Progressive Income Tax: The Tax Policy America Needs

Nicholas Oakes

Abstract: *Income tax has enormous implications on many aspects of American life. It is the main source of the government's revenue and it dictates how much money will be deducted from every worker's income. There has been a recent movement for a flat tax regime to take over the current progressive United States income tax code, especially by members of the Republican Party. This paper uses secondary research and evidence from private research institutions, such as the Tax Foundation and the Tax Policy Center, and government publications, such as IRS data and the federal budget from the Office of Management and Budget to argue that the progressive income tax code, with some improvements such as fixing loopholes and introducing a new tax rate for the super-rich, proves to be better than a flat income tax in the areas of tax revenue collection, reversing income inequality, and providing useful tax incentives. The results found prove that a progressive income tax, with modifications, is the best income tax policy for the United States and a flat income tax would be detrimental to the United States economy and the intrinsic values that American citizens hold dear.*

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration" (U.S. Const. amend. XVI). The Sixteenth Amendment declared the United States Congress to have the power to collect income tax since it was ratified in 1913. The specifics on how the income tax would be used have been debated ever since. The United States currently employs a progressive system, but there has been increasing support for a flat tax system, making income tax a very controversial subject among economists, policy makers, and politicians. Today, the income tax is 48.6% of total tax revenue in the United States at about $1.546 trillion dollars (CBO, 2016). Changing the income tax code in any way has tremendous effects that touch every aspect of the United States from tax revenue to every individual American worker. Policy makers and economists need to realize the pitfalls of a flat tax

and implement a more progressive tax code than is currently in place in order to increase tax revenue, decrease income inequality, and maintain positive tax incentives to preserve America's long-held values of opportunity and equality.

Definitions and Background

A progressive tax is one where people are taxed differently based on their income. A person who makes more money pays a bigger portion of their income to income tax than a person who makes less money. How much a person is taxed is not decided on a sliding scale, but more simply in different tax brackets. The table below illustrates exactly what those tax brackets are for 2017.

Rate	Taxable Income Bracket	Tax Owed
10%	$0 to $9,325	10% of Taxable Income
15%	$9,325 to $37,950	$932.50 plus 15% of the excess over $9325
25%	$37,950 to $91,900	$5,226.25 plus 25% of the excess over $37,950
28%	$91,900 to $191,650	$18,713.75 plus 28% of the excess over $91,900
33%	$191,650 to $416,700	$46,643.75 plus 33% of the excess over $191,650
35%	$416,700 to $418,400	$120,910.25 plus 35% of the excess over $416,700
39.6%	$418,400+	$121,505.25 plus 39.6% of the excess over $418,400

Table 1. Single Taxable Income Tax Brackets and Rates, 2017
Source: The Tax Foundation

A common misconception that people make when they look at tax brackets is that the second their income breaks into the next highest tax bracket, all of their total income is taxed on that rate. If that were the case, people would pay more total money to income tax the second they move up into a new bracket and have no incentive to move up a bracket. The way income tax actually works is as follows: the first $9,325 a person makes is taxed 10%, all money made between $9,326 and $37,950 is taxed at 15%, income made from $37,951 to $91,900 is taxed 25%, and so on. A flat tax, on the other hand, is exactly what it sounds like: a single tax rate that is applied to every person that makes an income.

As stated earlier, the United States currently has a progressive income tax and has had a progressive income tax since the ratification of the 16th amendment in 1913. This tradition of a progressive tax is being threatened by recent support for a flat tax, specifically by the GOP. In the latest election, Republican candidates such as senator Ted Cruz, senator Rand Paul, and Dr. Ben Carson all proposed their own version of a flat tax. Ted Cruz's "Simple Flat Tax Plan" planned to compile all tax brackets into one at a rate of 10%, while leaving the first $36,000 tax free (Cruz For President, 2015). Senator Rand Paul's tax plan, the "Flat and Fair Tax" would tax income at 14.5% with the first $50,000 of income tax exempt for families of four (Lundeen & Schuyler, 2015). Dr. Ben Carson's flat tax plan would tax every single worker at 14.9% (Pomerleau, 2016). In a global perspective, there has also been movement toward a flat tax. Estonia switched to a flat income tax in 1994, starting the movement. Since then, 16 other countries have joined them. Over the years, there has been more support for a flat tax in America making this debate increasingly relevant, and important.

