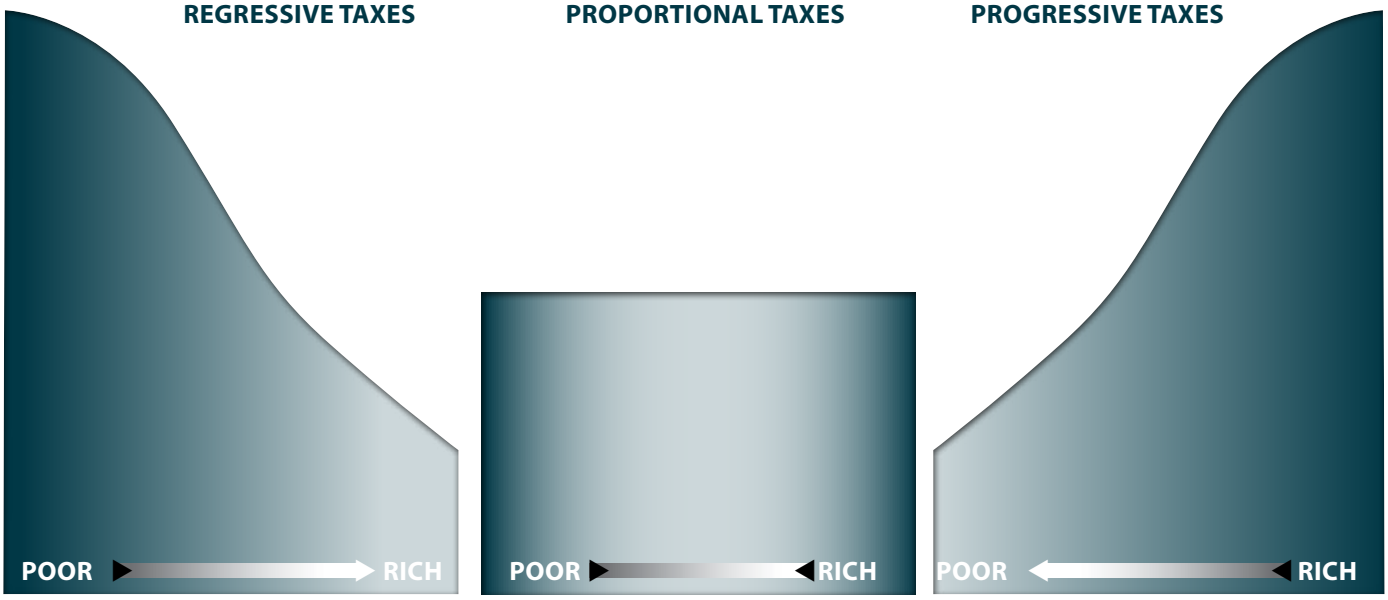
CHAPTER ONE
TAX FAIRNESS FUNDAMENTALS

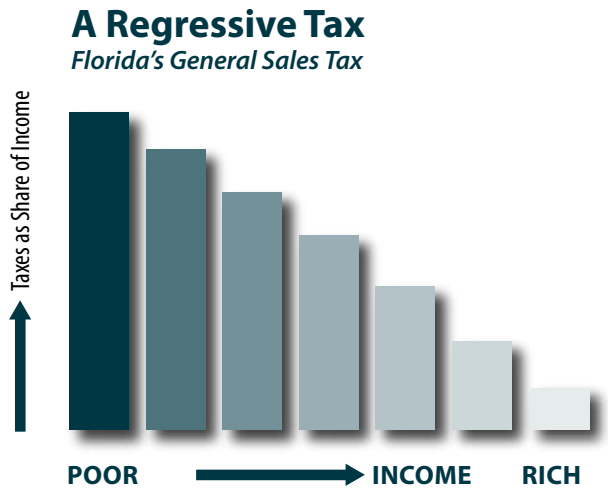
> **"The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state . . . [As Henry Home (Lord Kames) has written, a goal of taxation should be to] 'remedy inequality of riches as much as possible, by relieving the poor and burdening the rich.'"** [1]
>
> *— Adam Smith, An Inquiry Into The Nature and Causes of the Wealth of Nations (1776)*

A fair tax system asks citizens to contribute to the cost of government services based on their **ability to pay**. This is a venerable idea, as old as the biblical notion that a few pennies from a poor woman's purse cost her more than many pieces of gold from a rich man's hoard. In discussing tax fairness, we use the terms regressive, proportional and progressive. As the chart below illustrates:

