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Taxation With Representation

“In this world nothing is certain but death and taxes.”

– Benjamin Franklin

Reality vs. Perception

Taxes are complicated and, much like death, something that most of us try to avoid thinking about at all costs. And, for good reason! But, there are a few basic concepts and definitions that can serve to make us all a smidge more educated when this topic comes up and can help us to frame our questions, if only for conversations within this group and in our own minds.

Marginal Tax Rate: The tax rate that would have to be paid if any additional dollars of taxable income were earned. This concept only applies in a tiered income tax system. For example, say we have a person who makes \$35,000, so their marginal tax rate is 15%, and another person who makes \$250,000, so their marginal tax rate is 33%. What that means is that Person #1 would pay .15 on each dollar earned, while Person #2 would pay .33 cents on each additional dollar earned.

Effective Tax Rate: The actual income tax paid divided by net taxable income before taxes, expressed as a percentage. See insert for an example.

A lot of people, when talking about their tax rate, make two mistakes. First, when considering which bracket they are in, they tend to use their gross income, which would include things that are excluded from taxable income such as 401k plan contributions and deductions. However, you can see that both definitions above are predicated on taxable income, not gross income, thus people tend to think themselves to be in a higher bracket than they actually are. Second, they talk about their marginal rate rather than their effective rate, which, as you can see from the examples that follow, can be drastically different. This creates dissonance between reality and one’s perception of their tax situation – and can be dangerous because we have a large population making election and other important decisions based on their perception of their reality!

Marginal rate	15%	25%	28%	33%	35%
Current Income Tax					
Income	35,000	60,000	100,000	250,000	1,000,000
Pre-tax savings	(5,250)	(9,000)	(15,000)	(37,500)	(150,000)
Standard deduction	(5,350)	(5,350)	(5,350)	(5,350)	(5,350)
Exemption	(3,400)	(3,400)	(3,400)	(3,400)	(3,400)
Purchases	21,000	42,250	76,250	203,750	841,250
Effective tax rate	13%	17%	20%	26%	33%
Tax	2,759	6,986	15,486	53,306	273,512
Tax/Income	8%	12%	15%	21%	27%
Difference		4%	8%	13%	19%

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This is important to keep in mind when you hear people or corporations bellyaching over their tax rate. If you asked them if they were referencing their marginal or effective rates (and if they actually knew the answer to that question), they'd probably be quoting what their marginal rate would be if the rate on their gross income applied. The focus of this packet and discussion are on individual rates because, believe it or not, they are drastically simpler. However, effective and marginal rates also apply to corporations and the same skewing can occur. For instance, a small company can be in the 35% tax bracket...but wouldn't you also be interested to know that they don't actually pay tax because they deliberately (and legally) reduce their taxable income to zero? This is a great example of how rhetoric and half-truths can be used to alter perceptions.

As we can see, tax rates are an opportunity to promote income distribution or wealth accumulation. Every time we vote, we are impacting which of these goals we'd like to achieve as a country.

Statistics - All returns filed for 2005 tax year

Tax rate	Number of Returns	Taxable Income	Tax Generated	Effective Rate	% of Taxable Income	% of Tax Generated
5%	1,186,478	8,366,689	418,410	5.00%	0%	0%
10%	25,509,473	130,966,265	12,621,978	9.64%	3%	1%
15%	49,321,395	1,523,119,579	196,726,409	13%	30%	20%
20%	2,960	264,683	42,933	16%	0%	0%
25%	21,996,816	1,481,883,051	249,302,533	17%	29%	26%
28%	3,730,002	508,431,935	105,372,670	21%	10%	11%
33%	1,479,592	387,519,395	92,351,980	24%	8%	9%
35%	953,005	1,094,229,516	315,443,028	29%	21%	32%
8615 - kiddie tax	141,612	2,119,463	433,021	20%	0%	0%
	<u>104,321,333</u>	<u>5,136,900,576</u>	<u>972,712,962</u>			

Notes: Based on all returns filed and categorized by marginal tax rate.

I guess the tax system is complicated for a reason...

So, even though this exercise might seem boring, it's important because we now have a basis for discussion of the propensity of taxpayers to vote against their own best interests and how misleading the rhetoric surrounding tax policy can be.

Also, a tiered (progressive) tax system will work differently than a flat (regressive) tax but as you can see, either method will have the inherent difficulties of how one calculates taxable income. Even the abolishment of income tax in favor of a sales tax (also regressive) would require an oversight agency to determine the definitions and calculations as well as to monitor and enforce compliance. In other words, go ahead and dismantle the IRS, Fair Tax supporters – but then what?

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But taxes are still so complicated! What about flat and sales tax systems?

Now that we have a better understanding of the basic principles of our current tax structure, let's discuss the impact of a flat tax and a sales tax. In order to keep this as simple as possible, all examples assume any system is exclusive of the others. Five different income levels are used but all scenarios assume a single taxpayer and a 15% savings rate. The previous table showing the current tax structure is shown again below for reference.

Current Income Tax					
Income	35,000	60,000	100,000	250,000	1,000,000
Pre-tax savings	(5,250)	(9,000)	(15,000)	(37,500)	(150,000)
Standard deduction	(5,350)	(5,350)	(5,350)	(5,350)	(5,350)
Exemption	(3,400)	(3,400)	(3,400)	(3,400)	(3,400)
Purchases	21,000	42,250	76,250	203,750	841,250
Effective tax rate	13%	17%	20%	26%	33%
Tax	2,759	6,986	15,486	53,306	273,512
Tax/Income	8%	12%	15%	21%	27%
Difference		4%	8%	13%	19%

For a flat tax example, we'll use Sam Brownback's (R – Kansas) 2005 flat tax proposal. This system would tax 15% on all earned income and specifically excludes unearned income (interest, dividends, rent, capital gains) with an exemption on the first \$25,000 of earned income.

