

Real World Graduation: Question 11

Edward D. Duvall
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Question 11

Some in Congress in 2006 proposed an income-tax modification bill that would have provided a 5% across-the-board reduction in federal income tax rates. The bill mandated that the highest marginal income tax rate would have been reduced from 38% to 33%; the next rate from 25% to 20%, and the lowest from 10% to 5%. Capital gains rates would remain unchanged. Critics have claimed that only the very rich would benefit from this measure. They were joined by Mr. Ralph Thompson, estimated to be the nation's fourth-richest person, who came out in opposition to the tax cut, saying, "Neither I nor any other wealthy people need an income tax cut." But people who favor the tax cut claim that the working people will benefit because they will have more money in their pocket. For example, the single person working a full-time job (40 hours per week) at \$6.50 per hour (just over minimum wage of \$5.75 per hour) would have their marginal rate reduced to 5%, so they would have received a tax cut of approximately \$4.57 per week after the combined standard deduction of \$8,750. Does this income tax proposal unfairly benefit the wealthy or unfairly penalize the working poor with regard to income tax rates?

- a) It unfairly benefits the rich because they will pay less in income taxes.
- b) It unfairly benefits the rich because they don't need the extra money, as Mr. Thompson said.
- c) It unfairly penalizes the poor because it left the minimum wage unchanged.
- d) It unfairly penalizes the poor because the proponents of the tax cut are lying: the extra \$4.57 won't buy much and isn't necessary.
- e) All of the above are true to some extent.

Answer to Question 11

This is a trick question. None of the answers are correct.

The arithmetic works like this. This person works 40 hours per week at \$6.50 per hour, which is \$260 per week. Assuming a 52 week work year, his total income is $52 \times \$260 = \$13,520$. His standard deduction is \$5,150, plus there is a personal exemption of \$3,500, for a total deduction of \$8,750. So his taxable income is $\$13,520 - \$8,750 = \$4,770$. At the old rate, he would pay $\$4,770 \times 0.10 = \477 in federal income taxes. Under the new rate, he would pay $\$4,770 \times 0.05 = \239 , a difference of \$238 per year. Or, dividing the \$238 by 52 weeks per year, he would get a tax cut of approximately \$4.57 per week.

Answer (a) is wrong because this proposal only reduces the amount of unfairness already imposed on the rich. To be fair with regard to income tax rates, the rich should pay the same rate as the poor. If this plan were enacted, the rich will still pay more than six times the rate of the poor, so if anything, it is still unfair to the rich.

Answer (b) is wrong because it has nothing to do with fairness one way or the other. Also, the proposal deals with taxes on income, not wealth. The wealth held by the rich will not be affected one way or the other by a change in the income tax because the income tax is imposed on what is earned in a given year. On the other hand, wealth is the accumulation of income from past years (upon which income taxes have already been paid). It is true that the rich will end up with more money from their current income, but how is that unfair? Why is it unfair for the rich to keep most of their income after paying taxes? If a person makes a higher income, does that not suggest that his time is more valuable than someone who makes less? To suggest that everyone's time should be valued equally is to say that an hour of your time on a basketball court is just as valuable as an hour of Kobe Bryant's time on the court. Would an hour of your time in a recording studio be as valuable as an hour of Paul McCartney's or Sean McComb's time? People are rich because they inherited it, they married into it, or they had a good idea, worked hard, and earned it. None of those are unfair.

Answer (c) is wrong because it is irrelevant to the question at hand. The bill before Congress did not address the minimum wage any more than it addresses the capital gains rate.

Answer (d) is wrong because the extra \$4.57 per week is still \$4.57 the person will keep instead of paying it to the government. The fact that \$4.57 per week (or \$238 per year) is not a particularly large sum does not make it unfair. Why is it unfair for the poor to pay less in taxes? If it is "unfair" for the poor to pay less in taxes, it must be "fair" for the poor to pay more in taxes, right? Hopefully there aren't any voters who are dumb enough to embrace this line of reasoning. The reason that tax cut appears so small for the working poor is that their taxes are very low to start with.

Under this proposal, both the rich and the poor will have more money to spend; the rich will simply have more than the poor (as always, that's why they're called "rich"). Of these, answer (d) is the worst one, because the logic requires one to believe that even a small income tax cut is bad, even for the poor. Note that the \$8,750 is the income of a person working part-time at about 29.3 hours per week at the \$5.75 minimum wage. Such a person would pay no income tax because his income equals the sum of the standard deduction and personal exemption. In other words, answer (d) embraces the false concept that anyone making more than the minimum wage must be rich, and therefore undeserving of a tax cut.

This is one of the many disadvantages of a personal income tax: it fosters class warfare under the guise of "fairness". There is nothing "fair" about any citizen being required to divulge, under penalty of perjury, their income status to irresponsible bureaucrats at the Internal Revenue Service. Secondly, "fairness" is

the wrong way to look at taxes because it ignores how income and wealth are created and utilized. The poor spend nearly all their income on living expenses; the rich use nearly all their income on either luxuries or investments. Expenditures for luxuries represent an increase in economic activity (someone has to supply them) and thus indirectly cause an expansion of employment. Investment creates opportunity for people to start their own businesses (including the poor) and also expands economic opportunity within existing businesses, which also benefits the middle class and the poor alike.

This debate shows the general degree of economic ignorance in America. The truth of the matter is, aside from any particular notion of "fairness", as societies generally become more prosperous, nearly everyone enjoys a higher standard of living than the previous generations. It is also true that those who have the most wealth will tend to gain more as the society continues to prosper, hence the saying "the rich get richer". But it is not generally true that as the rich get richer, "the poor get poorer", as is commonly stated. As societies become wealthier, the standard of living slowly increases, even for the poor.

The progressives (socialists) would have you believe that those with high incomes should be taxed such that their net income after taxes would only be slightly larger than those making the smallest amount. That is the socialist system: everyone (except for the political ruling class) ends up either poor or just above poverty. The reason that socialism fails is that it attempts to use slogans and brute force instead of economic reality. Economic reality shows that economic progress can occur only by expansion of capital; capital has to come from savings; savings is the difference between income and expenses; and if everyone has only enough income to meet their immediate expenses, then there can be no savings, no capital, and no economic progress. That is why the Soviet Union collapsed, and why Cuba, North Korea, and Venezuela are economic basket-cases. It also explains why the vast majority of people in Communist China will spend their lives walking behind a water buffalo, scratching out a subsistence living.