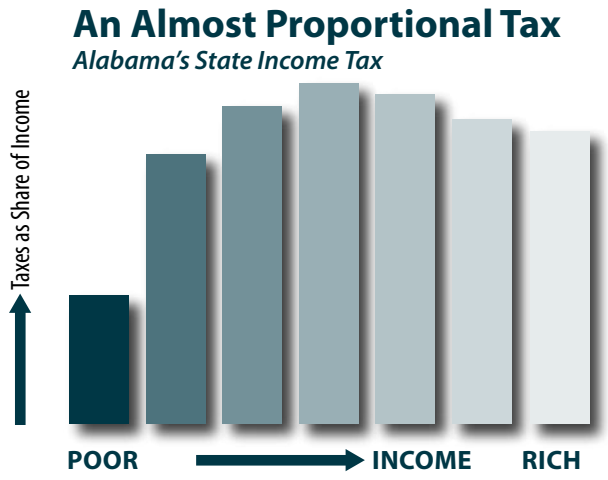
- A **regressive** tax makes middle- and low-income families pay a larger share of their incomes in taxes than the rich.
- A **proportional** tax takes the same percentage of income from everyone, regardless of how much or how little they earn.
- A **progressive** tax is one in which upper-income families pay a larger share of their incomes in tax than do those with lower incomes.



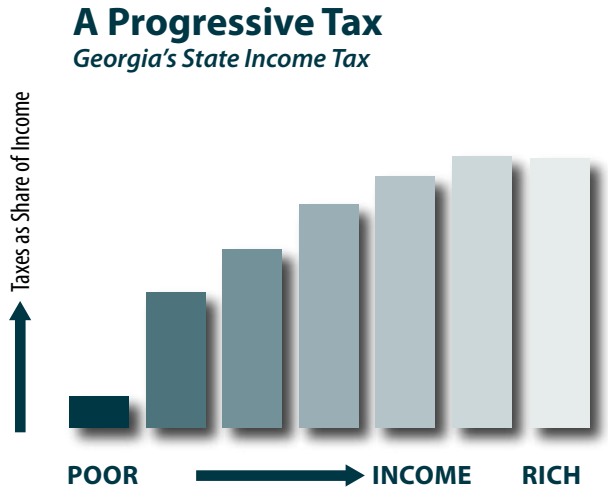
Few people would consider a tax system to be fair if the poorer you are, the more of your income you pay in taxes. But that's exactly what regressive taxes do. They require middle- and low-income families to pay a much greater share of their incomes in taxes than the wealthy. Fairness is, of course, in the eye of the beholder. Yet almost anyone would agree that the best-off families should pay at a tax rate at least equal to what low- and middle-income families pay. State and local taxes pay for the schools, safe neighborhoods, clean water and air, public transportation and other things that make for a better community and enhance quality of life. Because these investments benefit everyone, it is imperative that every household pay its fair share.



The sales tax is a regressive tax, as can be seen in the chart at left of Florida's sales tax. Because sales taxes are levied at a flat rate, and because low-income families spend more of their income on items subject to the sales tax than do wealthier taxpayers, sales taxes inevitably take a larger share of income from low- and middle-income families than they take from the wealthy. Excise taxes on cigarettes, gasoline and alcohol are also quite regressive, and property taxes are generally somewhat regressive.



Some believe that a proportional, or "flat," tax structure is fair. They argue that if everyone pays the same share of income in taxes, then everyone is treated equitably. But this view ignores the fact that taking the same share of income from a middle- or low-income family as from a rich family has vastly different consequences for each. Low-income families must spend most (or all) of their income just to achieve the most basic level of comfort. Even middle income families spend most of what they earn to sustain only a modest standard of living. A tax on these families can cut directly into their ability to make ends meet. In contrast, the same tax will hardly affect the life style of the wealthiest families at all. An almost-flat personal income tax (like Alabama's, shown in the chart at left) is an example of a tax that can be proportional.[2]



Source: ITEP Microsimulation Model

Progressive taxes are the fairest taxes. Personal income taxes are the only major tax that can easily be designed to be progressive. Low-income families can be exempted entirely and tax rates can be graduated, with higher tax rates applying to higher income levels, so that middle-income and rich families pay taxes fairly related to what they can afford. An example of a typically progressive income tax is Georgia's tax, shown in the chart at left: the poorest taxpayers pay the smallest amount as a share of income, and taxes increase with each income level.

