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The Progressivity of The Common Sense Tax

The Common Sense Tax (www.thecommonsensetax.org) is a proposal to vastly simplify federal taxation. The proposal is designed to be revenue-neutral assuming no response of the economy to the proposal's significant growth potential. The proposal is also designed to maintain or enhance the system's progressivity, as properly measured, to improve most Americans' incentives to work and save, and to significantly expand the economy's productivity and output.

Key Features of the Common Sense Tax

The Common Sense Tax or CST is extremely simple. It has just four features – a new, lower-rate FICA tax with no earnings ceiling, a single-rate tax on the incomes of married and single households above high thresholds, the taxation of corporate income at the personal, rather than the corporate level, and the replacement of the federal Gift and Estate tax with taxation of bequests and gifts received under the CST's income tax.

A New Lower Rate FICA Tax with No Ceiling

The CST FICA tax replaces, in their entirety, both the current FICA Social Security (OASDI) payroll tax and the current FICA Medicare (HI) tax. Instead, the CST features a 13 percent employer-paid Social Security and Medicare (OASDHI) FICA payroll tax on *all* labor earnings; i.e., the CST's FICA tax has no taxable earnings ceiling.

In contrast, the current Social Security payroll tax taxes covered labor earnings at a 12.4 percent rate up to a ceiling, which is $113,700 for 2013. The current Medicare payroll tax taxes all labor earnings at a 2.9 percent rate and the labor earnings of high-income households (married couples with adjusted gross incomes above $250,000 and singles with adjusted gross incomes above $200,000) at an additional .9 percent. The current system also features a 3.8 Medicare tax on unearned incomes for high-income households.

The current FICA tax is nominally "paid" half by employers and half by employees. Economists don't believe this employer-employee distinction matters, at least in the long run. Instead, they believe that employers reduce what they compensate their workers in accord with the taxes they need to pay on their workers' behalves. But to ensure that middle- and low-wage workers benefit immediately from the 2 percentage point reduction in the FICA payroll tax rate, the Common Sense Tax levies its 13 percent payroll tax only on employers.

A New Personal Income Tax

The second CST feature is a new personal federal income tax, which taxes, at a 25 percent rate, only incomes above $100,000, in the case of married couples, and above $50,000, in the case of single individuals. Given these very high exemptions, the CST reform would eliminate annual income tax filing for over two thirds of American households.

The CST personal income tax eliminates all deductions and other tax breaks, with three exceptions – the charitable deduction, the Child Tax Credit, and the Earned Income Tax Credit (to be calculated based on reported FICA earnings). The charitable deduction is an important mainstay of religious and secular non-profit institutions. And the Child Tax Credit and Earned Income Tax Credit are refundable, making them critical support systems children and others in dire need.

The CST personal income tax taxes all income above the thresholds no matter how or where it is earned. This includes the labor income households receive as employees, the profits they earn on *all* the businesses, including corporations, they own, the interest income they earn on their savings, and the income they earn on their real estate. By taxing business profits as they accrue and by defining business profits to include the proceeds, including capital gains, accrued from sale of business assets, there is no need to tax capital gains or dividends, with all the difficulties and distortions that entails.

Elimination of the Corporate Income Tax, but Immediate Taxation of Corporate Profits at the Personal Level

Under the Common Sense Tax, owning shares of a C-corporation, whether a U.S. or foreign corporation, would be no different from owning a share in a small business. If you are above the relevant threshold, you have to pay taxes on the income earned on your behalf by your C-corporations as it is earned. To make sure you'd have the cash to pay the taxes, C-corporations would be required to distribute a minimum of 25 percent of their annual profits, including revenues from sale of their assets, as dividends. This may sound like a bigger imposition on corporations than is the case. Corporations, on average, already distribute close to half of their profits each year as dividends.

Under today's tax system, households with proprietorships, partnerships, small S-corporations, and similar entities have to pay taxes on their business income as they earn it. But if they own shares of large C-corporations, no taxes are due on their share of the corporation's income until they receive dividends or sell their shares. If owners of partnerships, proprietorships, and subchapter S corporations, virtually all of which are quite small, are forced to pay taxes, as they accrue, on the profits their businesses make on their behaves, corporations will be able to manage as well.

Elimination of the Federal Estate and Gift Tax, But Taxation of Bequests and Gifts Received under the CST Income Tax

Bequests and gifts received would be treated just like other potentially taxable income in determining annual CST income tax liability. Thus, anyone with incomes, including bequests and gifts received, in excess of the CST income tax threshold will pay, at the margin, 25 cents in taxes on every dollar inherited or otherwise conveyed.

