



# Taxes: Equity vs. Efficiency

## Part II

The only difference between death and taxes is that death doesn't get worse every time Congress meets.

Will Rogers



# 1990 and 1993 Tax Increases

- Some critics of the 1986 TRA reforms claimed that it was a “giveaway” to the rich.
- The 1990 and 1993 tax increases resulted in creating five tax brackets instead of three.
- The top marginal tax rate was raised to 39.6 percent.



# The Bush Tax Cuts (2001-2010)

- President Bush made tax cuts his top priority after he was elected.
  - Reduce marginal tax rates to encourage more production.
  - Provide tax incentives to encourage more education, saving, and family development.



# Reduced Marginal Rate

- The lowest marginal rate was lowered to 10 percent to increase the disposable income of low-income workers and give them more incentive to work.
- The highest marginal tax rate was reduced to 35 percent.



# Education Incentives

- To increase college enrollments, the bill provides a \$3,000 tax credit for college tuition.
- The tax credit induces only a small change in college enrollments, yet introduces both horizontal and vertical inequities.



# Family Incentives

- To encourage marital stability, the bill reduces the marriage penalty in the standard deduction.
- To help defray the cost of raising children, the child tax credit was increased.



# Saving Incentives

To encourage saving, the Tax Relief Act of 2001 raised the limit on retirement savings accounts and phased out the estate tax.



# Payroll, State and Local Taxes

The federal income tax is only one of many taxes the average taxpayer must pay.



# Sales and Property Taxes

- We gauge tax burdens in relation to people's incomes.
- Sales taxes and property taxes are both regressive.
  - A **regressive tax** is a tax system in which tax rates fall as incomes rise.



# Sales and Property Taxes

Sales taxes and property taxes are regressive because poor people pay a larger percentage of their income on these taxes than do rich people.



# Excise Tax

- taxes placed on the purchase of certain goods
- example tobacco and gasoline
- federal tax



# Social Security Tax

- tax on income generated from employment
- federal tax
- half of tax is imposed on employer and other half on employee



# Property Tax

- tax on the value of your property – home, business, etc
- revenue raiser for state and local government
- also used for schools and special districts

