The Effect of Taxation on the Economy

As with most things in economics, taxation is a mixed blessing. It is a blessing for those who receive dollars from taxpayers, which is about 40% of the population; and it is a nuisance for those who have to pay the taxes. The objective of this unit is to help you understand taxes and understand how they affect your life and the economy.

The income tax system began in earnest in 1913 with the Sixteenth Amendment to the Constitution that gave Congress legal authority to tax income. A rudimentary income tax system was tried during the Civil War but was eventually declared unconstitutional. There was no income tax during the high watermark of America's industrial capitalism, beginning in about 1870 and continuing to 1910. If you made money in that era, you kept it. Many of the most famous capitalist names emerge from this era: Rockefeller, Carnegie, McCormick, Swift, and Vanderbilt.

Two major disasters in our economic history, the Great Depression and World War II, changed the role of taxation and government forever. Beginning in the mid-1930s, following the ideas of John Maynard Keynes, the U.S. government began to spend money much more aggressively. In the past, government believed mostly in a balanced budget, but that changed when the Great Depression lingered for an entire decade.

Later, to finance a two-front, world war, taxes were raised to about 90%. Thus began the era of big taxes to pay for big government. Taxes, of course, have fallen from that lofty peak to a more modest 35% marginal tax rate at present, but the number of taxes has increased exponentially. All but six states have an income tax; likewise, many counties and cities have an income tax.

Though there are many ways to slice the tax onion, perhaps the best is the following:

**Progressive taxes:** This is a tax system in which tax rates increase as income increases. In other words, the more money you make, the more taxes you pay. This system places a greater burden on those best able to pay and almost no burden on the poor. For example, according to Internal Revenue Service (IRS) statistics, the top 50% of earners pay 97% of the taxes. The top 1% of earners pays 30% of all income taxes. On the other hand, over fifty million people, or one-third of the adult population in the United States, pay no taxes whatsoever.

**Regressive taxes:** In theory, these are the opposite of progressive taxes; these tax strategies fall more heavily on the poor. Common sense would suggest that these would be rarely used in a well-organized economy, but in fact, they are among the most commonly used because of their relative invisibility. Sometimes called the nickel and dime tax, regressive taxes tend to be small for each individual event; therefore, they are not widely noted. A good example of a regressive tax is the sales tax. It takes a much larger percentage of a poor person’s income than the income of someone of wealth. The reason there is no protest is that it takes such a small amount of money on
each event, typically 7%.

Other examples of regressive taxes are the Social Security tax and Medicare tax. Social Security takes 6.2% of your gross income, plus 1.45% for Medicare. Of American workers, 70% pay more to Social Security and Medicare than to income taxes.

**Proportional tax:** The third type of tax system is a proportional tax; it is sometimes called a flat tax. A flat tax system would place a single tax rate on all members of society—say 15%. Proponents argue that everyone would pay the same rate of taxes; therefore, it would be more fair. In exchange for the simplicity of a flat tax, taxpayers would need to give up all deductions. Therein lays a major problem because millions of homeowners would lose the deductibility of real estate taxes and interest payments.