Is the Common Sense Tax Progressive?

The CST has a number of progressive elements. Consider first payroll taxation. Today's FICA payroll tax taxes workers (ignoring the employer-employee tax "payment" distinction) on 15.3 percent of their wages up to $113,700, but only 2.9 percent above this ceiling, increasing to 3.8 percent for married households earning more than $250,000 and single households earnings more than $200,000. Consequently, four fifths of today's payroll tax is extremely regressive.

True, the FICA tax, both below and above the earnings ceiling, is divided 50-50 between employers and employees. But, to repeat, economists don't believe this distinction matters, at least in the long run. But, as mentioned, to ensure that middle- and low-wage workers benefit immediately from the reduction they receive in the payroll tax rate, the Common Sense Tax nominally levies its 13 percent payroll tax only on employers. To further enhance the system's progressivity and protect Social Security's long-term financial position, Social Security benefits will, under the reform, be calculated based only on covered earnings as currently defined.

Consider next the Common Sense Tax's personal income tax. By setting high thresholds for taxable income, the Common Sense Tax would instantly end the income taxation of all households of low or modest means. In combination with the Common Sense Tax's payroll tax reform, such households would get what they desperately need – more money to spend, save, and invest in these difficult economic times.

The vast majority of workers will only face the 13 percent marginal FICA tax on their additional labor earnings. Those with labor and asset incomes that put them above the thresholds would face a 38 tax on additional labor income – the CST 13 percent FICA plus the 25 percent CST income tax. This is lower than the top effective tax rate of 43 percent that high earners face under the current federal personal income tax due to the phase out of deductions.

Under the CST, the vast majority of households will face a zero marginal tax on their saving. I.e., they will be in a zero marginal CST income tax bracket and face no taxation on additional asset income they earn from saving. For higher income savers, the marginal CST tax on earning additional asset income, via saving, will be 25 percent. For some of these households, this tax is much lower than they now face. For others it is higher. Indeed, very high-income households can arrange their affairs to pay very little if any taxes on their asset incomes. The main methods of doing so are arranging to receive asset income in the form of capital gains, deferring the realization of capital gains, and entirely avoiding income taxation of accrued capital gains by passing appreciated assets

to their heirs via what is know as a step up in basis. Yes, the new tax law taxes realized capital gains of high income households at a 20 percent rate and yes, there is a new 3.8 percent Medicare surtax levied on the asset incomes of high-income households. But for the rich, paying taxes on asset income remains, to a large extent, a matter of choice, not necessity.

The CST permits no one to play games when it comes to paying taxes on their asset income. The CST is designed to require tax payments on asset income earned, whether directly or via a company one owns, as it accrues. As a consequence, modeling tax payments under the CST is easy. What's difficult is knowing what households are paying under the current system since they have such good asset-income tax avoidance options.

In this analysis, I first calculate personal asset income taxation under the current tax system assuming that 75 percent of asset income accrues in the form of capital gains and dividends that is immediately realized with other 25 percent taxed at ordinary income tax rates. But I then reduce by half this calculated tax burden in light of the ability of asset holders to defer and, indeed, entirely avoid personal capital income taxes under the current system. Since avoidance of taxes on asset incomes is more common among the rich than the poor, this assumption overstates the progressivity of the current system.

Not only can the rich avoid capital gains taxation under the existing federal income tax (EFT) via deferring realizations and passing assets at debt. They also have a variety of ways to avoid estate and gift taxation under the current tax system. The fact that the federal Estate and Gift Tax is producing just $14 billion in revenue in an economy with over $50 trillion in personal wealth and, arguably, roughly $3 trillion in annual bequests and inheritances is testimony to the ability of the rich to escape taxation of these transfers. Indeed, the effective tax rate on bequests and gifts appears to be less than 4 percent. As indicated, under the CST, all high-income recipients of bequests and gifts will pay 25 percent on these receipts. This said, the analysis here abstracts from bequests and gifts as well as inheritances to keep the presentation simple and to make as few arguably arbitrary assumptions as possible.

As for the corporate income tax, its elimination will leave the U.S. with the lowest corporate tax rate of any developed country. Assuming other countries don't match this move, this policy should stimulate substantial new investment and job creation in the U.S., leading to higher wages for U.S. workers. Indeed, my own recent co-authored research, based on a multi-country general equilibrium simulation model, suggests a potential 10 percent rise in workers' real wages over time relative to what they would be under current tax policy.

