

Lecture 21

TAXATION AND DEMOCRACY

November 22, 2006

I. WHAT IS TAXATION?

1. What is Taxation: Two Answers

Answer #1:

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Answer #2:

The total economic pie is produced through complex interdependent economic activities. This pie needs to be divided up between public purposes and private purposes. Taxation is the way of accomplishing this in a capitalist economy.

2. Tax ideology and class interests

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Key question:

Who really benefits from a particular view of the problem? In whose interests is it to insist that taxation is the way government takes *your* money? Is this understanding more in the interests of the rich and powerful than of ordinary citizens or the poor?

[But Note: Showing that a particular view serves the interests of privileged groups does not show that the view is incorrect.]

II. The Logic of Income Taxes

1. Three different views of Tax Fairness

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- (1) Everyone pays the same *amount* (a “poll tax”)
- (2) Everyone pays the same *percentage* on their income (a “flat tax”)
- (3) Everyone should have the same *tax burden*, make the same sacrifice (a “progressive tax”)

The Flat Tax idea

Compare two people: one earns \$10,000/year, the other earns \$100,000/year. Suppose there is a “flat tax” of 25%. This means that the poor person pays \$2,500 in taxes and the affluent person \$25,000 in taxes. This means that the better off person pays 10 times as much.

If these two people were the only tax payers, the richer person would pay over 90% of total taxes for the common good – schools, police, the military, etc. Is this fair?

What is an “Equal Burden”?

Compare the same two people: one earns \$10,000/year, the other earns \$100,000/year. They each get a raise of \$10,000. What does it mean for them to have “equal burden” or “equal sacrifice” in the taxation *on this additional income*?

Suppose there is a “flat tax” of 25%. This means that the poor person and the affluent person each pay \$2,500 taxes on their additional income. Is \$2,500 the same burden on a person earning \$20,000 as on a person earning \$110,000?

2. U.S. MARGINAL INCOME TAX RATES 2006 (single tax payer)

Bracket 1. 10% on income between \$0 and \$7,550

Bracket 2. 15% on the income between \$7,550 and \$30,650

Bracket 3. 25% on the income between \$30,650 and \$74,200

Bracket 4. 28% on the income between \$74,200 and \$154,800

Bracket 5. 33% on the income between \$154,800 and \$336,550

Bracket 6. 35% on the income over \$336,550

Example: A person who earns \$85,000 will pay total income taxes of \$18,131, or a total tax rate of 21.5%. Here is how that is generated:

Income bracket	income earned in this bracket	%	Tax due
1	\$ 7,550	10%	\$755
2	\$23,100	15%	\$3,465
3	\$43,550	25%	\$10,887.50
4	\$10,800	28%	\$3,024

3. Tax System Complexity as a cover for privilege

Problem #1: How to define “taxable income”

Examples:

- **A family with 5 children vs a single adult earning the same amount of income**
- **A person with large medical expenses vs a person with no medical expenses earning the same amount of income**
- **A person whose house is destroyed by a hurricane vs a person whose house is undamaged earning the same amount**

Solution: Tax Deductions

3. Tax System Complexity as a cover for privilege

Problem #2: Deductions become a policy tool to create incentives for people to do certain things

Examples:

- **Charitable contributions:** If you give \$10,000 and your marginal tax rate is 35%, you get back \$3500 in tax refunds, so the contribution only really cost you \$6,500. In effect the government is giving the charity \$3,500. [Note: this is a major way in which the government supports religion: the tax system allows you to allocate tax revenues to churches].
- **Home mortgage interest deduction:** If you have a million dollar mortgage on an expensive house and have \$10,000 in interest a month and your marginal tax rate is 35%, this saves you \$3,500 a month, or \$42,000/year.

Tax “Loopholes”: tax deductions that reduce the fairness of the tax system.