Flat Tax (Brownback)					
Income	35,000	60,000	100,000	250,000	1,000,000
Exemption	(25,000)	(25,000)	(25,000)	(25,000)	(25,000)
Taxable income	10,000	35,000	75,000	225,000	975,000
Tax rate	15%	15%	15%	15%	15%
Tax	1,500	5,250	11,250	33,750	146,250
Tax/Income	4%	9%	11%	14%	15%
Difference		4%	7%	9%	10%

For the sales tax example, we'll use the FairTax proposal, which was a sales tax proposal promoted most prominently by former Republican Presidential candidate Governor Mike Huckabee (R – Arkansas). This system would tax purely on consumption and would abolish the following current Federal taxes: income, payroll, gift, estate, capital gains, Social Security and Medicare.

Sales Tax (FairTax)					
Income	35,000	60,000	100,000	250,000	1,000,000
Savings	(5,250)	(9,000)	(15,000)	(37,500)	(150,000)
Consumption allowance	(10,400)	(10,400)	(10,400)	(10,400)	(10,400)
Purchases	19,350	40,600	74,600	202,100	839,600
Tax rate	23%	23%	23%	23%	23%
Tax	4,451	9,338	17,158	46,483	193,108
Tax/Income	13%	16%	17%	19%	19%
Difference		3%	4%	6%	7%

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These scenarios are drastically simplified but it is an attempt to provide an apples-to-apples comparison of the varying proposed methods of taxation at various income levels. Under a flat or sales tax, the effective and marginal rates are the same by definition. And note what the tax divided by total gross income would be, as well as the rate difference between the income levels in the example.

Specifically, take a look at the rows titled “difference”. This shows us the difference, percentage wise, between the differing income levels. Under the Brownback option, the million dollar earner pays only 10% more in tax than the \$35,000 dollar earner while under our current system that differential is 19%, thereby shifting more of the tax burden to the higher income earner in the current system than in Brownback’s proposed system. This comparison also holds true as compared to the Fair Tax option and this is why our current system is more progressive than either of these proposed options. If we decide that a progressive system is good, than this would be a better system. Which is not to say that we couldn’t make it more progressive – just that it is more progressive than the proposals that have been floated by members of the Republican party lately.

A couple of the most touted pieces of the Bush tax cuts (otherwise known as the Economic Growth and Tax Relief Reconciliation Act of 2001) were decreases in capital gains rates and estate taxes. Prior to this, capital gains were taxed at the same rates as earned income. Since then, capitals gains have been taxed at 15% (5% for taxpayers who would otherwise be taxed at a rate below 25% if it were ordinary income). The estate tax changes include an increasing exemption with a complete phase out of all estate tax in 2010 (after which the whole thing reverts to the way it was pre-Bush tax cuts). If you must die, 2010 is the year to do it if you are rich enough to have an estate exceeding \$1,000,000! These changes have been portrayed as an overall tax cut, which it is, but you have to wonder who reaps the greatest gains... those of us with primarily earned income or trust fund babies. You decide ☺.

If we decide that we’d like to achieve a tax system that promotes income distribution, what are some ways to achieve that? Making capital gains rates the same as earned income rates would clearly provide more in taxes from those in the upper income level. It’s hard to imagine that those in more modest income tax brackets have significant capital gains in the first place – where would they ever find the extra cash to invest in the first place? Reducing the taxes on the lower brackets and/or increasing the rates on the higher brackets would also achieve the goal of income redistribution.

So what are the candidates proposing to do about taxes?

At this point, you may be wondering where our current candidates stand regarding tax policy. Well, that’s a subject in and of itself, so to keep it simpler, let’s just compare the areas of their policies that relate to the discussion at hand. Needless to say, this is just the tip of the iceberg and you should really check out the link to the Tax Policy Center on the Resources page to look at more of the candidates’ respective ideas for tax reform. In short, however:

Democratic candidates: Both Clinton and Obama would like to restore the pre-Bush higher tax rates on the top two personal income tax brackets. Obama would further restore the capital gains rates to the pre-Bush levels. Both of these would have the impact of more tax being paid by both high earners and those with large capital gains (generally the result of large investment accounts).

Republican candidate: McCain would support making the Bush income and investment tax cuts permanent and reducing corporate tax rates.

Mandatory Reading & Other Resources

Links:

- **Tax Me If You Can** – the official movie website
(<http://www.pbs.org/wgbh/pages/frontline/shows/tax/>)
- **Tax Policy Center -- 2008 Presidential Candidates' Comparison** – 2008 presidential candidates' tax proposals presented in comparative form
(http://taxpolicycenter.org/taxtopics/election_issues_matrix.cfm)
- **Internal Revenue Service** – official website of the IRS
(<http://www.irs.gov/>)
- **Internal Revenue Service -- Tax Stats** – specific IRS statistics used in the packet
(<http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133521,00.html>)
- **Americans For Fair Taxation** –this website argues in support of the Fair Tax
(<http://www.fairtax.org/>)
- **Wikipedia Flat Tax** –resource for specific details used in examples given in the packet
(http://en.wikipedia.org/wiki/Flat_tax)

Books:

- *Small is Beautiful: Economics as if People Mattered* by E.F. Schumacher