The theoretical presumption, supported by simulation as well as empirical analyses, both detailed and anecdotal (e.g., the Irish Miracle) -- that higher corporate taxation discourages investment and, thereby, reduces workers' wages -- is why many public finance economists, regardless of their political persuasions, view the corporate income tax as a disguised tax on labor. From this perspective, eliminating the corporate tax is yet another reason the Common Sense Tax appears to be more favorable to American working men and women than the current tax system.

Capital Mobility and the Progressivity of the CST

The view that corporate capital is highly mobile internationally can matter for assessing the CST's progressivity. In the extreme, if corporations can move their capital abroad at low cost in response to tax advantages, the owners of corporations, whether they are Americans with wealth or foreigners with wealth, will bear the worldwide average effective corporate tax rate and earn the prevailing global after-tax rate of turn.

In this *full capital mobility* case, the revenue the U.S. government collects on corporate profits comes from the pockets of all global wealth holders, not just American wealth holders. Under this *view*, cutting the U.S. corporate tax will have little affect on American investors in corporations, who, like other global investors, will enjoy their small share of the reduction in global taxes on corporate profits. But it will, to repeat, affect U.S. workers who will experience higher demand for their services and, consequently, earn higher real wages, as capital flows back into the U.S.

In the analysis below, I first present results assuming zero capital mobility and then show results assuming full capital mobility. The zero capital mobility assumption is the one commonly made in analyzing corporate and other tax reforms, not because it's more realistic, but because it is hard to say for sure how fast capital will flow into or out of the company or the degree to which real wages will change.

Under the zero capital mobility assumption, Americas with assets are assumed to be stuck investing them in the U.S. and, consequently, cannot avoid the corporate income tax by moving their investments off shore. In this case, the U.S. corporate tax can be viewed as being paid by corporations on behalf of their Americans shareholders, and it's appropriate, as I do, to impute the corporate taxes paid on their behalf in showing the total tax burden facing different households under the existing federal tax (EFT) versus the CST.

In contrast, the full capital mobility assumption entails no imputation of corporate taxes to households because the U.S. corporate tax makes no difference to the return they receive from their investments. I.e., the elimination of the U.S. corporate tax rate, in the context of full capital mobility, will lead to an inflow of enough capital sufficient to drive down the return to capital received by households investing in U.S. corporations to where it was in the presence of the corporate tax.

With zero capital mobility, the government loses corporate revenues in switching to the CST, but picks up more personal asset income tax revenue because the households now earn, at the personal level, the unchanged pre-tax return to capital.

With full capital mobility, the government loses corporate revenues in switching to the CST, with experience no increase in personal asset income tax revenue because the return households earn on their assets doesn't change. It's set from abroad, with the pre-tax return in the U.S. falling, thanks to the inflow of capital, by enough to equal the return American investors can earn abroad.

On the other hand, there is a gain in revenue arising from the increase in wages and, thus, total CST-taxable personal income for households above the CST thresholds.

In examining the progressivity of the CST under the assumption of full capital mobility, I assume a rise real wages of 8 percent – a figure implied by both back-of-the-envelope calculation and a detailed multi-country simulation model.

The bottom line is that under the assumption of zero capital mobility, the CST appears more progressive than the EFT with respect to its treatment of low and middle class households. But under the full capital mobility assumption, which seems most realistic, the CST appears to be even more progressive because it raises the incomes of workers relative to those of the rich.

Before presenting these results, however, it's important to define the term "progressivity."

How Should We Measure Tax Progressivity?

Economists distinguish inequality within and across generations, and the issue of tax progressivity or fairness is, at its heart, a matter of within-generation or intragenerational inequality. To see this point, consider an economy that is unchanging through time and in which all members of each successive cohort are identical to each other and to the cohorts who came before and will be born in the future. Further assume the government taxes workers on their wages, but places no taxes on retirees. If we look at this economy statically we see oldsters (the retirees) paying no taxes and youngsters (the workers) paying taxes. Furthermore, if people are big savers when young in this economy, the oldsters may have higher total incomes due to the income they earn on their assets than the youngsters.

From a static/point-in-time/cross-section prospective, this tax system seems regressive. Those with high incomes – the oldsters – pay no taxes, while those with low incomes – the youngsters – pay taxes. But this, clearly, ignores the dynamic (over time) reality, namely that today's oldsters paid their fair share of taxes when they were young and that their lifetime tax treatment by the government was no different from that of today's young workers.