Tax Revenue

Tax revenue is at the center of attention when there is talk of tax reform. Under a progressive tax in 2016, the Congressional Budget Office (CBO) reported total federal government revenues of about $3.3 trillion (CBO, 2016). Of the $3.3 trillion, $1.546 trillion was collected from individual income taxes (CBO, 2016). With income taxes being approximately 46.8% of total revenue, any change to the collection of income tax would have a great effect on the United States' main source of revenue. This is the money that pays for the country's infrastructure, education, law enforcement, and other government departments and agencies.

There are many outcomes that could occur under a flat tax regime, depending on what the rate is and what kind of tax exemptions there are. There is one constant consequence across the board for any flat tax plan that is being proposed right now, and that is major decreases in income tax revenue. The Tax Policy Center (TPC), an independent research company, researches and analyzes tax policies such as Ted Cruz's "Simple Flat Tax Plan." In the TPC's analysis, they found that Ted Cruz's flat tax plan would reduce income tax revenue by $11.9 trillion within ten years of implementation (Rosenberg, Burman, Nunns, Berger, 2016). Proponents of Senator Cruz's plan argue that the loss will be offset by budget cuts, mainly the removal of the Internal Revenue Service (IRS), and increased investment incentives created by the flat tax. After factoring value-added tax revenues, the TPC found that the entire flat tax plan would still decrease revenues by $8.6 trillion within 10 years (Rosenberg et al., 2016). The deficits grow even more when additional interest owed on the deficits following a flat tax are calculated in. The TPC found that the United States would also owe a total of $1.6 trillion within 10 years (Rosenberg et al., 2016). After accounting for the decreased revenue, the value-added tax revenues, and the additional interest costs, Senator Ted Cruz's flat tax plan would add $10.2 trillion to the United States national debt within 10 years of implementation (Rosenberg et al., 2016). Debt of this degree is subject to any legitimate implementation of a flat tax, not just Cruz's plan alone. There is simply no amount of budget cuts that would be able to offset an increase of debt at this magnitude. A debt this big would be seen all through America in the form of decreased school funding, decreased infrastructure growth, fewer government jobs and programs, and decreased funding to the federal justice and law enforcement.

In contrast, the current progressive tax code is not putting the United States at risk for financial failure and is sustainably funding the nation's government and economy into the future. The Office of Management and Budget (OMB) budgeted progressive income tax revenue for 2017 to be $1.719 trillion (OMB, 2016). This could directly pay for all discretionary non-defense programs in 2017, budgeted to be $564 billion; all defense programs, budgeted to be $577 billion; and all Medicare expenses, budgeted to be $567 billion, with $11 billion left to help pay for other programs (OMB, 2016). The revenues the current progressive tax provides are the life blood that makes mandatory programs such as social security and Medicare, and discretionary programs such as education, national defense, and infrastructure development possible. Taking care of the elderly and sick and funding education are at the heart of American values that would be lost without the necessary revenues.

Income Inequality

Income inequality is an increasingly troublesome problem in the United States. The rich are getting richer while the lower class remains stagnant. The latest data collected by the United States Census Bureau (BOC) shows that, in 2015, the top 20% of Americans make 50% of total American income while the bottom 60% only make 27.1% of income in the United States. To put this into better perspective, the top 5% make 21.8% of the income and the bottom 20% only make 3.3% (BOC, 2016). The following figure is from an economic research report by the Federal Reserve Bank of San Francisco and displays the trend of income share in America since 1970 using data from the BOC (Lansing & Markiewicz, 2016).