III. Myths & Realities about taxes in the US

1. Are taxes high in the US?

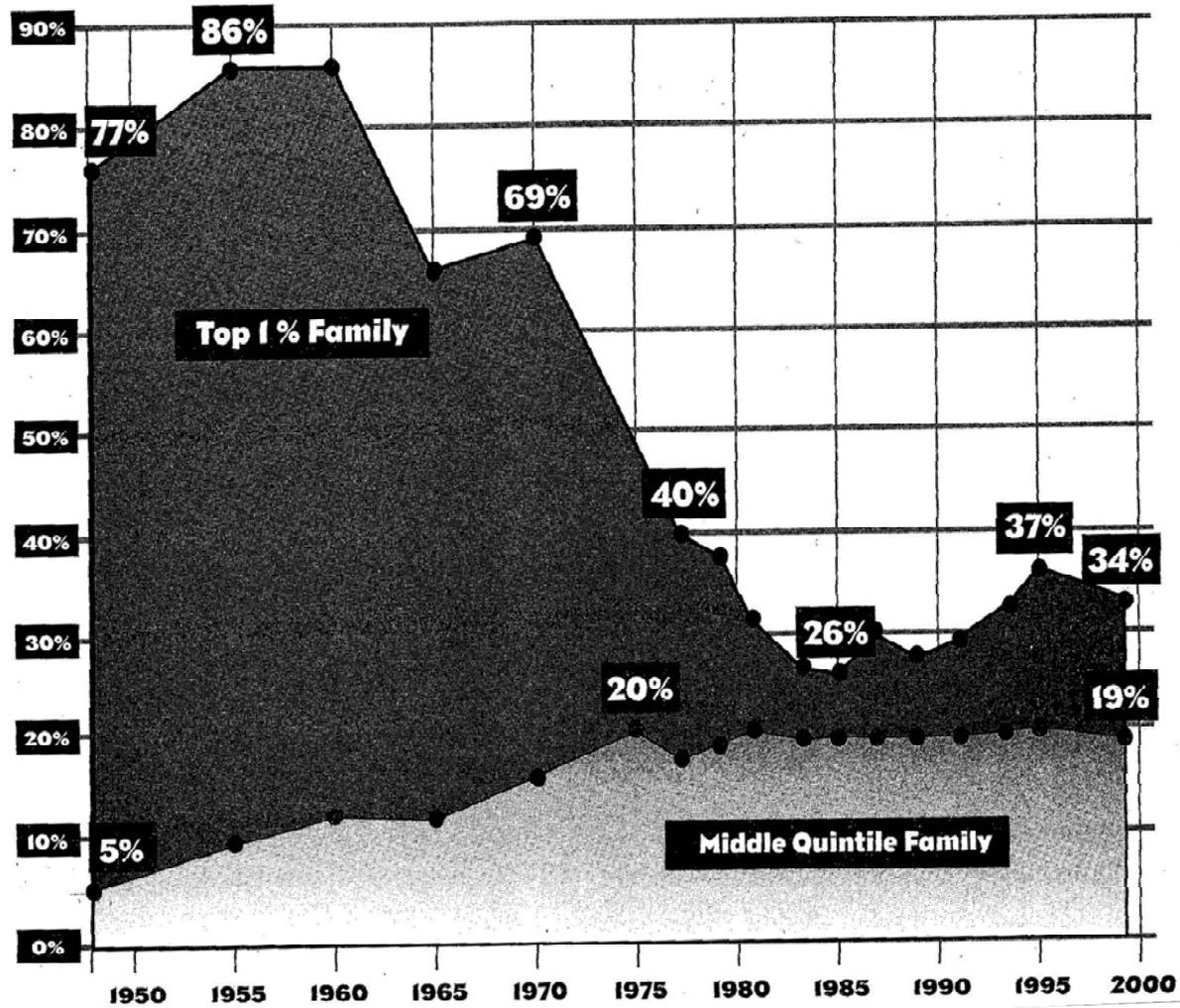
Country	Total tax receipts as % of GDP	Country	Total tax receipts as % of GDP
Australia	30.6	Luxembourg	41.8
Austria	43.9	Mexico	16.0
Belgium	45.7	Netherlands	42.1
Canada	38.2	New Zealand	35.6
Czech Republic	40.4	Norway	41.6
Denmark	50.4	Poland	35.2
Finland	46.2	Portugal	34.3
France	45.8	Slovak Republic	35.3
Germany	37.7	Spain	35.1
Greece	37.1	Sweden	52.2
Hungary	39.2	Switzerland	34.4
Iceland	36.3	Turkey	31.3
Ireland	32.3	United Kingdom	36.3
Italy	43.3	United States	28.9
Japan	26.2	EU average	41.6
Korea	23.6	OECD average	37.3