In short, comparing the point-in-time tax payments of different contemporaneously living cohorts is comparing apples to oranges. It can produce a picture of tax regressivity when none actually exists. It can also make the tax system look progressive when it's not. Assume, for example, that the tax system only taxes income earned from assets. Then we'd have only oldsters paying taxes and, if their incomes were higher than those of workers, the system would look progressive even though, on a lifetime basis, everyone in the economy is paying the same taxes over her lifetime.

Unfortunately, such apples-to-oranges comparisons occur routinely in Washington. In considering tax progressivity, Congress routinely categorizes households based on their current

annual incomes and measures taxes paid relative to current annual income. And the leading tax analysis center – the Brookings-Urban Institute's *Tax Policy Center* – does the same. In contrast, the above example indicates that we need to consider inequality within each cohort and measure remaining lifetime tax burdens relative to remaining lifetime resources. Remaining lifetime resources are defined as the present value of a household's future labor earnings plus its current assets (net financial wealth).

To see how real tax regressivity or progressivity would arise, suppose that in the above example, each generation comprised of both low- and high-wage workers. Now consider a tax system that taxed total income (wage plus asset income) only up to a threshold. By comparing the ratio of remaining lifetime tax payments to remaining lifetime resources for youngsters with low and high remaining (in their case, full) lifetime resources, we'd see that the tax system is regressive. A similar picture would emerge by determining how the remaining lifetime net tax rate (remaining lifetime taxes divided by remaining lifetime resources) differed across oldsters with low and high remaining lifetime resources.

Five Stylized Households for Illustrating the Distributional Impact of The Common Sense Tax

To illustrate the distributional impact of The Common Sense Tax, I've modeled three age cohorts of 30-, 45-, and 60-year old married couples who have four different fixed (in real terms) levels of labor incomes ($12,500, $50,000, $250,000, and $1,000,000) as well as rich, non-working couples at these ages, each of whom has $25 million in initial assets at age 30.

Couples with the first two labor-income levels have roughly the annual incomes of the average of the 1st and 3rd quintiles of nationwide income. The couple with $250,000 in labor income represents the average income of the 80th to 99th income percentiles, the $1,000,000 income-household falls within the 99th to 99.9th percentile, while the $25 million-assets couples would fall within the 99.9th to 100th percentile of the overall income distribution.

For each couple, I compare total as well as personal taxes paid under the existing federal income tax (EFT) and the CST. I also show average lifetime tax rates, defined as the ratio of the present value of total taxes to total resources (the present value of future labor earnings plus holdings of current assets). Since I have two cases (full and zero capital mobility), three age cohorts, and five incomes per cohort and two tax systems, there are 60 cases to consider.

To calculate lifetime taxes under the two taxes, I rely on Economic Security Planner, which is a lifetime financial planning program developed by my company, Economic Security Planning, Inc. The program determines how much households should spend and save each year to achieve a stable living standard per household member. Getting spending straight is important for understanding future taxes. How much people save each year affects what they spend, which determines their assets and asset income in each future year, and asset income affects tax liabilities.

In the course of finding a household's annual spending targets, ESPlanner makes highly detailed calculations of annual taxes that a given household will pay to federal and state governments over the rest of its life. In this analysis, the focus is purely on federal taxes, so I assume that the households live in Texas, which has no state income tax. I also ignore estate and gift taxes under the existing tax system as well as the taxation of inheritances and gifts received under the CST. I expect that this omission of the taxation of private intergenerational transfers understates the progressivity of the CST given the apparent very low average tax on such transfers under the current federal Estate and Gift Tax.

The 30 year-olds are assigned zero initial assets. To keep total resources the same, the 45 year-olds under both the CST and the EFT have initial assets equal to the assets accumulated under the EFT by the 30 year-old cohort at the time they are 45. Similarly, the 60 year-olds have initial assets equal to the assets accumulated under the EFT by the 45 year-olds by the time they are 60.

In modeling the existing federal income tax, I assume that the $12,500 income couple saves nothing in tax-deferred retirement accounts, the $50,000 couple saves 5 percent of earned income per working year in such accounts, and the $250,000 and $1,000,000 couples contribute to retirement accounts at the maximum elective deferral limit of $17,500. The $25 million-assets couple cannot make tax-deferred retirement accounts since they have no earned income.