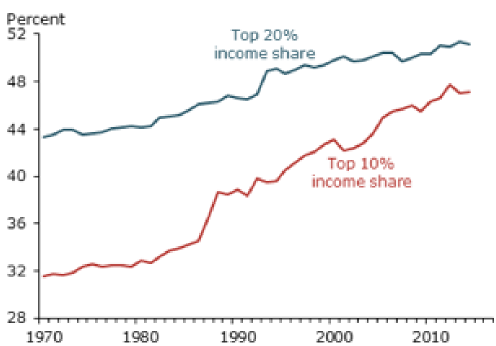

Figure 1. Income share in America since 1970. Source: Federal Reserve Bank of San Francisco

As seen in the graph, the top 20% of earners' income share has steadily increased over the years and the top 10% of earners in the United States' income share has increased even more sharply. Marcia Clemmitt from CQ Researcher states that, "most analysts agree that a certain amount of income inequality is valuable because it gives people incentives to work hard and try out new business ideas, in hopes of reaping big rewards. However, many are skeptical that current U.S. inequality levels are risk free or contribute much to building the economy" (Clemmitt, 2010, p. 994). Clemmitt summarizes expert analysts' opinions that income inequality has benefits for the United States economy, but the rate that income inequality is growing in America is proving to hurt the economy. The goal is not to abolish income inequality, but rather to limit it to a sustainable level that is beneficial for the economy and the welfare of the people. How a tax code affects income inequality is a main concern when evaluating the impact proposed tax reform will have on the economy and the welfare of the country. Flat taxes and progressive taxes affect income inequality extremely differently.

A flat tax plan can vary greatly depending on the flat tax rate being applied to everyone, and what portion of the population, if any, is tax exempt. After analyzing some of the most popular flat tax plans that have recently been proposed, it is clear that they would all consistently increase income inequality in America. In the Tax Policy Center's (TPC) analysis of Ted Cruz's flat tax plan, they found that:

> All income levels would receive tax cuts, but the highest-income households would receive the largest cuts, both in dollars and as a percentage of income. The highest-income 1.0 percent would get an average tax cut of over $400,000 (26 percent of after-tax income), and the top 0.1 percent would get an average tax cut worth nearly $2 million, 29 percent of after-tax income. By contrast, the lowest-income households would receive an average tax cut of $46, or 0.4 percent of after-tax income. Middle-income households would receive an average tax cut of nearly

$1,800, or about 3 percent of after-tax income (Rosenberg et al., 2016).

Even though Cruz's new flat tax would increase every quintile of income earners, it would treat everyone very differently. The top quintile would receive astronomical increases in after tax income, both in dollars and in percent of income, while the lower quintiles would receive minuscule increases in comparison. The Tax Foundation did a similar analysis on Dr. Ben Carson's proposed flat tax plan and saw similar results. On a static basis (not accounting for other economic factors that would affect after tax income as a result of the new tax plan), there would be decreases in after tax income for the entire bottom 90% of earners (Pomerleau, 2016). The second decile range would see the biggest decrease in income at -14.83% and the bottom 10% of earners would experience a -13.10% reduction in after tax income (Pomerleau, 2016). The only group of American earners that would benefit on a static basis would be the top 10%, seeing an increase of after tax income of 16.21% (Pomerleau, 2016). The top 1% would experience a 33.44% increase of income (Pomerleau, 2016). These numbers may be unrealistic depending on exactly how the tax plan would affect other areas of the economy such as capital investments, and job growth. When the Tax Foundation did a dynamic analysis (accounting for other factors that would affect after tax income resulting from the new tax code), there is an increase in after tax income across the entire income distribution. The bottom 10% would see a 2.46% increase in after tax income and the second decile of earners would see a small 0.51% increase of after tax income (Pomerleau, 2016). The middle-class earners of the income distribution would see a decent increase of around 13% while the top 10% of earners would experience a huge 30.3% increase of after tax income, and the top 1% would experience an even bigger 44.58% increase (Pomerleau, 2016). The dynamic distributional analysis of Dr. Ben Carson's tax plan shows better numbers, in terms of income inequality, than the static analysis but would still benefit those at the top of the income distribution far more than the ones in the middle and the bottom. Increasing the income of the earners at the top would surely make America's income inequality problem much worse than it currently is. This is a problem that the flat tax would have, if implemented, that the Republican Party does not address.