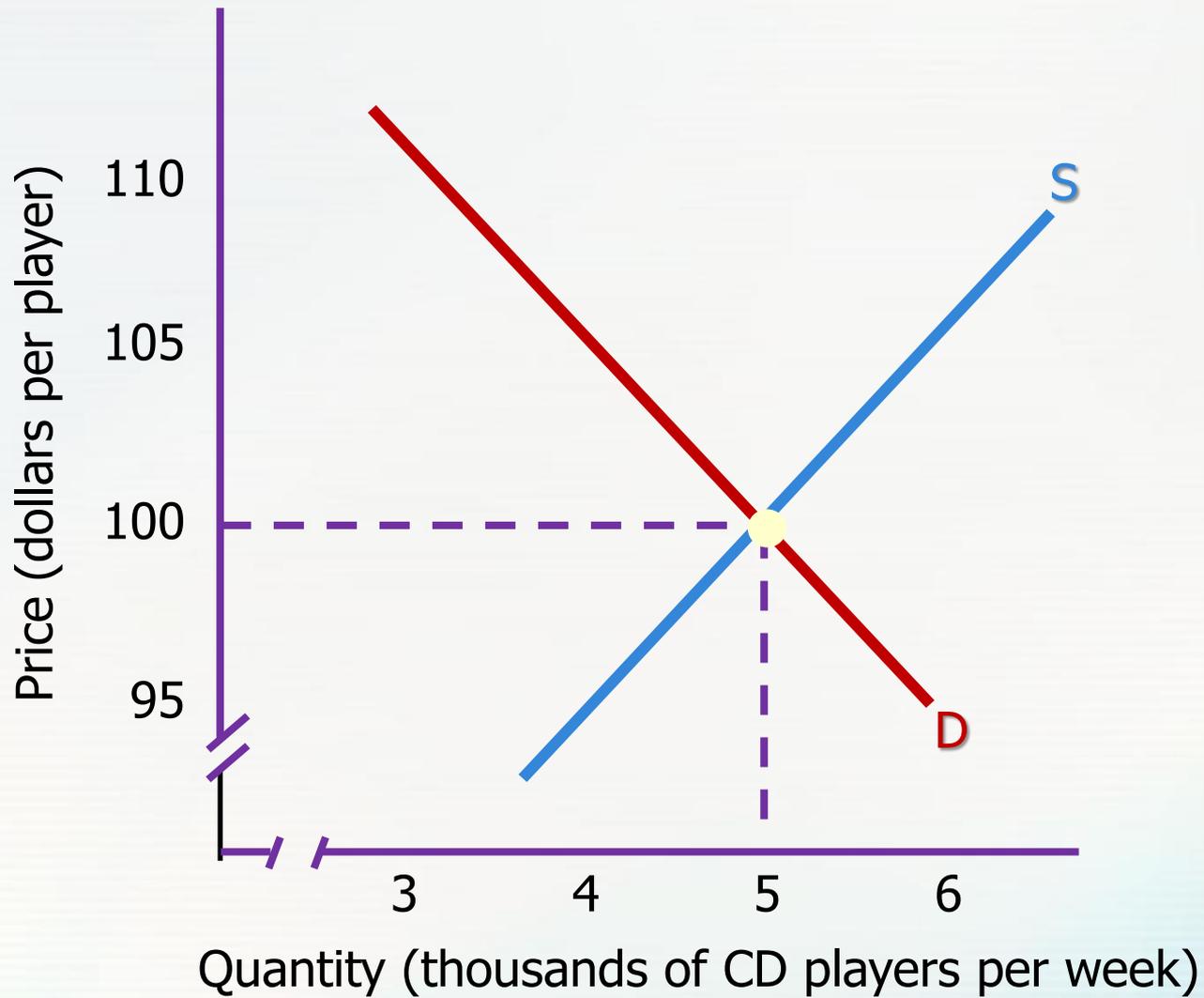


# Sales Tax

- tax on the purchase of a wide variety of goods – cars, computers, clothes, books, etc
- state tax to raise revenue to run state government
- no federal sales tax



# Chart: The Sales Tax





# Tax Incidence

- **Tax incidence** is the distribution of the real burden of a tax.
- The burden of property taxes is reflected in higher rents.
  - Landlords tend to pass along to tenants any property taxes they must pay.
  - People who rent apartments pay higher rents because of property taxes.



# Payroll Taxes

- Labor demand reflects the marginal revenue product (MRP) of labor.
  - **Marginal revenue product (MRP)** – the change in total revenue associated with one additional unit of input