There are no tax-deferred retirement contributions under the CST since the CST eliminates, at the margin, tax breaks from all retirement accounts. But in considering the CST, I assume that the 45 year-old and 65 year-old households have the same initial tax-deferred (e.g., 401(k) or regular IRA) retirement-account balances as they'd have at those ages under the EFT. Withdraws from these initial retirement account holdings (to which no further contributions are assumed to be made) are included, under the CST, with other income to determine if the married households being considered have total incomes in excess of the $100,000 taxable threshold. Hence, the retirement account transition rule being used here with respect to moving the CST is simply to preclude further tax advantaged contributions to any retirement account and to treat withdrawals from existing, tax-deferred (non-Roth) retirement accounts as equivalent to other CST-taxable income.

All couples retire and begin receiving Social Security benefits at their Social Security full retirement ages (FRA). As indicated, Social Security benefits are assumed to continue to be based on the current definition of covered earnings.

The 30 year-olds have 2 children ages 2 and 0. When the children are between ages 19 and 22 they spend the following on tuition per year per child for college -- $0 for the $12,500 couple, $7,500 for the $50,000 couple, and $60,000 for the $250,000, $1,000,000 and $25 million asset couples. These children are ages 17 and 15 for the 45 year-old couple.

The $12,500-earning couple has a house valued at $70,000. The $50,000-, $250,000-, and $1,000,000-earning couples have houses valued at 3 years income. The $25 million asset couple has a house worth $6,000,000. All 30 year-old households have a 30-year fixed mortgage at 5 percent interest for 80 percent of the value of the house. Property taxes are 1.5 percent of the value of the house and homeowners insurance is 0.3 percent of the value of the house. The 45 year-olds have 15 years remaining on the mortgage with a balance equal to that of the corresponding 30 year-old couples when they reach age 45.

Calculating Lifetime Tax Rates Assuming Zero Capital Mobility

I assume that corporations earn, on a nominal basis, a 10 percent annual return before paying any taxes. Under the CST and assuming zero capital mobility, households receive this full 10 percent nominal return on their corporate investments. Under the EFT, corporations are assumed to pay a 7.3 percent nominal return on their investments to households. This rate equals the assumed 10 percent corporate nominal rate of return times 1 minus my assumed effective marginal corporate income tax rate of 27 percent, i.e. 7.3 percent = 10 percent x (1-.27).[1] Stated differently, households under the EFT are, in effect, able to deduct the payment of corporate taxes from their personal asset income since they face taxes not on the 10 percent earned by corporations, but on the 7.3 percent they receive directly or indirectly after corporations pay their 27 percent marginal tax.

The EFT results assume that 75 percent of this 7.3 percent post-corporate tax investment income is received by households in the form of long-term capital gains or qualified dividends and is taxed as such. The remaining 25 percent is taxed as ordinary income. But the resulting asset income taxes are then reduced by half to accommodate the deferral of capital gains and dividends as well as the avoidance entirely of capital gains and dividend taxes by passing appreciated assets at death (the aforementioned step up in basis).

In order to compare all taxes paid under the EFT with those paid under the CST under the assumption of capital immobility, I need to impute annual corporate taxes paid on behalf of households under the EFT. To do so, I multiply each household's imputed corporate asset income by the assumed average marginal corporate tax rate of 27 percent divided by 1 plus inflation, where imputed corporate asset income is 10 percent of the household's regular and retirement assets. I calculated the income taxes allocable to asset income based on the ratio of asset income to taxable income.

[1] In a recent study, see http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2231640, Duanjle Chen and Jack Mintz estimate the marginal effective U.S. corporate tax at 35 percent. Katarzyna Bilicka and Michael Devereux, on the other hand, recently estimated a 23 percent effective U.S. corporate tax rate. The two studies use somewhat different definitions of the tax rate. Chen and Mintz incorporate state corporate taxation, from which we abstract in this analysis. Bilicka and Devereux, on the other hand, are less comprehensive in measuring U.S. effective federal marginal tax rates. In reviewing these two studies, 27 percent appeared to be the best rate to use here.

However, there is a substantial difference between the average effective and the marginal corporate income tax rates, reflecting the current system's significant inframarginal corporate tax breaks. To arrive at the imputed corporate taxes paid on behalf of households net of these tax breaks, I reduced the present value of imputed corporate taxes, calculated as just described, by 48.1 percent, which reflects the difference between the 14 percent average effective corporate tax rate, calculated from the National Income Statistics, and the 27 percent marginal effective corporate tax rate.

Calculating Lifetime Tax Rates Assuming Full Capital Mobility

With perfect capital mobility, eliminating the U.S. corporate income tax does not mean that the return received on their assets by U.S. households rises to 10 percent. Instead, capital flows into the country to lower the pre-tax return down to its current 7.3 percent value, which is, by assumption, being set in the global marketplace. Consequently, in the full mobility case the switch to the CST does not elicit more personal asset income taxation via an increase in the pre-tax return as it does in the zero mobility case.