Almost every state relies on some combination of regressive, proportional and progressive taxes. When you add these taxes together, the overall **progressivity** or **regressivity**

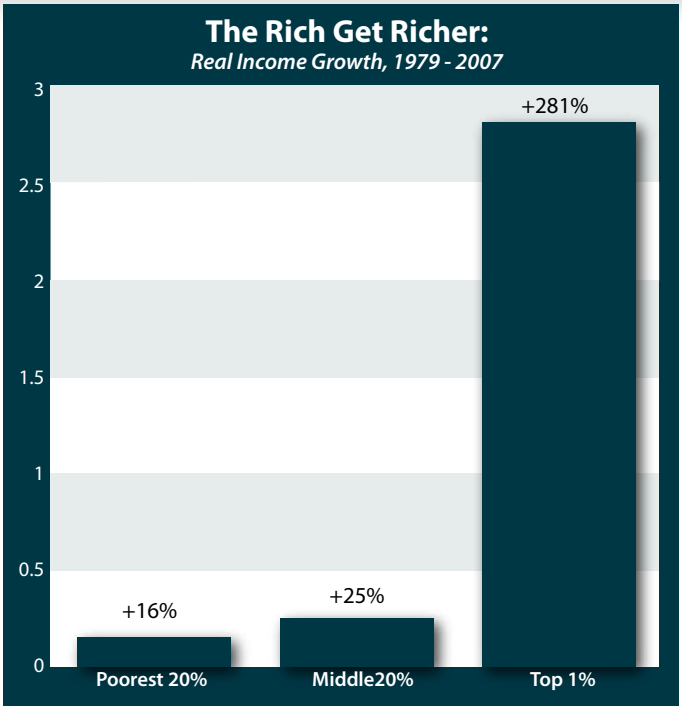
of a tax system is determined by (1) the degree of progressivity or regressivity of each tax within the system and (2) how heavily a state relies on each tax. Thus, a state that relies on regressive sales, excise and property taxes more heavily than its mildly progressive income tax will end up with a very regressive tax system overall. An example of a state like this is Illinois. At the other end of the spectrum, even the most progressive income taxes are only sufficient to make a state's tax system roughly proportional overall. An example of a state that achieves this result by relying more on its progressive income tax than on regressive sales, excise and property taxes is Vermont. The charts below illustrate Illinois and Vermont's tax systems.

Why Tax Fairness Matters

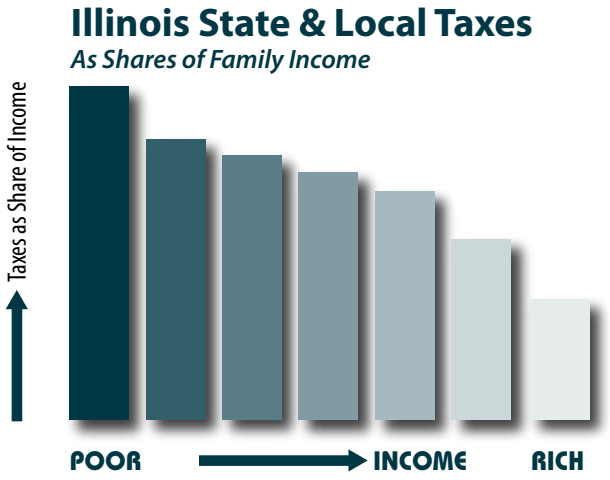
Tax fairness is an important goal for state policymakers, for several reasons. For one thing, a regressive tax system raises money from the people who have the least of it. This is illogical at best. The wealthiest one percent of Americans have more income than the poorest 40 percent put together. And the best-off 20 percent of Americans make more than the remaining 80 percent combined. Soaking the poor just doesn't yield much revenue compared to modest taxes on the rich. Fair taxes are essential to adequate funding of public services because they tax those who have the most to give.

