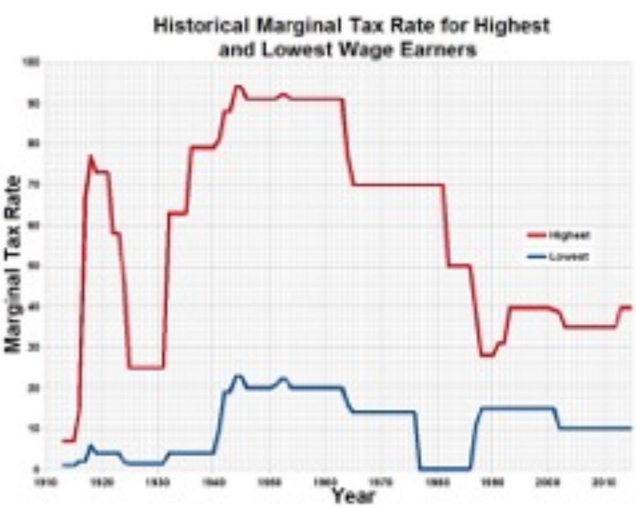
What Should an Effective and Fair Federal Tax System Look Like?

Federal taxes support the operation of the Federal government's many activities. They include individual income taxes, corporate income taxes, excise taxes, employment taxes and estate and gift taxes. However, most discussions of the tax system focus on the personal income tax. We probably need to start out with definitions of "effective" and "fair." Let's define effective to mean a tax that would generate sufficient revenue, given desired expenditures, to balance the Federal budget over a normal business cycle—a level of taxes that might yield a deficit when the economy slumps, but a surplus to pay back the shortage when the economy recovers.

Defining fair is more of a challenge. Fundamentally, this seems to come down to two issues—what to tax and the set of tax rates. Do we tax income or consumption? Does everyone pay the same tax rate or should the tax rate be progressive, where higher income or consumption means a higher tax rate? In the case of an income tax the question then becomes how do we decide the tax rate on each level of income? In the case of a consumption tax, implementing a progressive tax can present a challenge.

After early attempts were declared unconstitutional, the 16th Amendment to the Constitution allowed the Federal government to institute an income tax. With an income tax, the primary issues are the marginal rate paid on varying levels of income and the deductions used to reduce taxable income.

The US income tax has always been progressive. The chart below shows the highest and lowest marginal rates since the income tax was introduced in 1913. Today the wealthiest Americans pay some of the lowest rates in history and the gap between the highest and lowest rates has narrowed considerably since 1960. Remember that these are rates and may not reflect the relative amounts of taxes paid at different levels of income.



The existence of deductions is the principal impediment to changing the current tax system. For example, imagine the effects on house prices mortgage interest was no longer deductible. People would have a smaller incentive to become homeowners and might choose to rent instead. Or the potential effect on charitable giving if the deduction for charitable giving was eliminated. This could cause a decline in the importance of private charity, placing pressure on assistance provided by the government. These examples show how our tax system affects many personal decisions and even, perhaps, the public/private balance.

But by the standards of most countries, the US tax system is not very progressive. The chart below shows taxes collected at all levels of government compared to other developed countries.

Due to the many deductions—home interest, charitable giving, state and local taxes, *etc.*—the average Federal tax rate paid by most Americans is lower than the marginal rates would imply.

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Next, consider a consumption tax. People with lower incomes spend more on consumption and less on savings than people with higher incomes. So by its very nature, a consumption tax is regressive unless it is modified in some way. Exempting necessities such as food and medicine from a consumption tax would make it less regressive, but would require an overall higher tax rate to generate an effective level of income. The same is true of a making a consumption tax more progressive by exempting some level of consumption from the tax. Because these implementation challenges, consumption tax proposals often include a "prebate" to effectively eliminate the consumption tax below a given level of income. The rebate would be provided monthly to every citizen to offset the taxes they pay on their consumption. Most estimates of the required rate for a consumption tax to be effective, given the current Federal budget, range between 25 and 30 percent. The range depends on the adjustments and whatever deductions are chosen. The debates surrounding consumption tax proposals show the complications any such tax plan faces (see for example the FairTax proposal).

Key questions to consider when considering a "fair" tax:

- *Do we want the tax to be progressive?*
- *What do we want to tax?*
- *Do we want to use tax policy to encourage (or discourage) certain activities?*

Progressive taxation has often been thought of as a way to mitigate the societal ills associated with excessive income inequalities. It is also seen as a positive means for the economic redistribution of wealth to reduce income inequality.   Countries with progressive taxation policies tend to exhibit high degrees of social happiness —the Scandinavian countries for example. This seems linked to the subjective well-being of their citizens due to the government delivery of shared public goods and services, such as education, health care, transportation, etc.

Conversely, a report published by the OECD in 2008 presented empirical research showing a negative relationship between the progressivity of taxes and economic growth. Some argue that tax progressivity undermines investment, risk-taking, entrepreneurship, and productivity because high-income earners tend to do much of the saving, investing, risk-taking, and high-productivity labor.

And there are other factors that affect the debate. The income tax is not the only source of the Federal government's revenues. What we do with other income sources can affect how we might want to deal with personal taxes.

- Should the corporate tax be reduced—or even eliminated? The US corporate tax rate is one of the highest in the world with a top rate of 39%. But in fact, the average corporate tax rate in 2015 was only 12.1% after deductions and exclusions.
- Should the US institute a value added tax (VAT)—a type of consumption tax? Most developed countries have a VAT in addition to an income tax, but a VAT amounts to double taxation—you're taxed once on your income and again when you spend it. A VAT is regressive because it falls more heavily on people who spend more of their income than they save.
- Should the US institute a financial transactions tax? This tax could produce a large amount of income, and proponents argue that it might help stabilize financial markets by limiting unproductive high frequency trading.
- Should the estate tax be eliminated—or increased? At present it applies only to estates over $5.45MM ($10.9MM for a husband and wife)—just 0.2% of all estates in the US. An estate tax has less impact on economic activity than other taxes.

Combinations of changes in these taxes could make it necessary to have higher personal tax rates to fund the budget if other sources of revenue were reduced or conversely, allow personal tax rates to be lowered if more revenue can be acquired from other types of taxes.