Instead, there is another source of revenue that arises, namely an increase in labor income, some of which will be taxable, arising from an increase in real wages. I.e., the counterpart of capital inflows making capital more abundant and, therefore, lowering the pre-tax return to capital from 10 to 7.3 percent is that these inflows make labor relatively scarce. As a result real wages rise – by my reckoning, 8 percent. To capture this effect, I increment each household's labor income by 8 percent in presenting the full capital mobility results.

Presentation of Results

After running the 15 stylized households for both the EFT and CST under the two capital mobility assumptions (i.e., 60 cases in all), I calculate the present value of the households' remaining lifetime resources, remaining lifetime spending, and remaining lifetime taxes (including, depending on the case, imputed corporate income taxes).

Remaining lifetime spending references the present value of all future spending, both discretionary and non-discretionary (e.g., paying off a mortgage). Lifetime resources includes the present value of all future labor earnings plus the value of existing assets plus the present value of future retirement account withdrawals net of contributions to these accounts.

Since ESPlanner presents all its results in real (today's) dollars, I discount each household's annual real taxes at the pre-tax real rate of return, which differs in the zero and full capital mobility cases. As indicated, with zero capital mobility, the real discount rate is 6.796 percent [(1.10/1.03) – 1]; with full capital mobility, the real discount rate is 4.175 [(1.07/1.03)-1].

Is Moving to the CST Progressive?

In considering the zero and full capital mobility results, bear in mind that they differ with respect to their pre-tax payments to capital and labor. With zero capital mobility, households earn 10 percent before inflation and taxes (including those paid on their behalf by corporations) and the introduction of the CST doesn't changes wages. With full capital mobility, households earn 7.3 percent before inflation and the introduction of the CST raises real wages by an assumed 8 percent.

In discussing the measurement of progressivity, I argued that it must be done on a cohort-by-cohort basis. I.e., we need to look at differences in remaining lifetime net tax rates across households of the same age, not across households of different ages. But if pre-tax incomes also change, as is the case under full capital mobility in switching to the CST, examining remaining lifetime tax rates does not suffice to show the full impact of different cohort members of the policy change. In this case, it's best to focus on the bottom line – how much remaining lifetime spending is impacted by the fiscal reform.

Table 1 focuses on this bottom line. It shows the impact on lifetime spending by cohort of moving to the CST in both the absence and presence of capital mobility. Tables 2-4 and tables 5-7 present calculations of remaining lifetime taxes, spending, and resources under the EFT and CST based assuming zero and full capital mobility, respectively.

Table 1's results show that the move to CST permits a significant increase in spending by low and moderate-income workers in all three cohorts. Take households earning $50,000, for example. With zero capital mobility, the spending increases are 4.8 percent, 6.6 percent, and 6.2 percent for the 30 year-olds, 45 year-olds, and 60 year-olds, respectively. With full capital mobility, the respective spending increases are even larger – 12.3 percent, 12.5 percent, and 9.0 percent.

These spending increases can be contrasted with the spending reductions experienced by our super wealthy households with $25 million in assets. In their case, moving to the CST produces, for all age groups, a roughly 1 percent spending reduction, if capital is immobile. If capital is mobile, the super wealthy experience a 9 to 12 percent spending decrease from the tax reform.

The reason the spending reduction for the rich is larger in introducing the CST when capital is mobile is that under the EFT asset holders don't pay the U.S. corporate tax on their asset income. Instead this tax is spread over global asset holders. As for personal asset income taxes, they are limited due to preferential capital gains and dividend tax treatment and the deferral or complete avoidance of capital gains and dividend taxation. The move to the CST in this context does not, however, perpetuate these personal asset income tax breaks. All asset income is full taxed at the 25 percent CST income-tax rate by households above the income thresholds.

In the absence of capital mobility, the switch from the EFT to the CST also eliminates the tax breaks with respect to personal asset income taxation, but the EFT is not as advantageous to asset holders as with full capital mobility. The reason is that corporate taxes are implicitly paid under the EFT when capital is immobile. Hence, eliminating the EFT doesn't entail eliminating a regime of relatively low effective asset income taxation and replacing it with a regime of relatively high asset income taxation.

The spending increases enjoyed by very low earners shown in table 1 are also substantial, although they are generally not as large as those experienced by households earning $50,000 per year. High-earning households with $250,000 and $1,000,000 in annual earnings also benefit, some quite substantially, depending on their ages, from the tax reform.

