

Different Tax Types Effect Equality

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ABSTRACT

The passage talks about whether it is much fairer to use income tax or consumption tax for people in different income brackets. We try to explore the history of taxation and both the benefit side and disadvantage side of different types of taxation. I used website, google scholar, having a research of key words like income tax, consumption tax and so on. Look for several essay that fit for my idea and record the data. My conclusion is that instead of consumption by value, further refinement could consider consumption as a portion of income as a better metric. Exemptions should be made readily available for earners in the bottom percentiles. This essay can be used in some situation like some people wanted to find out the tax policy stuff or they want to build a thought about "Perfect tax collection mechanism". They can have some useful opinion according to my passage.

KEYWORDS

Economics; Tax; Equality

1. INTRODUCTION

Ever since the 1980s, middle-class wages have stagnated watching as top earners pull ahead along with the average cost of living (citation). Despite the prevalence of progressive tax systems, warranted scrutiny of the rich and by extension capitalism often ignore the outsized contribution of top earners to the overall revenue mix, contributing over 90% in countries like China. This essay will discuss whether transitioning to a consumption tax will mitigate some of the perennial issues regarding taxation and why a 60/40 mix between income and consumption tax might be an optimal middle way. I begin with the history of taxation as a source of government revenue and dynamic capital allocator. Various economic and social arguments in support of either tax system are offered and respective merits are assessed. A section will follow to show the complex global governance landscape and cooperation challenges in a competitive dynamic. Lastly, the effects on two specific groups will be discussed.

2. HISTORY OF TAXATION

2.1. As a Source of Government Revenue

Taxation emerged as early as Egypt and Mesopotamia to fund infrastructure. Early forms of taxation such as the Roman slave taxes and Greek land taxes consisted of a combination of regressive wealth and consumption taxes, rife with exploitation of the peasants and exemptions for the powerful. The Industrial Revolution brought direct income taxes and bureaucracies. By the 1930s, the social security tax emerged as a form of "forced savings" and excise taxes to disincentivize unpalatable behaviors. Post WWII, US tax rates have become increasingly regressive. In the 1980s, Reagans and Thatcher started to assault progressive income tax schemes from all angles.

2.2. As Dynamic Capital Allocator

Most of the U.S. tax revenue comes from individual income tax (~42%), and a small portion from consumption (~16%), compared to 32.1% in the OECD (Bunn, 2024). Most of the EU revenue from taxes on labor (including social security contributions) amounted to 50.6% of total tax revenues, revenues from taxes on consumption reached 27.3% of the tax mix, and the remaining 22.1% was obtained from taxes on capital (Bunn, 2024).

3. INCOME TAX DESIGN

3.1. Advantages

Taxes are necessary but a design that balances economic growth with social equity is difficult. Proponents of income tax argue that income and by extension, wealth, is a fairer basis of appropriation than spending. A proper scheme will optimize for a stable revenue base at the lowest cost to economic growth since a consumer would use a lower interest rate in his consumption planning than the producer in his planning (Hall, 1968).

3.2. Disadvantages

However, there is evidence to suggest that income taxes reduce the incentive to earn and therefore, to innovate (Ackigit et al, 2022). Savers also suffer from the reduced compounding of their investments, without income tax, a dollar in savings will multiply by 7.91x after 24 years at a 9% annual compound interest rate, compared to 2.73x and a 6% CAGR at a rate of 33%. A regressive income tax scheme, for instance, will tax labor heavily, further compressing productivity and exacerbating social inequality.

4. CONSUMPTION TAX

4.1. Proponents of a Consumption Tax

Proponents of a consumption tax argue that consumption is both a more just basis of appropriation and is easier to administer (Hall, 1968). Common forms of the consumption tax could either take the form of a value-added tax (VAT), levied at each stage of consumption, to a sales tax, at the point of final sale. Consumption tax reduces demand proportionally by an equivalent interest rate. Consumption tax benefits from a broader base and less discriminating assessment. It's widely agreed that switching to a national tax on expenditures will have little effect on labor supply and may increase individual savings (Marples, 2023).

4.2. Advantages

Furthermore, a shift to consumption tax could potentially eliminate the use of tax havens but require substantial international coordination and diplomacy to address the concerns of countries currently benefiting from tax arbitrage. Tariffs and taxes on trade flows would also be reimagined. While VATs have relatively small elasticities of trade flows compared to tariffs (citation), a consumption-based tax system would have profound implications for export competitiveness, industrial policy, and savings incentives. Such a shift could influence trade agreements and tariffs, causing trade distortions. Retaliatory actions from trade partners can be expected and multinational corporations whose operations would be directly affected, are likely to lobby heavily against such reforms and consider offshoring their operations. Moreover, immigrants could face additional hardships, as domestic spending would now be taxed, reducing the funds available for remittances.

5. OTHER PROPOSALS

5.1. Current Status of Income and Consumption Taxes

Income tax differentiates between sources of income (wage, salary vs. self-employment), and therefore diverts labor from its most efficient allocation (Long, 1982). But just like how income tax discourages success, consumption tax could similarly discourage innovation (Lin et al, 2023) Innovation intensity decreases while innovation quality remains stable to sustain the competitiveness of firms. Many attempts at some versions of the consumption tax have failed. Politicians are reluctant to support reforms perceived as unfair.

5.2. Hall – Rabushka Flat Tax (Not Support)

Proposals such as the Hall – Rabushka flat tax as well as the FairTax Act in the 118th Congress, have met significant resistance from economists and progressives. These proposals absolve individual's wage and pension income from tax and instead rely on some version of a flat tax. Detractors countered, labeling the new system regressive, asking lower-income individuals to pay more simply because they consume a larger proportion of their income.

6. CHANGE OF TAX RATE

6.1. Top Incomes

The most significant tax rate changes in the US have predominantly occurred at the very top income brackets, typically falling during republican terms (Regan, Bush, and Trump) and rising during democratic terms (Clinton and Obama). There is a clear negative correlation between top marginal rates and top income levels with an estimated elasticity of 0.7 for long-run reforms and >1 for short-run reforms (Stantcheva, 2017) Top earners derive the majority of their income from capital appreciation while proportional consumption is relatively low (citation).

6.2. Comparison

Under a consumption-based tax system, the top 10% have significantly more flexibility to adjust their consumption levels compared to the bottom 10%, whose income primarily stems from informal wages and part-time employment. Currently, the top 50% paid 97.7%, and the bottom 50% contributed 2.3% of revenue. A shift toward a heavy reliance on consumption will see more revenue deriving from the bottom 50%.

7. CONCLUSION

However, consumption tax offers notable benefits. They emphasize wealth accumulation and discourage overspending. To minimize adverse effects, a gradual, experimental approach to incorporating consumption tax is advisable. Policymakers can analyze consumption baskets and behavior to optimize rates and reduce admin costs. The experiment will have the additional incidental benefit of a large trove of economic data available for fiscal planning and other priorities. Further, policymakers need to decide whether to tax two goods at different rates and provide a credible argument. Instead of consumption by value, further refinement could consider consumption as a portion of income as a better metric. Exemptions should be made readily available for earners in the bottom percentiles.

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