2. Are taxes fair in the US?

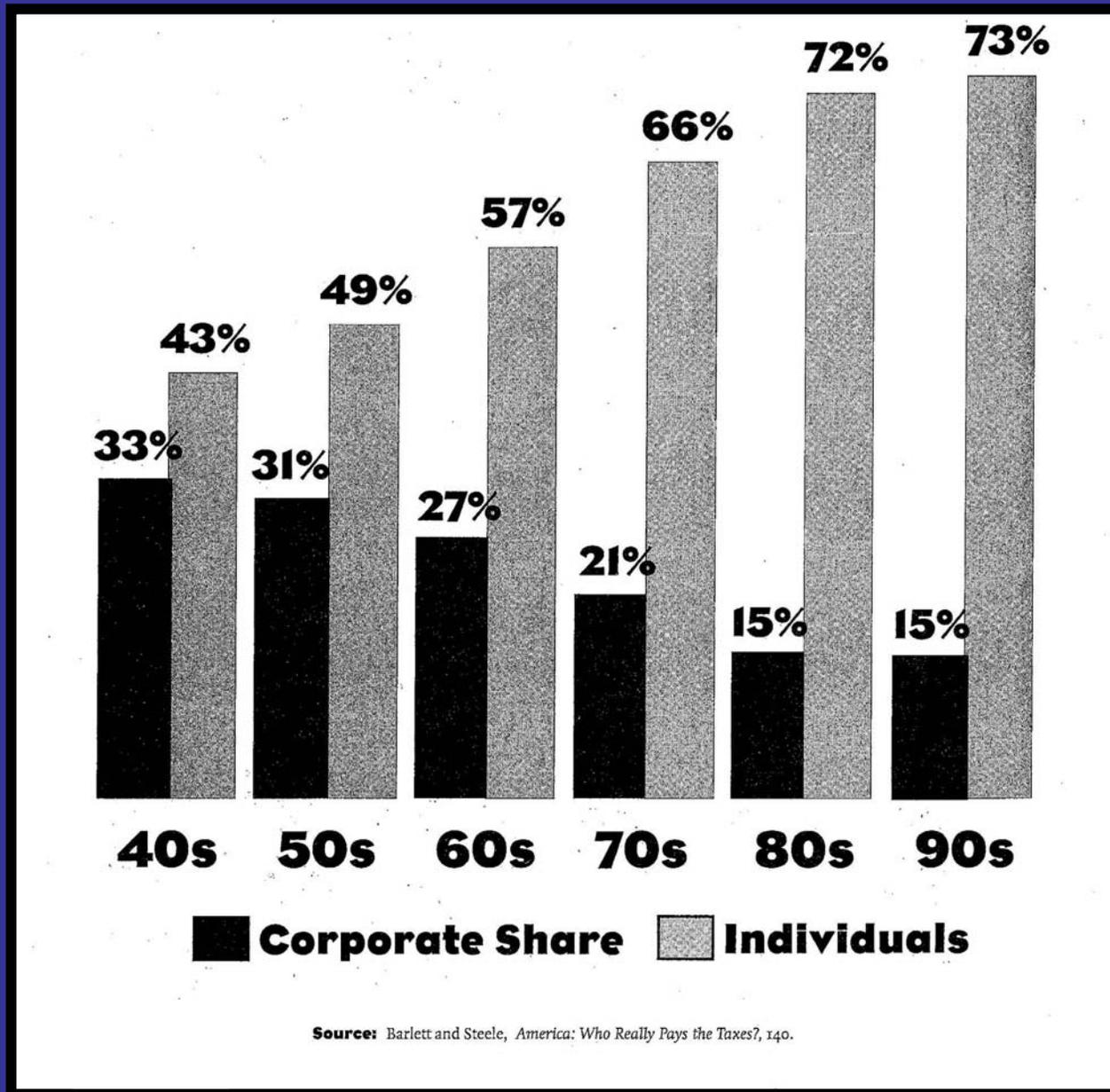
U.S. average State & Local taxes as share of family income (for non-elderly married couples)

	Income Group	
	lowest 20%	Top 1%
Sales & Excise Taxes	6.7%	1.1%
Property Taxes	4.5%	1.9%
Income Taxes	1.3%	5.0%
Total	12.5%	7.9%