After observing the effects a flat tax would have on income inequality, it is clear that it would simply make the problem worse. In contrast, a progressive tax and an even more progressive tax code are tools that can help reduce the income inequality crisis in America. Peter Diamond, a professor of economics at the Massachusetts Institute of Technology, sums up the argument for a progressive tax fixing income inequality as, "the more tax revenue that comes from those with the highest incomes, the less need to come from everyone else" (as cited in Glazer, 2014, p. 353). This is exactly what the current progressive tax system is doing for America right now, but income inequality is still growing. This is because the current progressive tax system is not doing its job of taxing the rich at the 39.6% like it is designed to do. Sarah Glazer, a CQ Researcher journal author, says, "the very rich rarely pay that 39.6 percent because of numerous loopholes, including a provision that lets hedge fund and equity fund managers count some income as capital gains, which is taxed at a lower rate" (Glazer, 2014, p. 352). These loopholes have led to very low effective tax rates for the top earners. Patching up these loopholes is one way that would make the top earners pay their share of taxes, moving to a more equal income distribution. Fixing the loopholes in the current code is not the only way progressive income tax can move to a more equal income distribution. Yale political science professor Jacob S. Hacker presents his idea of fighting back against income inequality by suggesting to, "[raise] the top rate on the truly rich — to 45 percent for those with annual incomes between $1 million and $10 million and to 49 percent for those with income of $1 billion or more" (Glazer, 2014, p. 345). Integrating tax brackets designated to earners that make more than the current highest tax bracket requirement at $418,000, like Hacker suggests, would increase the taxes deducted from their incomes, reducing income inequality. A progressive tax system is a useful tool in fighting back against income inequality. With some changes to the current progressive tax code, such as fixing loopholes and adding higher tax brackets for the super-rich, income inequality could be pulled back into an efficient and sustainable state.

Simplicity and Tax Incentives

Along with tax revenue and income inequality, when tax reform is being discussed and debated, simplifying the tax code is always a concern. The current tax code has been growing in length and complexity at an accelerated rate from year to year. The following graph created by the Tax Foundation plots the length of America's tax code over time since 1955.

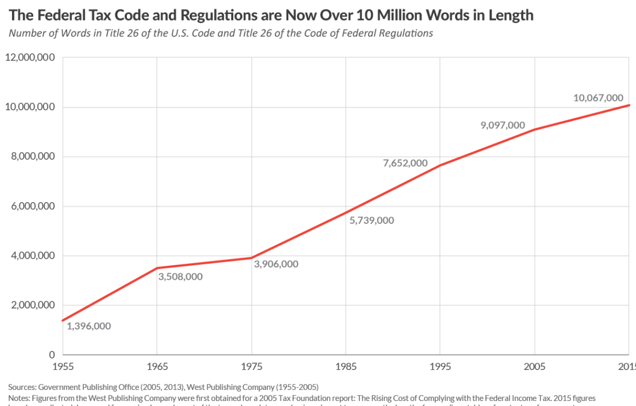

Figure 2. American Tax Code length since 1955. Source: Greenburg, 2015

As of 2015, the tax code was a staggering 10,067,000 words long. This complexity is a big problem for politicians and American citizens alike. In a 2015 poll run by the Pew Research center, 72% of Americans expressed that they were bothered by the complexity of the tax system (2015). Every legitimate current tax proposal directly addresses simplifying the current tax code to make it understandable for every American and to eliminate the loopholes created by the complexity.

