken as tax. However, the increases are marginal, that is, the higher rate applies only to a portion of income above a certain level. Progressive taxes are supported for a number of reasons: higher earners have more ability to pay; higher earners gain more from the public goods financed through taxes; some higher earnings may be a direct result of the public good financed through taxes; *etc*. However, many exemptions and loopholes have complicated the current income tax system to make it less progressive. These tax expenditures have been created for the best of reasons: the mortgage interest deduction encourages home ownership. The charitable giving deduction encourages private charity, *etc.* Proposals for changing the current system are legion. However, very few of the proposals for reforming the current tax system wrestle with the difficult issues: how many politicians are in favor of eliminating the “big four” tax expenditures: home mortgage interest, state and local taxes, fringe benefit deduction and preferential rates on capital gains and dividends? Without addressing those issues, tax reform of the current system is a nonstarter. Claims that “eliminating loopholes” can reform the current tax system are simply demagoguery. As a result, most the proposals for change are aimed at sweeping away the current system and replacing it with something different.

The Contenders

- A Flat Tax
- A Consumption Tax—either a final consumption tax or a value added tax (VAT)

The primary arguments for both of the contenders are that they are simple and fall equally on all taxpayers. It is clear that a flat tax has the potential to be simple, but all income (wages, salaries interest, capital gains) would have to receive the same treatment. Likewise, a consumption tax could be simple, certainly if is in the form of a national sales tax. A VAT might be slightly more complex, but the infrastructure for collecting it is already in place.

The principal criticism of both the flat tax and a consumption tax is that they are not progressive. Whether one judges this as a positive change or not depends largely on one’s position in the income distribution. Paying equal shares has some innate appeal. Over the past sixty years changes in the tax system have yielded no conclusive evidence that either increasing or decreasing progressivity in the tax system affects economic activity. Thus this becomes an ethical question rather than an economic one.

A related question is the potential for a flat tax or a consumption tax to be actively regressive, especially for people at lower income levels. At lower income levels, a significant portion of income—perhaps all—is spent on consumption. Savings are low or nonexistent. At higher and higher levels of income consumption takes up progressively less and less of income. Such a structure can lead to increasing inequality as higher income levels receive income from past savings. Because of this potential for regressivity most flat and consumption tax proposals come with some provision that exempts income below some level from taxes.

Specific Proposals

A flat tax would tax all incomes at the same percentage. Current day proponents of a flat tax argue for its simplicity and fairness in comparison to the current income tax. Calculating taxes would be easy because no matter what you earn, you would pay one rate for all your income. A pure flat tax would also eliminate deductions and credits to further streamline tax filing and payment. Proponents of the flat tax argue that beyond being simple, it's also fair. Because everyone would pay the same tax rate, usually proposed at somewhere between 17-23%, all would pay an equal proportion of their income in taxes. Finally, flat tax supporters say a simplified, uniform tax rate would encourage economic growth.

Opponents of the flat tax argue that it is a more "regressive" method of taxation and would create a system that favors the wealthy. In terms of individual income and wealth, a regressive tax imposes a greater burden (relative to resources) on the poor or low-income population than on the rich—there is an inverse relationship between the tax rate and the taxpayer's ability to pay as measured by assets, consumption, or income. Regressive taxes reduce the tax incidence on people with greater ability to pay as they shift the incidence disproportionately to those with lower ability-to-pay. While a flat tax may appear to be fair to all and simple to calculate, most proposals actually shift the burden of taxation to lower- and middle-class families. Small businesses may also suffer under a flat tax if they are unable to deduct expenses that cut into profits. To offset the regressivity of a pure flat tax, some form of deductions or credits would have to be built into any flat tax system, potentially creating ia set of complicated rules.

The FairTax is a proposal to reform the current federal tax code of the United States by replacing all federal income taxes even payroll taxes (Social Security and Medicare taxes) with a single national consumption tax on retail sales of goods and services. The FairTax would apply a tax, once, at the point of purchase of all new goods and services for personal consumption. To compensate for the regressivity of this tax, the proposal also calls for a monthly payment to all households of lawful U.S. residents as an advance rebate, or "prebate," of tax on purchases up to the poverty level.

In the proposed legislation, the tax rate would be 23% for the first year, based on the total amount paid on the goods and services, including the tax ($23 out of every $100 spent in total). The rate would then be automatically adjusted annually based on federal receipts in the previous fiscal year.

The plan's supporters believe that a consumption tax would have a positive effect on savings and investment, that it would ease tax compliance and reduce evasion, and that the tax would increase economic growth by encouraging businesses to locate in the U.S., and increase U.S. international competitiveness. The plan claims to increase transparency for the federal budget. Opponents contend that a consumption tax of this size would be extremely difficult to collect, and would lead to pervasive tax evasion. They also argue that the proposed sales tax rate would raise less revenue than the current income taxes do now.

This is in fact a key question surrounding the FairTax—whether it could be revenue-neutral; that is, whether the proposed rate would result in unchanged federal tax revenues. Economists, advisory groups, and political advocacy groups disagree about the tax rate required for the FairTax to be truly revenue-neutral. Also, the FairTax's effect on the distribution of taxation or tax incidence (the effect on the distribution of economic welfare) is a point of dispute. The plan's supporters argue that the tax would broaden the tax base, that it would be progressive, and that it would decrease tax burdens now being carried by the wealthy. Opponents argue that a national sales tax would be inherently regressive and that it would decrease the taxes paid by the wealthy. Households at the lower end of the income scale spend almost all their income on essential goods and services, while households at the higher end are more likely to devote a significant portion of income to savings. Opponents also argue that imposing a national retail sales tax would drive transactions underground and create a vast underground economy. Under a retail sales tax system, the purchase of intermediate goods and services that are factors of production are not taxed, since those goods would produce a final retail good that would be taxed. Individuals and businesses may be able to manipulate the tax system by claiming that purchases are for intermediate goods, when in fact they are final purchases that should be taxed.

While many economists and tax experts support a consumption tax, problems could arise with using a retail sales tax rather than **a value added tax (VAT)**. A VAT imposes a tax at every intermediate step of production, so the goods reach the final consumer with much of the tax already in the price. The retail seller has little incentive to conceal retail sales, because much of the good's tax has already been paid. Retailers are unlikely to subsidize the consumer's tax evasion by concealing sales. In contrast, a retailer has paid no tax on goods under a sales tax system. This provides an incentive for retailers to conceal sales and engage in "tax arbitrage" by sharing some of the illicit tax savings with the final consumer. In the United States today, a general sales tax is imposed in 45 states plus the District of Columbia (accounting for over 97% of both population and economic output). Proponents argue that this provides a large existing infrastructure for taxing sales, thus making a VAT easy to implement at the federal level. Some argue, therefore, that a VAT could replace income taxes as a fairer means of supporting government services.