Income Tax Day—Flat and Simple, or Fair and Complicated?

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This article is the fourteenth in a year-long series about economics and holidays.

April 15th is the deadline for filing your federal tax return, and in many states, your state tax return. Unlike most of the holidays in this series of essays, income tax day is not related to a historical event or the turning of the seasons. It's just an arbitrary day chosen by the federal government as a deadline—late enough in the year so that people have a chance to collect the documents and fill out the forms for the year that ended 3-1/2 months ago, early enough so that the government has some revenue for the last half of the fiscal year that ends on October 1st.

Americans have been paying federal income taxes since the 16th amendment to the Constitution was ratified in 1913. The original income tax had marginal rates ranging from one percent on the first $20,000 of taxable income to seven percent on income over $500,000. The revenue needs of World War I quickly drove the top bracket rate up to 67% on incomes over $2 million. The top bracket rate dropped to 25% in the 1920s, only to rise again during the Great Depression. By late in World War II, the top rate was 94% on incomes over $200,000. The top bracket rate dropped to 91% after the war and stayed there until 1964, then to 70% until 1982, when it fell again to 50%. Today, the maximum marginal rate is 35%.

But the marginal or top bracket tax rate is not even close to the amount of tax paid as a percent of income. In 2010, for example, that top rate of 35% only applied to taxable income (after deductions and exemptions) over $373,650. Dollars of taxable income under $373,650 were subject to marginal rates ranging from 10% to 33%. After exemptions, deductions, credits, and applying lower rates to the first parts of income, the average American paid 12.7% of gross income in federal income taxes in 2007.

It's true that the tax code is long and complicated. It's also true that, for the vast majority of taxpayers, it's not that complicated. Families who don't itemize or claim credits for buying new houses or making their existing homes more energy efficient can file quickly and easily. Tax preparers and tax preparation software have also simplified the task of filling out tax returns. Nevertheless, there is a movement to vastly simplify the federal income tax code to the point where it can be filed on a postcard. That proposal is called the flat tax. Economist Alvin Rabushka is credited with developing the idea, which has been reflected in a variety of proposals and takes some responsibility for various tax simplifications and rate reductions.

Strictly speaking, the proposed flat tax is not flat. It exempts some floor amount of income per household and taxes the rest of income at a single flat rate. For a poor household, that exempt amount may be 80% or 90% of income, so the flat rate would only apply to a small part of income. For a wealthy household, that same exempt amount would be a much smaller share of total income, so the flat rate would apply to most of income. As a result, the poor household would be paying a much lower percentage of total income in taxes than the rich household. So even a flat tax is progressive, although it would be much less progressive than our current structure with rates ranging from 10% to 35%. In an overall state and local revenue system with lots of regressive taxes that hit poor and middle income households harder, there's something to be said for a fairly progressive federal income tax as a balancing factor. But perhaps simplification is worth giving up that benefit of our present system?

Not necessarily. There's one more important complication in going to flat and simple. We would have to give up some cherished deductions and credits. For middle income households, there are three important tax incentives (or what economists call tax expenditures) that would be affected. One is the deduction for mortgage interest and property taxes on their homes. Most households figure those deductions into deciding how much home they can afford to buy. Suddenly the deduction is gone! Middle and upper income households also take the tax deduction into account when they make charitable contributions. The higher your marginal rate, the less it costs you to give another dollar to charity. Under the flat tax, the charitable deduction would be gone. It's hard to know what the impact would be on charities ranging from churches and colleges to soup kitchens and museums.

The biggest hit for middle income households, however, would come in employer-provided fringe benefits, of which the largest are health insurance and pension contributions. Fringe benefits typically cost about 30% of wages and salaries, so all of a sudden the federal government would think you were earning 30% more for tax purposes. People also save in tax exempt forms that would no longer enjoy that tax privilege. A flat tax would discourage saving for retirement and providing health insurance.

The income tax is complicated for a number of reasons. Certainly it is full of loopholes and privileges granted to particular firms and individuals. But it does offset some of the other regressive taxes in the system. And it's also a great way for the government to encourage us to do things we should be doing anyway—saving for retirement, reducing our carbon footprint, investing in our homes, contributing to charity. So before we join the tax protestors and demand that the income tax be simplified, we need to take a look at our own tax forms and think about what is our fair share to pay and what good things we did just because the tax code was encouraging us to do the right thing.