Understandably, then, simplifying the tax system is one of the main points made by proponents of the flat tax. Flat tax proposals often include a "postcard" idea that would make it so every American simply needs to fill out a postcard-sized form to file their taxes instead of hiring a tax professional to sort through various financial documents to get their taxes filed correctly. In Ted Cruz's flat tax plan, Cruz calls this "The Cruz Simple Flat Tax Postcard" and only has 14 items that need to be filled out along with standard identification information (Cruz for President, 2015). Such simplicity would dramatically cut tax compliance costs and hours dedicated to tax compliance. Demian Brady, the director of research at the National Taxpayers Union Foundation, did a study and found that, in 2015, "the total economic value of the compliance burden can be valued at $234.435 billion" (Brady, 2016). This $234.435 billion is made up of direct taxpayer costs of software and professionals that get their taxes done, lost productivity costs of time spent doing taxes, and increased costs to consumers because of corporate compliance costs. Senator Ted Cruz cites these costs in his tax proposal as "deadweight loss and it doesn't even produce even a single truck or tortilla" (as cited in Cruz For President, 2015). Supporters of the flat tax see it as the tax reform needed to eliminate loopholes and inefficiency and as a solution to America's complicated tax code.

Despite its alluring ease, the very simplicity that a flat tax promises would come at a cost, not only of tax revenue and increased income inequality, but also of losing valuable, welfare-inducing tax incentives. Part of what makes the tax code complex is the different tax incentives (deductions) that are put in place to give people tax breaks for doing things that benefit society. Dr. Holley Ulbrich, an economics and public policy professor at Clemson University, describes the tax incentives that would be lost under the simplification of a flat tax. Dr. Ulbrich names three tax incentives that would directly affect middle income earners. The first is tax deductions related to mortgage interest and property tax expenses. Dr. Ulbrich says, "Most households figure those deductions into deciding how much home they can afford to buy" (Ulbrich, 2011). Losing these tax deductions would increase the expenses associated with mortgage payment and property tax expense. The second tax incentive that would be lost under a flat tax is tax deductions awarded to charitable contributions. A study done by the University of South California tested the effect tax incentives had on charitable contributions and found that, "the tax elasticity of charitable giving is about -4 — a large effect, and one greater in magnitude than most papers using individual tax return data have estimated" (Duquette, 2014). A -4 elasticity means that for every 1% increase of tax costs of charitable contributions, there is a 4% decrease in the amount of charitable giving, concluding that the tax incentives have a big effect on the amount of money people give to charity. The third tax incentive Dr. Ulbrich says will be lost under a flat tax is employer-provided fringe, the loss of which, she says, would be "the biggest hit for middle income households" (Ulbrich, 2011). Fringe benefits typically include programs such as retirement saving and health insurance. Employers designate about 30% of wages and salaries to provide these services for employees and money put into these programs is either tax exempt or taxed at a lower rate (Ulbrich, 2011). Taxing these fringe benefits "would discourage saving for retirement and providing health insurance" (Ulbrich, 2011). The current tax code is surely complex, and there is value in simplifying it; nobody is arguing that. However, simplifying the tax code would be at the expense of the incentives that promote equality and opportunity. These incentives drive economically and socially beneficial activities such as buying houses, engaging in charitable contributions, and providing fringe benefits, and removing them would discourage core American values that are currently being promoted.

Conclusion

Income taxes play an integral role in the United States economy. They play a role in every American worker's life and are the lifeblood of the government as the number one source of federal revenue. The income tax structure that is chosen by the country will impact every aspect of American life. There has been recent movement towards a flat tax, mostly by members of the Republican Party. After analyzing how a flat tax would impact four main areas of concern, tax revenue, income inequality, simplicity, and tax incentives, it is evident that a flat tax falls flat when compared to a progressive tax. A flat tax would substantially decrease revenues, even with proposed budget cuts, while a progressive tax supplies the government with 46.8% of its total revenues collected. Income inequality would skyrocket under a flat tax as it benefits the rich and hurts the lower class in a regressive manner. But a progressive tax implemented correctly, or an even more progressive income tax, are tools that can keep income inequality at a sustainable level and prevent the adverse effects of too much inequality. Simplicity is the major selling point for flat tax proponents. It is widely accepted that the current tax code is too complex and is increasing in complexity, but switching to a more simplistic flat tax would come at the expense of the positive tax incentives that are part of a more complex progressive tax code. It is imperative that policymakers realize the stated pitfalls that come with a flat tax and continue to use a progressive tax that promotes equality and opportunity as America's income tax code.

Note: This essay was composed in Dr. David Reamer's AWR 201 class.

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U.S. Const. amend. XVI