Changes in Total Lifetime Tax Rates in Moving to the CST, Assuming Zero Capital Mobility

Tables 2-4, show that the differences between the CST and EFT in remaining total lifetime tax rates as well as the levels of remaining lifetime resources, spending, and taxes. The general picture that emerges is a reduction in lifetime tax rates (remaining lifetime taxes divided by remaining lifetime resources) that's largest for households earning $12,500 and $50,000.

For example, there is a 6.3 percentage point reduction in the lifetime tax rate of 30 year-old households earning $12,500 per year. Or take 60 year-olds earning $50,000 per year. Their lifetime tax rate falls by 5.5 percentage points.

Table 2 illustrates that the impact on different households may not be monotone with respect to higher levels of earnings. The 30 year-old households making $250,000 per year experience a 2.5 percentage point increase in their remaining lifetime tax rate, whereas the household making $1,000,000 per year experience a .4 percentage point reduction in its lifetime tax rate. This non-monotonicity is not surprising given the highly complex and non-linear nature of our existing federal tax system, which, recall, features the Alternative Minimum Tax as well as rising nominal tax rates at higher taxable income levels.

While it would be nice to show that the CST is more progressive in all respects, including hitting $1 million earners with at least a large a tax hike as those earning $250,000, no simple system of taxation will have sufficient degrees of freedom to achieve that objective. But in considering the broad pattern of results it's important to bear in mind that few workers experience a set path to their earnings. Their earnings rise, fall, rise again, fall again and, in general, can resemble a random walk with a trend. Indeed, economists generally model individual earnings paths as evolving from precisely this type of statistical process. Hence, those earning $1,000,000 today may, and likely will, be earning both much less and much more at different dates in the future.

Consider next tables' 5-7 results for the full capital mobility cases. Here, we see, generally speaking, even more progressive pattern of changes in remaining lifetime tax rates within each cohort. For example, among 30 year-olds, lifetime tax rates fall for the two lowest income groups, but rise for the next two income groups, and rise substantially for the very rich household. But again, because wages rise in switching to the CST (a point evidence in the higher CST lifetime resources shown in tables 5-7), the pattern of remaining lifetime spending changes, seen in table 1, is most relevant since it incorporates not just changes in tax rates, but also changes in levels of pre-tax labor earnings.

Conclusion

This memo shows the impact on a cohort-specific basis of switch from the existing federal tax system to the Common Sense Tax. I considered three cohorts, five stylized households within each household, and two different assumptions about international capital mobility. The results, broadly speaking, show that moving to the Common Sense Tax would be progressive, helping low and middle income workers to the benefit of those with very large amounts of wealth. Assuming full capital mobility, as seems most appropriate, low and middle income working households would experience not only a significant reduction in their remaining lifetime tax rates, but also a significant increase in their pre-tax wages.

Table 1

Changes in Remaining Lifetime Spending From Switching to the Common Sense Tax With and Without Full Capital Mobility

Income/Assets	30 Year-Olds	45 Year-Olds	60 Year-Olds
$12,500 Zero Mobility	5.4 percent	4.2 percent	3.7 percent
$12,500 Full Mobility	9.7 percent	4.1 percent	3.8 percent
$50,000 Zero Mobility	4.8 percent	6.6 percent	6.2 percent
$50,000 Full Mobility	12.3 percent	12.5 percent	9.0 percent
$250,000 Zero Mobility	-3.3 percent	2.9 percent	12.6 percent
$250,000 Full Mobility	1.3 percent	5.5 percent	9.1 percent
$1 million Zero Mobility	0.6 percent	3.4 percent	3.5 percent
$1 million Full Mobility	3.3 percent	2.3 percent	-1.7 percent
$25 million Zero Mobility	-1.1 percent	-1.4 percent	-1.3 percent
$25 million Full Mobility	-12.9 percent	-11.7 percent	-10.3 percent

