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Our Current Tax v. The Flat Tax v. The Fair Tax: What's The Difference?

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Progressive PGR +0.81% income tax. This is the system that we have now. A progressive income tax is exactly what it sounds like: the rate of tax increases as income (however measured) increases. Technically, you can create a progressive income tax system even when stated tax rates remain flat by using personal exemptions, tax credits and tax deductions to alter the effective tax rate. Although our current system isn't very popular at home, it's perhaps the most common tax system used in developed countries around the world. Countries that use a progressive income tax system include China, Japan, Australia, France, Germany, Italy, Canada and the United Kingdom.

People like a progressive tax because it raises revenue by taxing those who can most afford to pay. Offering tax breaks for those at the bottom should, in theory, give those taxpayers the opportunity to increase their wealth and work their way out of poverty. And, of course, progressive tax should encourage the distribution of wealth, making it less likely that dynasties would concentrate their wealth as they did in pre-Revolutionary War England.

People don't like a progressive tax because it treats people differently: those at the top are charged with paying more, as a percentage of income, than those at the bottom. While it's true that some taxpayers - like Warren Buffett - pay a lower effective tax rate than many in the middle class, the U.S. still has one of the most progressive systems in the world, collecting the largest share of taxes from those at the top. According to the Tax Foundation, the top 1% of taxpayers have consistently paid more in federal income taxes than the bottom 90% since 2003 and that share has increased almost every year since 1980 (beginning with President Reagan's tax reform efforts). This is true even when paying more in taxes does not necessarily result in increased services. Progressive taxes are also considered more complicated than other forms of tax (just look at the length of our existing Tax Code).

Flat tax. A flat tax is exactly what it sounds like: a consistent tax rate applied to all tax brackets. A true flat tax would mean, as Dr. Carson explained, that everyone would pay the same tax rate regardless of income (he suggested 10% since that "works for God"). Flat taxes are usually imposed on wages only, meaning that there's no tax on capital gains or investments. Russia is considered to be the world's largest economy with a flat tax (some of the Baltic states also have a flat tax).

People like a flat tax because it feels more fair: everyone pays the same percentage of tax across the board. A flat tax is more simple and should mean that there would be less call for taxpayers to pay to have returns prepared; some suggest that it would completely eliminate the need for the Internal Revenue Service (IRS). Flat taxes are also supported in the business and investment communities since dividends, distributions, capital gains and other income not tied to wages are generally exempt from tax: this should spur investment and savings.

People don't like a flat tax because a true flat tax impacts taxpayers disproportionately even though the tax is proportionate. For example, let's assume a tax rate of 10%. For a household making $1,000,000, that 10% would represent $100,000 in tax. For a household making $10,000, that 10% would represent $1,000 in tax. The baseline cost of living does not change as income changes: with respect to a gallon of milk or gas, for example, the cost of that milk or gas doesn't cost less for the poor than for the wealthy. If basic expenses like food and fuel are relatively inelastic, while a flat tax may be proportionate, the effect of the tax may be disproportionate. If you mix in other circumstances (caring for a disabled child or several minor children), the effect is even more dramatic. To resolve those issues, most flat tax plans typically include an exemption for low income taxpayers, the elderly and the disabled. Many flat tax plans, such as Sen. Paul's, also include tax deductions and tax exemptions, which, of course, moves the tax away from being flat and more towards being progressive. As that happens, you also move away from the likelihood IRS could be eliminated. Additionally, imposing a tax only on wages means that those who work for a living and receive a traditional wage (typically, the middle class) would pay a higher rate on gross income than those who receive most of their income through dividends and capital gains (like Warren Buffett) or distributions from partnerships and S corporations (think former Senator John Edwards) which, it's argued, produces an inequitable and unfair result.

Fair Tax. The Fair Tax is capitalized for a reason: it's a formal proposal rather than a generic term. It differs from both the progressive income tax system and the flat tax in a very dramatic way: it is not a tax on income. The Fair Tax would replace all existing income taxes - as well as payroll taxes - with a single consumption tax. The tax, as proposed, would be a 30% tax on purchases of new goods and services, excluding necessities due to a "prebate." The "prebate" is akin to a refund and is offered at the beginning of each month so that certain purchases are essentially tax-free.

People like a Fair Tax because it eliminates taxes on payroll and income: taxpayers get to keep their entire check and won't have to make those dreaded estimated payments. It's considered more fair than a progressive income tax since taxpayers are taxed on consumption of goods and services which are, on some level, expenditures that can be controlled at will (the exception being necessities which are not exempt under the Fair Tax). Additionally, since certain kinds of goods and services are always going to be in demand, a tax on consumption is considered more stable than a tax on wages. All taxpayers would be subject to the tax, including those that are engaging in illegal activities. People also like a Fair Tax because, since retailers would collect and remit taxes directly to the Treasury, the IRS could be eliminated.

People don't like a Fair Tax because it has never been tried in any other country in the world causing some to fear that it is too experimental (a transitional hybrid system combining income and Fair Tax has been floated). The Fair Tax is also considered by some to be regressive since necessities are still subject to tax. Additionally, since the burden for collection shifts from the federal government to individual businesses, some of which are not currently collecting taxes (those which sell exempt goods, businesses in states where there are no sales taxes and businesses currently not subject to taxes on providing services), there's a concern about the added burden that would place on those businesses, specifically small businesses. And while the tax purports to do away with those who make money off of the current tax system, the Fair Tax does provide a fee for acting as a collection agent which adds another layer of complexity.

Keep in mind that this is meant to be a quick comparison of the different kinds of tax plans being touted. The devil, of course, is in the details, and each candidate has a different take on how these plans might be implemented under their respective administrations. Additionally, entire books and white papers have been written about each of these kinds of tax: if you want more information about any specific plan, I'd encourage you to check them out.