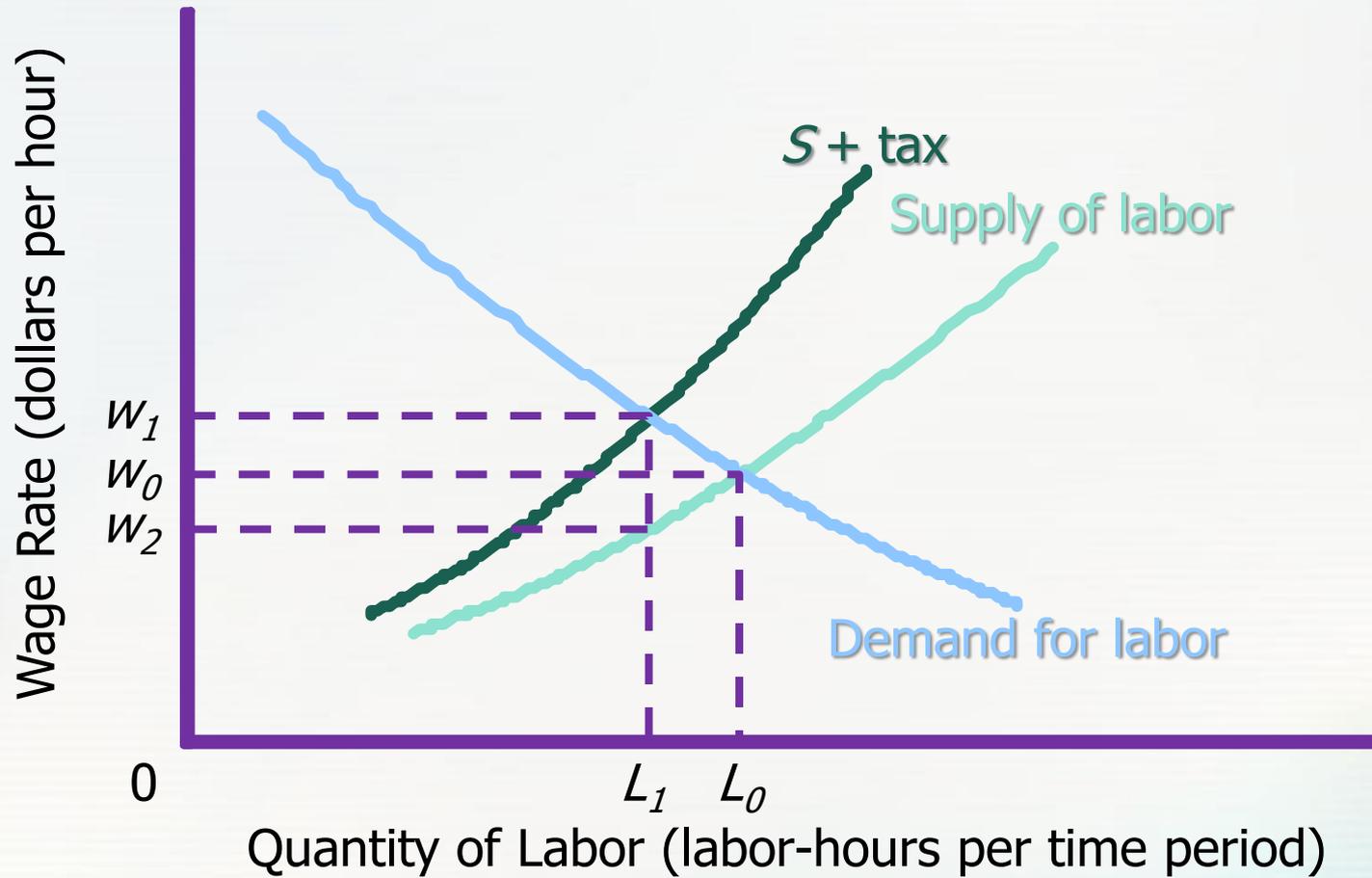


# Payroll Taxes

- MRP sets a limit to the wage an employer is willing to pay.
- Fewer workers are employed and the net wage is reduced when a payroll tax is imposed.



# Chart: Incidence of a Payroll Tax





# Taxes and Inequality

The regressivity of the Social Security payroll tax and of many state and local taxes offsets most of the progressivity of the federal income tax.