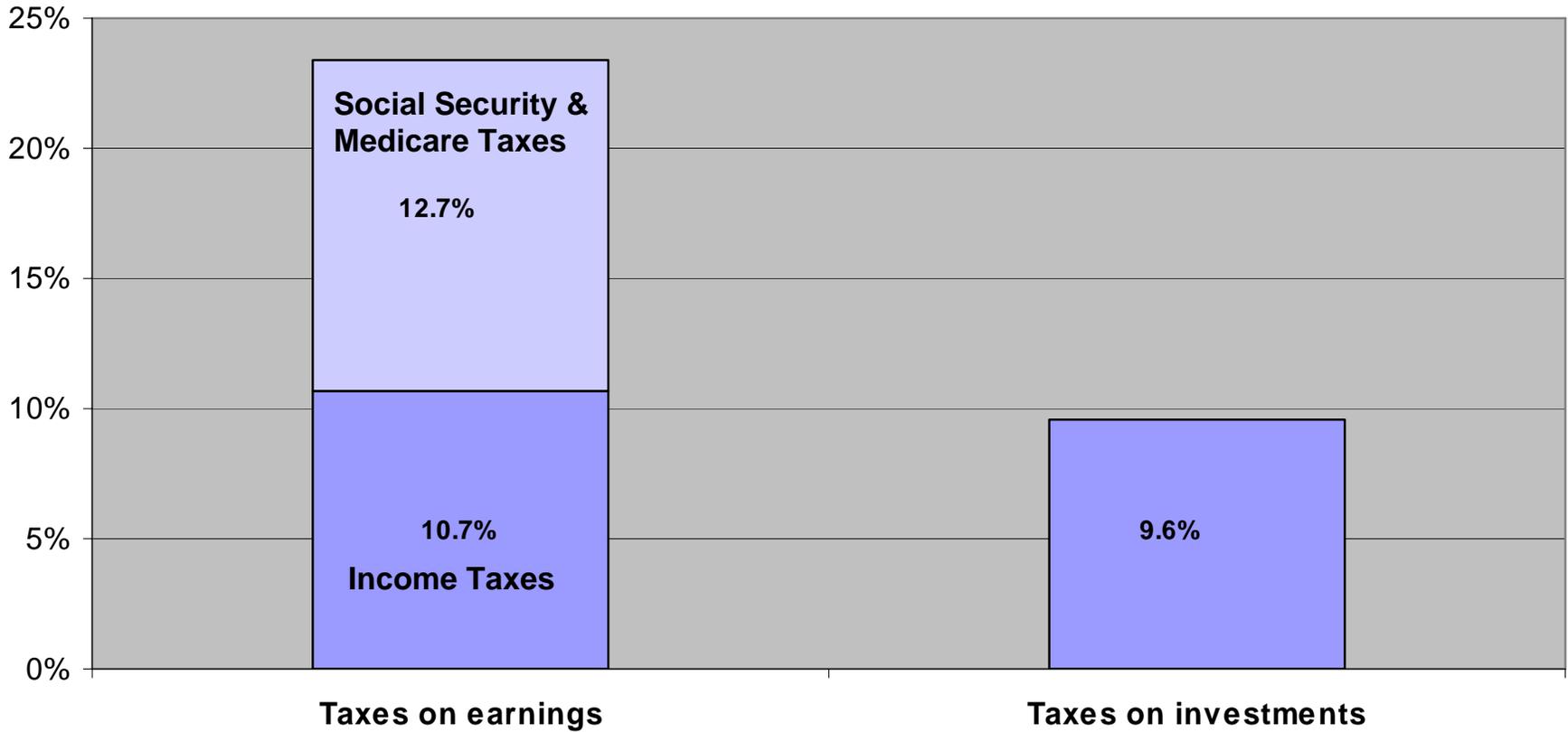
Effective federal tax rates (income tax + payroll tax) for the middle-quintile family and the top 1 percent of families, 1948-99



III. MYTHS & REALITIES OF TAXES



2004 Federal Taxes on Earnings vs Taxes on Investments



IV. The Attack on the Affirmative State

1. Definition of the *Affirmative State*

A state that provides a wide range of public goods and plays active role in solving social problems and advancing public purposes.

Examples of affirmative state activities:

- **Education: K-12, higher education, life-long learning, skill retraining**
- **Building infrastructure like roads, sewers, high speed rail**
- **Providing health care and preventive health**
- **Proving eldercare and daycare for preschool children**
- **Public safety**
- **Subsidies for the arts and recreation**
- **Regulations of: pollution, health and safety in the workplace; food quality and product safety; truthful advertising.**

2. Three-pronged attack on the Affirmative State

- (1) Attack on the legitimacy of Taxation: constant reiteration of the idea that taxation is oppressive, that the government is taking away your money.**
- (2) Attack on the intentions of Government: Big Government is oppressive; it wants to dominate, regulate and control your lives for the benefit of bureaucrats; politicians and bureaucrats are corrupt.**
- (3) Attack on the competence of government: Big Government is filled with red tape, incompetence, stupid regulations that generate great inefficiencies.**

3. Four types of anti-Affirmative State transformations

1. Cutbacks of publicly funded programs

- **Less funding for higher education, therefore higher tuition**
- **Less funding for medical research**
- **Less funding for job training, public housing, etc.**

