Worksheet 16.2

Regressive or Progressive Taxes - which road to follow towards fiscal discipline?

The structure of a nation's tax system depends on the nation being observed. In the US, federal income taxes are higher than they are in Switzerland, but in Switzerland there is a nationwide sales tax (VAT) that the US does not have. Much of Switzerland's government revenue comes from the value added tax and other indirect taxes, which means households keep much more of their earned income.

Since the US income tax system is progressive, while Switzerland's sales tax is regressive, we can conclude that the overall tax burden in Switzerland is shared more evenly across households of higher and lower incomes, while in the US high income households share a relatively larger burden of the nation's tax revenues.

In the United States, where the government has not had a balanced budget since 2001, there has been much talk about creating a national sales tax to help raise revenue to pay for many of the social plans that the Obama administration wants to pursue, such as national health care. VATs and sales taxes are regressive, which means more of the tax burden is born by low income households compared with high a direct, income tax, which is progressive, meaning the higher a household's income, the greater percentage it pays. But with large budget deficits projected for the next decade in the United States, new sources of tax revenue are needed. Read from 'Everybody who understands' to 'about the money' in the article 'Once considered unthinkable, US sales tax gets fresh look'.

To counter claims that a national sales tax is regressive, advocates point out that such a tax would allow the federal government to lower income tax rates for low income Americans, giving them more disposable income to spend on goods and services, which would be more expensive because of the VAT.

Another option the government could consider is a tax on greenhouse gas emissions. A carbon tax would create new tax revenue for the federal government and help reduce the negative externalities causing global warming and encourage development of alternative 'green' methods of production.

In the short-term, it is unlikely that the US government will legislate any significant new taxes. Both a nationwide sales tax and a carbon tax have been largely ignored under the argument that during a recession any new tax on industry might slow the recovery in output of the country's manufacturers and retailers.

America's long period of strong growth, low savings, and deficit financed government spending will necessitate belt-tightening in the near future as ultimately the government will have to start financing its budgets through tax revenues, not the issuing of new debt. Carbon taxes, higher marginal income taxes, or a national sales tax are all options the US government will have to choose from. For now, it appears it's choosing none of these, and instead increasing the national debt and the moneys supply to try to encourage economic growth. The path towards fiscal discipline is a hard one to get started on, especially during a recession when new taxes are just not politically possible.

Questions:

1. What makes a sales tax regressive if everyone has to pay, say, 10% on top of the regular sales price of a good or service?
2. How does the US government finance its massive budgets when its revenue from taxes don't even come close to equaling the amount of spending?
3. Why is it important for a country, in the long-run, to achieve a balanced budget?
4. What would you prefer to do: pay a higher income tax or a higher sales tax? What are the pros and cons of direct versus indirect taxes?