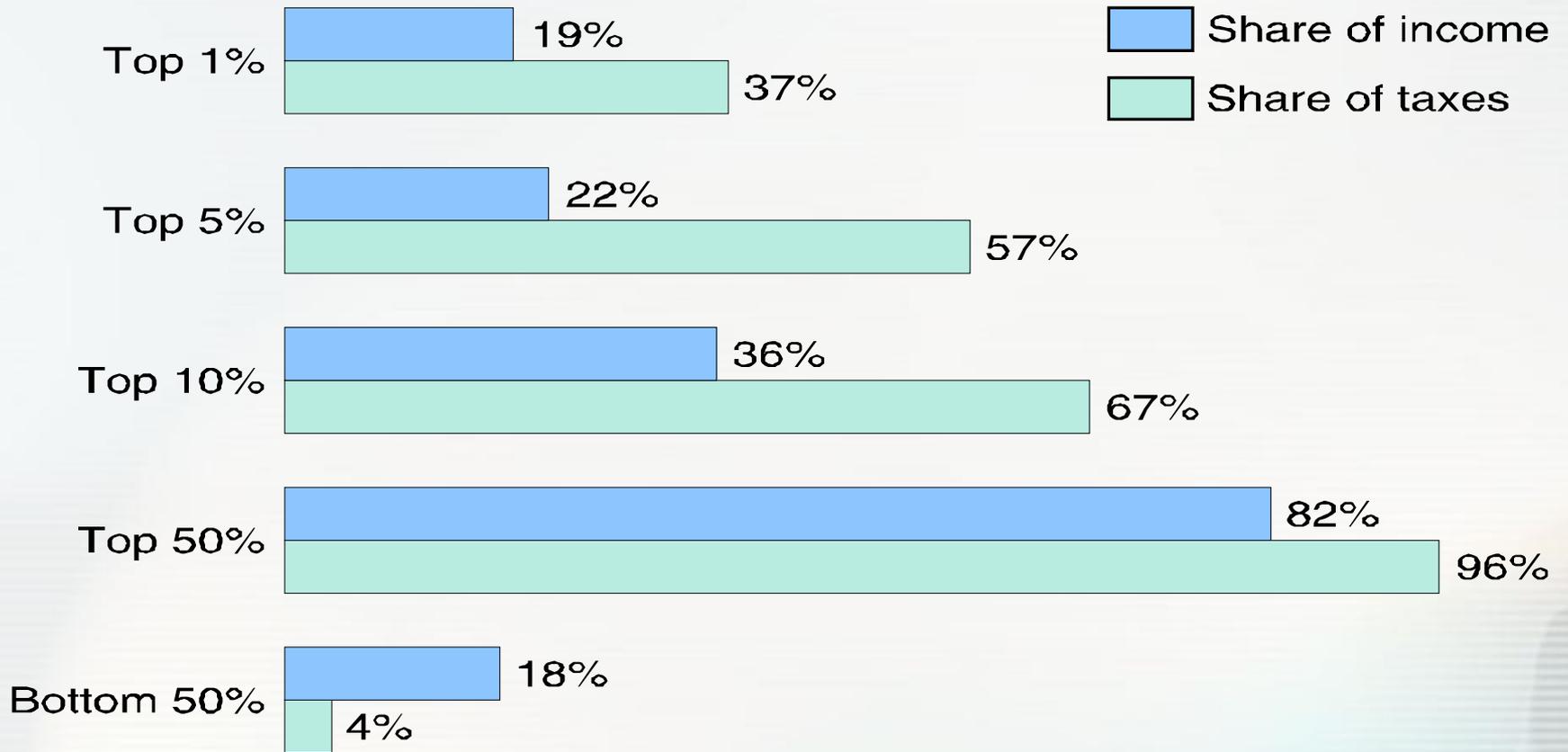


# A Proportional System

When all is said and done, the tax system as a whole ends up being nearly proportional.



# Chart: Taxes on the Rich





# The Impact of Transfers

- The government completes the redistribution process by transferring income to consumers.
- **Income transfers** are payments to individuals for which no current goods or services are exchanged.

# The Impact of Transfers



Direct transfers – welfare benefits, social security payment and unemployment insurance – are more likely to be progressive.

# The Impact of Transfers



Most indirect transfers – education, agricultural stability – are less likely to be progressive and may even be regressive in some cases.



# What Is "Fair"?

- To many people, the apparent ineffectiveness of the tax-transfer-system to redistribute income is a mark of government failure.
- **Government failure** – government intervention that fails to improve market outcomes



# The Costs of Greater Equality

- The greatest potential cost moving toward greater equality reduced incentives.
- Absolute income equality breaks the market link between effort and reward.
- The argument for preserving income inequalities is thus anchored in a concern for productivity.

# The Benefits of Greater Equality



The first economic argument for greater equality is that the present degree of inequality is more than necessary to maintain work incentives.



# The Benefits of Greater Equality

- The second argument is that low-income earners might actually work harder if incomes were distributed more fairly.
- Finally, if greater equality was achieved via tax simplification, a more efficient allocation of resources might result.



# A Flat Tax?

- **Flat tax** is a single-rate tax system.
- The key features of a flat tax include:
  - Replace the current system of multiple tax brackets and rates with a single tax rate that would apply to all taxable income.
  - Eliminate all deductions, credits and most exemptions.



# Simplicity

- A major attraction of the flat tax is its simplicity.
  - The current 1400-page tax code that details all the provisions of the present system would be scrapped.
  - All 437 IRS tax forms would be replaced by a single postcard-sized form.