2. Deregulation

- **Weaker regulations of toxic waste**
- **Weaker regulations of logging**
- **Weaker regulations of product safety**

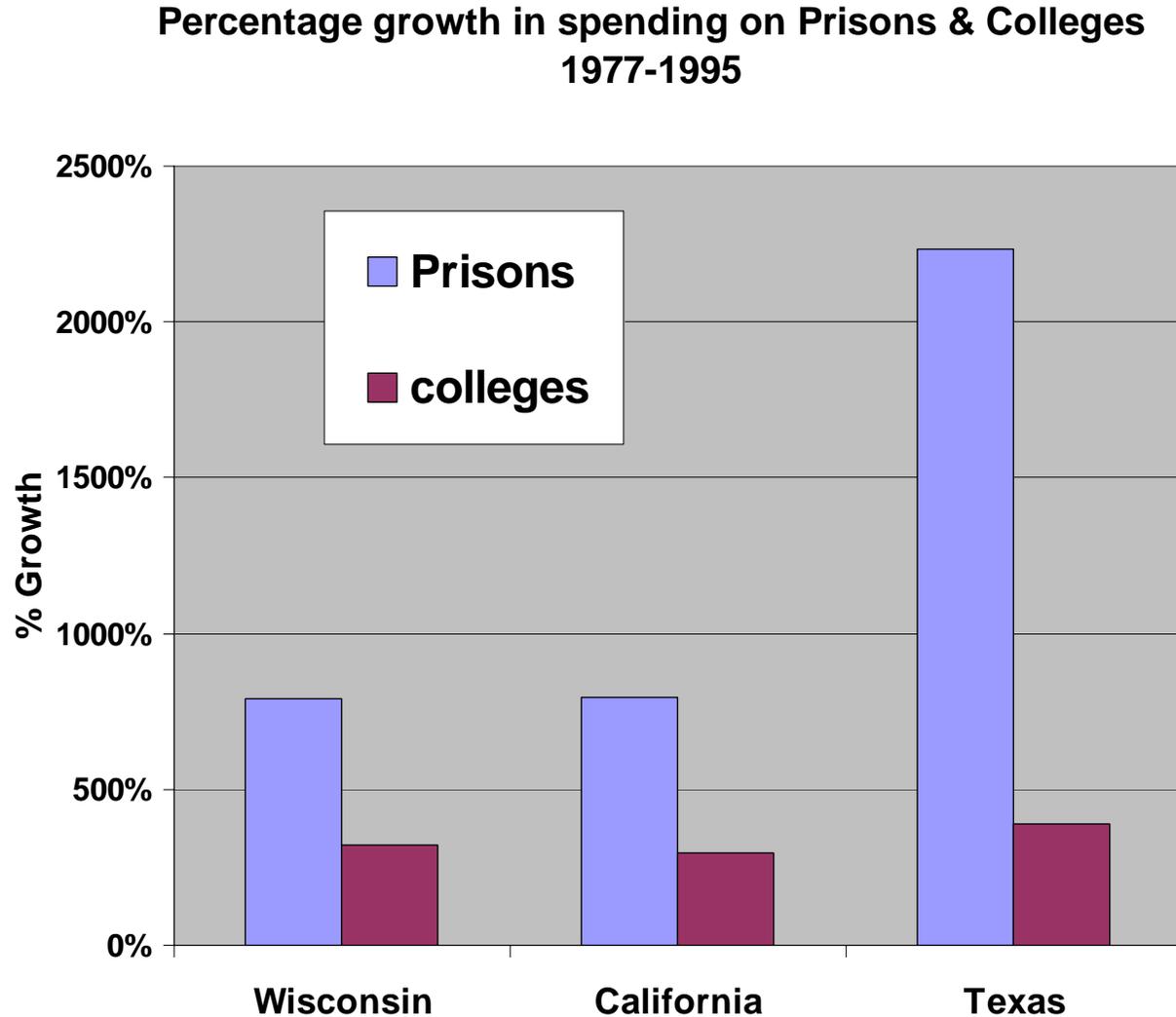
3. Lax enforcement

- **Few inspectors of health & safety**
- **Few auditors on taxes**
- **Fewer food quality inspectors**

4. Privatization

- **Prisons**
- **Military subcontractors – food, mercenaries**
- **Public utilities privatized**

4. The exception: military & Prisons



Growth of prison population, 1974-2004

Prisoners per
100,000 adults

