Advantages and disadvantages of a income tax economics essay

An income tax is a rate charged on the income of individuals as well as business (companies or other legal entities). Individual income taxes often tax the total earning of the individual, while corporate tax often taxes net profit of the company. Different tax systems exist, with varying degrees of tax incidence. Income taxation can be progressive, proportional or regressive. Tax systems define income differently such as inclusion of windfall earnings, and often allow notional reductions of income such as a reduction based on number of children supported.

Generally the income tax is employed in a progressive manner, meaning as one earns a higher salary a higher proportion (percentage) of his income is taxed. The idea of a progressive income tax has garnered support from economists and political scientists of many different ideologies, from Adam Smith in The Wealth of Nations to Karl Marx in The Communist Manifesto. Income taxes used in most countries around the world are characterized by a progressive scheme, but are not without criticism.

The Disadvantages

The implementation of an income tax system is very complex, especially when trying to regulate the rich and the corporations. So complicated in fact that an entire industry exists to simply monitor and control the system. The government must enforce every line of the tax code, for example in the US the IRS requires 90, 000 tax accountants. The IRS and tax audit industry might do more for the economy if they were retrained to in some other manner.

Another part of the same industry of tax accountants consults the big corporations and the rich on ways how to exploit tax policies' loopholes. Tax evasion and deceitful avoidance favours the wealthy as they are the ones able to pay for costly tax ' advice'. As legendary investor Warren Buffet has been known to say, it is unfair that his secretary pays 30% in taxes while his accountants manage for Buffet to only have to pay 17% on his income.

Some argue that for those in the lower middle class and lower classes, an earnings tax may be a financial hardship, regardless of the amount. In cases where households are just living by their means any deduction even the smallest may result in a significant decline in the standard of living, unlike income deductions to high grossing households who save the majority of their income.

Others believe that income tax is a violation of a citizen's individual freedom. Especially Libertarians, argue that tax on earnings violates the individual's right to decide how to use the money he earns. They also state that a progressive tax code is unfair to the wealthy and favours the poor, by calling it a tax on success. In the US in 2007, half of all income tax revenue was paid by the richest 5% of the country.

An income tax that gets progressively more burdensome the more money you make reduces the incentive to work harder and be productive the higher you move up the ladder. While income tax disincentives working more and incentivizes working less at the same time, the Laffer curve portrayed below highlights the trade-off between work and tax revenue.

Figure 1 – Curve starts at a point where 0% tax equals 0 government revenue. Taxes increasing from low levels, increases revenue to the government. However, there would come a point (t*) where tax rates would not make it as worth working so hard. This lack of incentives would lead to a fall in income and therefore a fall in tax revenue. The logical end point is with tax rates at 100% where no-one would bother to work (understandably) and so tax revenue would return to zero.

The Advantages

The income tax allows for progressive taxation on the amount of money you make. A person making €15, 000 a year will pay less (percentage wise) than someone making €150, 000 a year. This is an effective strategy to distribute the wealth. Considering most of the population fits into the lower brackets, most of the population should favour such a program. Without income tax, personal and corporate profits would be out of control and unregulated. Unscrupulous individuals and greedy corporations could earn heaps of ill-gotten money, since they would not have to account for their earnings.

This current system also allows for a stable income stream for the government. For example, even at 10% unemployment, 90% of the workforce is still making money. As the workers make money, the government can maintain an income stream, even in a depression. Income tax helps the government build a superior infrastructure, which otherwise would be probably impossible to finance through expenditure tax only.

By comparing income tax to its expenditure counterpart others argue that not all people consume at the same rate, therefore tax on earnings is a more equitable way of assessing tax than with a consumption tax. People with lower incomes would be the most impacted by a straight tax on consumption, since even necessary items like cars would be significantly more expensive. On an individual basis income is an easier way to levy taxes and decide deductions. While people may deal with a few pay slips they have to save, in consumption tax, people might have to save receipts for every purchase they made during a year in order to qualify for tax breaks. In this sense income tax is more flexible because it allows people to claim deductions on their tax returns, such as childcare expenses, losses of a personal property and other financial challenges.

Albeit differently implemented, income tax is present everywhere throughout the world. Low personal income tax countries such as the US and Japan promote their highly consuming economies through low personal rates but limit their colossal corporations through a high corporate rate. Scandinavian countries, Belgium and France need abnormal tax revenues to finance their government expenditure and social benefits. Places like Ireland, Poland Hungary and the Slovak Republic stimulate their much needed development by attracting investment with low corporate taxation.

Figure 2- The ‘ Personal rate’ is the average rate of income tax for a worker on the average income in that country. The ‘ Corporate rate’ is the mean combined corporate income tax rate which includes central and sub-central rates.

(B)

Lately, pure tax economists argue that a consumption tax is superior to an income tax because it comes closest to attaining the so called “ temporal neutrality”. Although impossible in reality, a tax would be considered to be temporal neutral if it did not alter spending habits, change behaviour patterns or affect the natural allocation of resources. Since an expenditure tax only taxes consumption, the good or service being consumed is largely irrelevant in reference to the allocation of resources.

An income tax creates a discrepancy between the value of a person’s work and what they actually receive (disposable income). This is weighs on the economy because it causes people to work less and pursue more leisure activities than would otherwise be the case if income taxes did not exist. The barrier created by income taxes also produces fewer saving because capital is taxed. This reduces investment, discouraging innovation and ultimately contributing to a lower standard of living when compared to a pure consumption tax. In other words, income taxes will actually cause greater consumption in the present while reducing future savings and future consumption.

A well planned consumption tax is more neutral and does not affect the allocation of resources as dramatically as an income tax. Taxes are only assessed on any income that is consumed (spent on goods, services, etc.) while not taxing savings. This eliminates any deterrent to savings and actually would encourage people to save more, increase available capital, and ultimately produce a more solid, robust economy.

To better understand the true impact of each tax system has upon the consumer and economy as a whole, consider someone who has earns an income and must pay tax in an income and expenditure tax scenario. Assuming:

Gross Income €20, 000

Tax rate: 20%

Pre-tax interest rate on investment: 5%

Income Tax Scenario

After-tax income: (€20, 000×80%=) €16, 000

Saves it and earns €800 interest after 1 year at 5% on €16, 000.

Pays further (€800×20%=) €160 in taxes on interest income.

Resulting in €16, 640 or a gain of 4% over the previous year.

Consumption Tax Scenario

If individual consumes everything they would give up €4, 000 in expenditure tax and end up with €16, 000 just like previous scenario.

If individual saves all income:

After-tax income: €20, 000

Earns €1000 interest after 1 year at 5% on €20, 000.

If resulting €21, 000 after 1 year were to be consumed at the 20% expenditure rate, individual is able to consume (€21, 000×80%=) €16, 800. This end amount represent a gain of 5%, 1% larger gain under the income tax system.

This system encourages more investment while not creating any tax distortion between present and future consumption.

The main argument against a consumption tax is that it would raise less revenue than an income tax if the two rates were the same. This is certainly true because capital is not taxed in the consumption-based system. While true, the long term effects of a consumption tax would be a greater accumulation of savings, more capital to invest, and an economy that is fundamentally stronger than one using an income tax system.