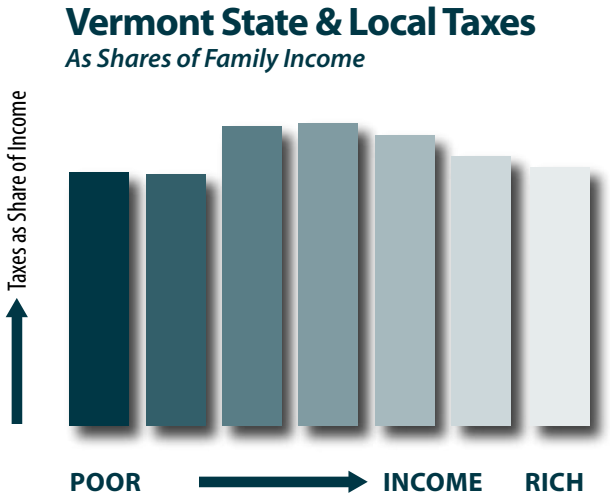
This flaw in using a "soak the poor," regressive tax system for raising revenue has been compounded in recent years. The wealthiest Americans have gotten much richer, while just about everyone else has gotten squeezed. The richest one percent of families in the United States saw their average pre-tax income rise by 281 percent in the twenty-one years from 1979 to 2007—that's in "constant dollars" (meaning it's adjusted for inflation)! Meanwhile, middle-income earnings grew by 25 percent over this period, and the poorest twenty percent saw their real pretax incomes grow by just 16 percent.[3]

It's no wonder that so many states with regressive tax structures are facing long-term structural budget deficits. They're continually imposing higher taxes on people without much money—the very people who have experienced the most meager growth in income over the past thirty years. These states are largely bypassing—that is, by taxing at very low rates—the people whose incomes have grown the fastest: the rich. In the long run, progressive taxes like the income tax are a more dependable source of revenue for state and local governments precisely because they tax the wealthy state



Source: Congressional Budget Office, "Data on the Average Federal Taxes by Income Group," June 2010.





Source: ITEP Microsimulation Model

Are Your State's Taxes Unfair?

A November 2009 ITEP report, Who Pays?, measures the fairness of state and local taxes in each of the 50 states and the District of Columbia. The report finds that almost every state requires its poorest citizens to pay more of their income in taxes than any other income group—and allows the wealthiest taxpayers to pay the least. Who Pays? is available on ITEP's website at www.itepnet.org/whopays

residents who have enjoyed the largest income gains in recent decades.

Fair taxes also help government in its relations with its citizens. The public accepts taxes because it values the services that government provides. When a tax system is unfair, however, there is a limit to the taxes the public will tolerate. It's one thing to ask people to pay taxes. It is another to ask them to pay more because others aren't paying their fair share. When states choose to balance their budgets by hiking taxes on the low- and middle-income families who are hit hardest by the current tax system, while giving the best-off families a free pass, this obvious unfairness undermines public support for revenue-raising tax reforms even when they are most desperately needed.

Finally, a fair tax system is important as a very real moral imperative. Taxes can amount to real money for any family. But for poorer families, it's money that could otherwise be used for food, clothing, a trip to the doctor or some other necessity. When a state decides to tax the poor at a high rate, it is forcing these families to make choices that no family should have to make—choices that are far harder than those faced by upper-income families.

Federal Taxes Matter, Too

When we evaluate the fairness of a tax system, we should also consider overlapping tax systems that affect the same taxpayers. It is important, in particular, to consider state and local tax policy in the context of federal tax policy.

While the rich have seen their incomes go up substantially faster than others, federal taxes on the wealthy have gone way down—resulting in an overall tax system that is much less progressive. In 2009, the wealthiest 1 percent of Americans paid 30.8 percent of their income in combined federal, state and local taxes, down sharply from 37.1 percent before the George W. Bush administration. By comparison, the other 99 percent of Americans paid, on average, 28.2 percent of their income in total taxes—almost as much as the wealthiest taxpayers.

So as states determine which taxes to raise and on whom, they should consider that federal taxes have been getting significantly less progressive. A state that raises taxes on the rich will almost certainly still leave them better off than they were before their huge tax cuts on the federal level. Raising taxes on middle- and low-income taxpayers, however, will compound the injustice of the federal tax shift that has taken place in the past decade.

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[1] Smith, Adam. *An Inquiry into the Nature and Causes of the Wealth of Nations.* New York: Random House, 1937.

[2] Alabama's income tax has a nominally graduated rate structure, but the top income tax rate applies to all taxable income over $6,000 for a married couples. As a result, 70 percent of Alabamans paid income tax at the top rate in 2009, making it an effectively flat income tax for most families.

[3] Congressional Budget Office, "Average Federal Taxes by Income Group," June 2010. http://www.cbo.gov/publications/collections/collections.cfm?collect=13 .