

Virtuous Tax Reform

Good tax policy should contain a number of elements. Let's review what they are.

Horizontal Equity

Horizontal tax equity requires that those with equal status—whether measured by ability or some other appropriate scale—should be treated the same. The US tax code fails the horizontal equity test in countless ways.

A determination of horizontal equity is clouded by the definitions of income and different types of taxes. There are a lot of different definitions...I'll name two ordinary income and capital gains income. The definitions result in two or more rates. The list of different types of taxes applying to different group is amazingly long at the federal level. Estate taxes, Social Security taxes, medical taxes, alternative minimum tax, excise taxes, import duties, and various user fees and taxes to name just a few.

Allowable deductions are different depending on the circumstances of the payer. Tax credits and preferences abound and cover all sorts of circumstances.

The net result is that taxpayers with similar cash flow pay wildly different amount of taxes.

Vertical Equity

Vertical equity, in turn, generally requires that those with less ability be treated favorably relative to those with greater ability. Debate during the creation of the income tax amendment clearly supported the idea of progressivity. Those that make more should pay more taxes and at a higher tax rate. Class warfare over the degree of progressivity continues to this day. Waves of populism have swept the country during times of national stress. The result has been top rates of up to 90 per cent of income. In the 1980s top rates were reduced to the low thirties, but have since crept back up to nearly 40%.

During the 60 years of high tax rates, virtually no one paid the top rates. Manipulation of the tax code to produce special exemptions, creative expense deductions, preferences and tax credit approached an art form during this period.

Much of the drive for tax reform in the 1980s was fueled by the realization that high tax rates yielded little additional revenue and certainly corrupted the tax

code. They also caused a poor allocation of investments and resources that weakened the potential of the economy.

Unfortunately, that art has continued to flower in this period of lower rates. The result has been that reform efforts have failed, and the tax code is more complex and lengthy than ever. The powerful have taken full advantage of this complexity. Now the very richest Americans pay tax rates that are similar to the Social Security and Medical tax rates paid by the poorest Americans.

Taxes at the federal level in the US are based on transactions. In addition to favorable tax rates on reported transactions, the very wealthy have become very adept at avoiding transactions altogether. As a consequence, they avoid taxes completely on much of their wealth creation.

Payers of ordinary income tax do experience the progressivity and vertical equity that tax writers envisioned. But the overall effect of vertical equity has been lost.

A Broad Tax Base

The issues of vertical and horizontal equity are closely related to two other elements...low tax rates and simplicity. Within the subject of simplicity lies the bulk of the US tax code. It is pretty clear from a study of tax history that the more people that pay taxes, the lower the rates will be. The lower the tax rate, the easier it is to collect it. The percentage of citizens that pay Social Security taxes and medical taxes has remained high and grown, because they apply to everybody that works without deductions. The number that pay income taxes has fallen dramatically. Fully 50% of the payers pay more Social Security tax than income tax. The very wealthy investment income class has little stake in ordinary income tax rates. These two voting blocks are generally indifferent to income tax rate increases, because they don't pay them.

What has developed is the basis for extreme moral hazard. The old saw that "if you rob Peter to Pay Paul, you can always count on the support of Paul" was never truer. "Tax that man behind the tree. But whatever you do, don't tax me." The tax base is extremely narrow for each type of tax and for the myriad of tax rates.

A lack of simplicity in taxation is at the heart of the problem. The electorate has been sliced and diced by a combination of selective taxation and selective spending. These small groups of voters are then manipulated by the powerful to

produce the tax system we have today. Proponents of the Fair Tax and various flat taxes are trying to dramatically simplify the number of taxes and tax rates to neutralize these effects. These groups are trying to increase the number of taxpayers and lower the rates that are paid.

Connecting Spending and Taxation

The disconnection between spending and taxation is pervasive throughout the current tax regime. A spending bill does not register on the radar of the taxpayer, because there is no direct relationship to current tax rates. The disconnection really occurs at two levels. First, as described above, tax code complexity obscures the real cost of spending, or politicians succeed in creating the picture that some one else is paying for a new benefit or initiative.

Second, budget deficits disconnect the current generation of taxpayers from the future taxation required to pay for a benefit. In the short run, there may be an effect on interest rates, but in fact changes in interest rates are not linked in the voters mind to spending. The goal of the Hedgehog Party is to require a balanced budget and reconnect current spending to current taxation. Coupled with simplicity in tax rates and deductions, the voters have an opportunity to measure whether a benefit or action is worth the cost in additional taxes.

Other Issues Related to Simplicity

The many different taxes and the many different tax rates charged to different voting groups are only part of the tax reform problem. Definitions of income, deductions, tax credits and tax preferences have just as big an effect on horizontal and vertical equity. In general, the Hedgehog party proposes to eliminate all tax credits, tax preferences, and all deductions save a single personal deduction. Defining income to maximize the number of taxpayers is a complex technical issue outside the scope of this summary but would be part of the enabling legislation of the Hedgehog Party tax reform.

The Asset Tax

The proposed National Sales Tax (Fair Tax) and the various Flat Income taxes are ineffective in taxing the very wealthy asset holder. Both would be a substantial help in restoring equity to transactional income. But substantial wealth is accumulated without any taxable transactions occurring. Most of this wealth is accumulated through appreciation of assets owned by the very wealthy.

The Hedgehog Party tax reform includes an asset tax applied at a maximum rate of 1% annually to the top 10% of asset holders.

Restricting the asset tax to the wealthiest members of society aims at the biggest source of revenue for the smallest number of tax returns.

Summary:

The goal is to make taxation as simply as possible, and to frame it in such a way that most citizens are affected by spending and taxation. Then it is a matter of voting.

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