# Fairness

- The flat tax would treat everyone equally and eliminate horizontal and vertical inequities.
- Some progressivity could also be preserved with a flat tax by offering personal exemptions.



# Efficiency

- Proponents of a flat tax claim it enhances efficiency as well as equity.
  - With a simplified flat tax, all the labor resources used to prepare tax returns could be put to uses that are more productive.



# The Critique

- As proposed by Dick Armey, the flat tax would not apply to all income.
  - Income on savings and investments would not be taxed so that saving, investment and economic growth is encouraged.



# The Critique

- This proposal creates vertical and horizontal inequities.
- Someone receiving \$1 million in interest and dividends could escape all income taxes, while a family earning \$50,000 would have to pay.

# The Critique



The transition to a flat tax would entail a wholesale reshuffling of wealth and income.

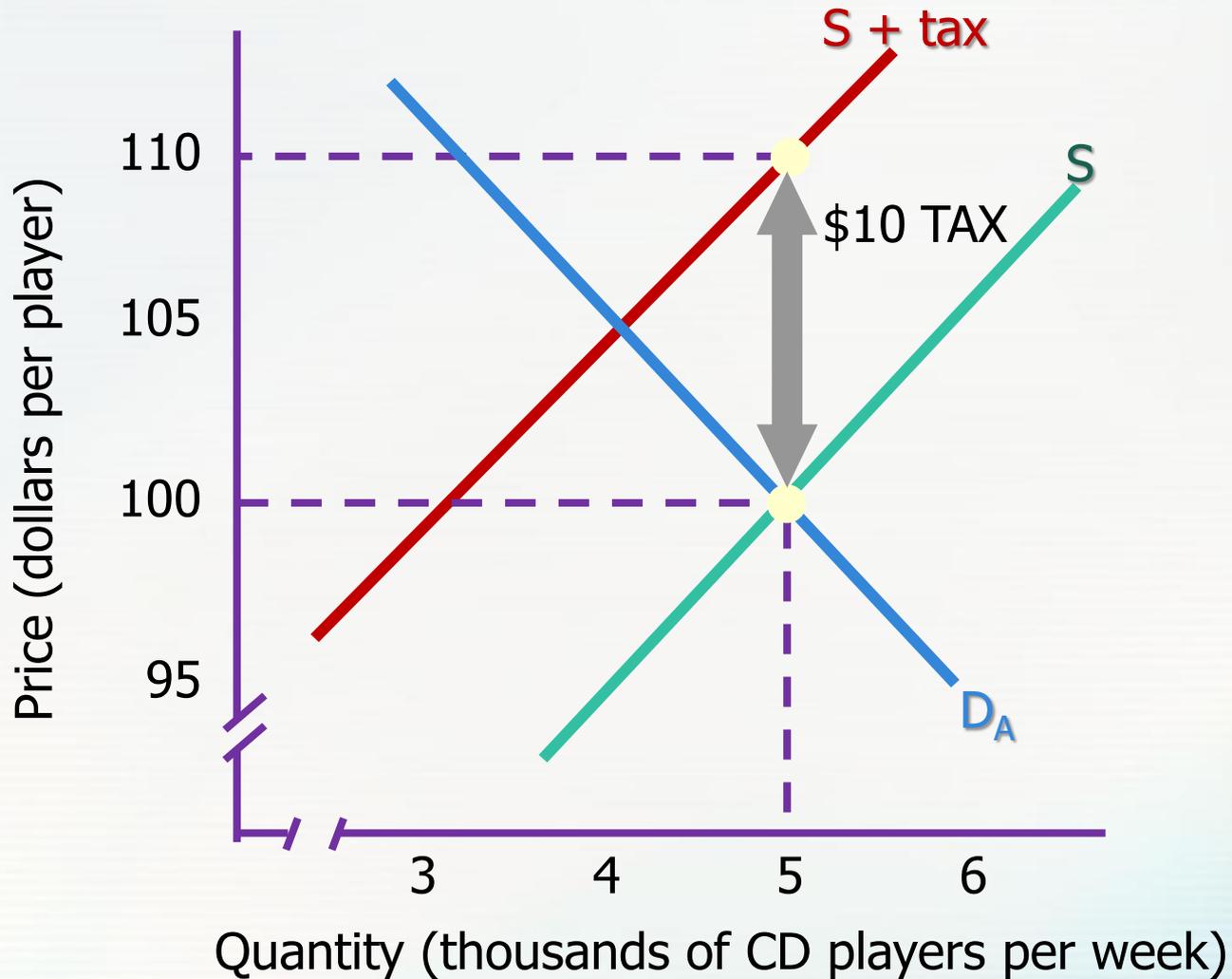


# Markets and Taxes

- The effects of a sales tax on:
  - price
  - quantity
  - efficiency

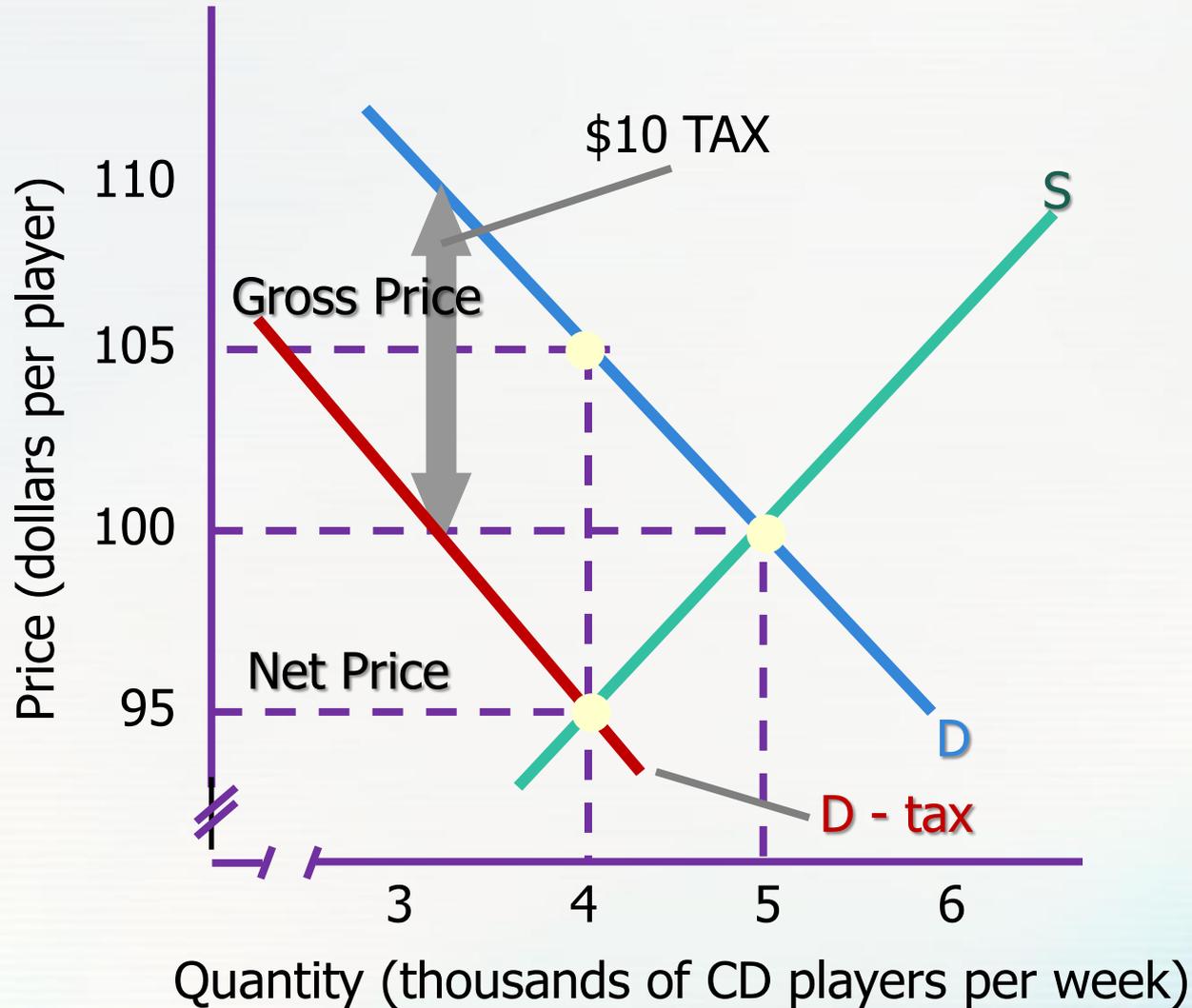


# Chart: The Sales Tax: Seller has Statutory Burden



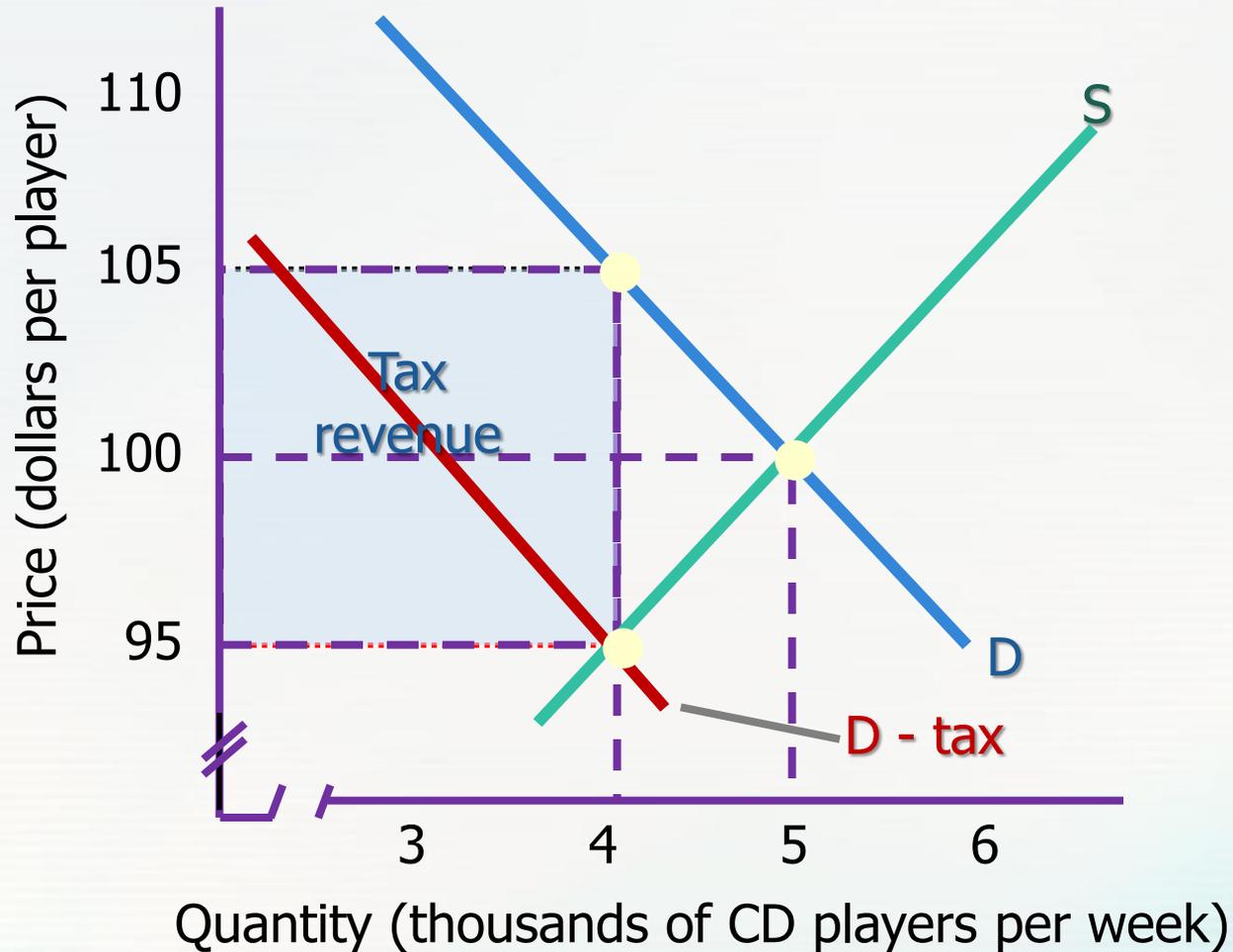


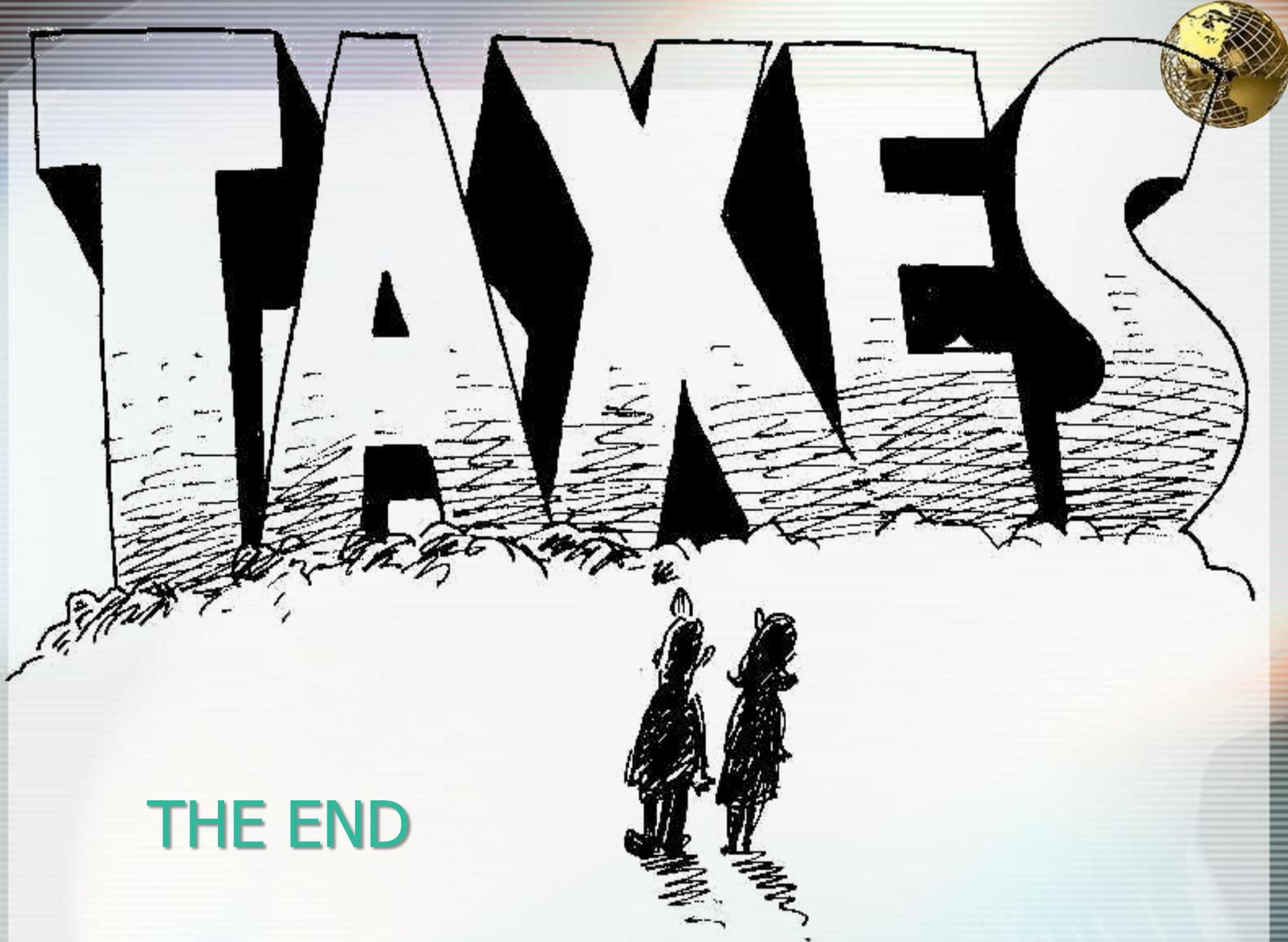
# Chart: The Sales Tax: Consumer has Statutory Burden





# Chart: The Sales Tax: Consumer has Statutory Burden





THE END