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Tax Inequity

By Richard W. Rahn

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Counterproductive system punishes success but claims to be progressive

So you have just finished preparing your income taxes, but did you understand the tax code? If you said yes, you do not know what you do not know. The U.S. tax code has become so long, complex, contradictory and devoid of common sense that no one can fully understand it - and this includes tax professionals and Internal Revenue Service (IRS) personnel. Can honorable persons of good conscience harass, fine and even imprison their fellow citizens for an alleged violation of laws and regulations they themselves do not completely know? But that is a topic for another column.

Tax economists have long argued that the U.S. income tax causes an enormous - and largely unnecessary - dead-weight loss to the economic system. The sheer cost and time burden of businesses and individuals trying to comply with the tax system - let alone the cost of the more than 100,000 bureaucrats at the IRS who claim to be administering it - waste hundreds of billions of dollars. This waste of resources unnecessarily reduces economic growth and job creation. A major reason this obscenity persists is that few lawmakers and IRS rule makers think seriously about the consequences of what they have done and are doing, or just don't care.

One person who does think seriously about tax and other financial issues, including the morality of the tax code, is California venture capitalist and financial scholar Kip Hagopian. Mr. Hagopian has a most timely and provocative article in the April-May issue of Policy Review (a publication of the Hoover Institution at Stanford University) titled "The Inequity of the Progressive Income Tax." The U.S. has had a progressive income tax (in which rates rise at higher income levels) since the beginning of the income tax in 1913. The progressive income tax is considered fair by many people. But is it? Mr. Hagopian argues that if people really think through the issue, they are likely to come to a very different conclusion.

Tax scholars have been debating the pros and cons of tax systems for centuries. Taxes on consumption - what people take out of an economy - are generally considered less destructive than taxes on labor and capital, which are inputs into an economy. As Mr. Hagopian notes, there are basically four (broadly defined) income tax systems debated in the literature:

- A per-capita, or “head” tax, which would require each person to pay his per-capita share of the costs of government.
- A proportionate or “flat” tax, which would tax each dollar of income at a single rate, usually with few if any exemptions or credits.
- A degressive tax, which is a proportionate tax only on income above a certain threshold or exemption. The exemption makes the system progressive but typically much less so than a system of graduated rates.
- A progressive tax, which taxes incremental income at higher marginal rates as income rises, resulting in an increase in taxes as a percentage of income as income increases.

The United States has one of the most progressive tax systems in the world. The top 1 percent of taxpayers pay 38 percent of all the income taxes despite having just 20 percent of the income. The top 10 percent of taxpayers pay 70 percent of the income tax while having just 46 percent of the income. At the other end, the bottom 50 percent of taxpayers pay just 2.7 percent of the income tax while having 13 percent of the income.

The income tax has become much more progressive in the past 30 years, resulting in a situation in which a relatively small minority of taxpayers pay the bulk of the taxes, while most Americans pay little or any income tax. This is causing an increasing disconnect between benefits from government and what most citizens pay for. One result is a greater polarization in the political realm where a majority of citizens increasingly demand more government benefits for which they want others to pay.

The Swedes were on this same destructive path, but they reversed course over the last couple of decades and made their tax system far less progressive even though their tax rates at all levels are above most of those in the United States. The result has been a tempering of demand for new government services as people at all income levels realize they will be the ones paying for those services and not some mythical “rich” person. The side benefit is that Sweden, as a result of tax and other reforms, now has one of the highest economic growth rates in the world.

Mr. Hagopian has carefully looked at the pros and cons of each system in a most dispassionate way, and concludes, “Since there is no perfectly equitable tax system, the goal must be to design the least inequitable system.” He concludes that the degressive system is the least inequitable. It is not possible to

summarize Mr. Hagopian's arguments for and against each tax system in a newspaper column; hence, I will not attempt the impossible. But for those who think a progressive system is equitable, please explain the equity in taxing one person at a higher rate on each extra hour he or she works to make life better for his family while taxing the less responsible and less industrious person at a lower rate.

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