Table 2. 30 Year-Old Married Couple Assuming No Capital Mobility

Income	Tax System	Total Resources	Total Spending	Total FICA Taxes	Income Taxes	Total Personal Taxes	Imputed Corporate Taxes	Total Taxes	Total Taxes / Resources
$12,500	Common Sense Tax	$183,439	$227,620	$21,812	($65,993)	($44,182)	$0	($44,182)	-24.1%
	Existing Federal Tax	$183,443	$216,002	$23,843	($61,157)	($37,314)	$4,751	($32,563)	-17.8%
	Difference	($4)	$11,618	($2,031)	($4,837)	($6,868)	($4,751)	($11,618)	-6.3%
$50,000	Common Sense Tax	$705,427	$636,806	$87,246	($18,629)	$68,618	$0	$68,618	9.7%
	Existing Federal Tax	$705,429	$607,708	$95,383	($342)	$95,041	$2,673	$97,714	13.9%
	Difference	($3)	$29,098	($8,137)	($18,287)	($26,423)	($2,673)	($29,097)	-4.1%
$250,000	Common Sense Tax	$3,410,279	$2,447,059	$436,232	$526,987	$963,219	$0	$963,219	28.2%
	Existing Federal Tax	$3,410,277	$2,532,009	$289,352	$529,234	$818,586	$59,689	$878,275	25.8%
	Difference	$2	($84,950)	$146,880	($2,247)	$144,633	($59,689)	$84,943	2.5%
$1,000,000	Common Sense Tax	$13,477,161	$8,457,644	$1,744,926	$3,274,588	$5,019,514	$0	$5,019,514	37.2%
	Existing Federal Tax	$13,477,167	$8,404,729	$707,428	$4,083,337	$4,790,766	$281,673	$5,072,439	37.6%
	Difference	($5)	$52,915	$1,037,498	($808,750)	$228,748	($281,673)	($52,925)	-0.4%
$25 Mil Assets	Common Sense Tax	$25,000,000	$18,112,308	$0	$6,887,694	$6,887,694	$0	$6,887,694	27.6%
	Existing Federal Tax	$25,000,000	$18,317,401	$675,160	$2,106,725	$2,781,885	$3,900,713	$6,682,598	26.7%
	Difference	$0	($205,093)	($675,160)	$4,780,969	$4,105,809	($3,900,713)	$205,096	0.8%

Table 3. 45 Year-Old Married Couple Assuming No Capital Mobility

Income	Tax System	Total Resources	Total Spending	Total FICA Taxes	Income Taxes	Total Personal Taxes	Imputed Corporate Taxes	Total Taxes	Total Taxes / Resources
$12,500	Common Sense Tax	$209,725	$209,024	$18,282	($17,585)	$697	$0	$697	0.3%
	Existing Federal Tax	$209,728	$200,536	$19,985	($18,570)	$1,415	$7,779	$9,194	4.4%
	Difference	($3)	$8,488	($1,703)	$985	($718)	($7,779)	($8,497)	-4.1%
$50,000	Common Sense Tax	$654,408	$583,060	$73,130	($1,788)	$71,342	$0	$71,342	10.9%
	Existing Federal Tax	$654,407	$546,803	$79,950	$22,704	$102,654	$4,946	$107,600	16.4%
	Difference	$1	$36,258	($6,820)	($24,492)	($31,312)	($4,946)	($36,258)	-5.5%
$250,000	Common Sense Tax	$3,262,282	$2,432,185	$365,650	$464,447	$830,097	$0	$830,097	25.4%
	Existing Federal Tax	$3,262,280	$2,364,475	$241,342	$531,046	$772,389	$125,415	$897,804	27.5%
	Difference	$2	$67,710	$124,308	($66,599)	$57,708	($125,415)	($67,707)	-2.1%
$1,000,000	Common Sense Tax	$12,465,557	$7,722,566	$1,462,598	$3,280,397	$4,742,995	$0	$4,742,995	38.0%
	Existing Federal Tax	$12,465,561	$7,468,578	$652,395	$3,707,538	$4,359,933	$637,055	$4,996,988	40.1%
	Difference	($4)	$253,988	$810,203	($427,141)	$383,062	($637,055)	($253,993)	-2.0%
$25 Mil Assets	Common Sense Tax	$18,828,934	$13,889,329	$0	$4,939,606	$4,939,606	$0	$4,939,606	26.2%
	Existing Federal Tax	$18,828,934	$14,085,820	$462,718	$1,453,729	$1,916,447	$2,826,672	$4,743,119	25.2%
	Difference	$0	($196,491)	($462,718)	$3,485,877	$3,023,159	($2,826,672)	$196,487	1.0%

Table 4. 60 Year-Old Married Couple Assuming No Capital Mobility

Income	Tax System	Total Resources	Total Spending	Total FICA Taxes	Income Taxes	Total Personal Taxes	Imputed Corporate Taxes	Total Taxes	Total Taxes / Resources
$12,500	Common Sense Tax	$224,574	$216,775	$7,795	$0	$7,795	$0	$7,795	3.5%
	Existing Federal Tax	$224,576	$209,128	$8,520	($1,664)	$6,856	$8,594	$15,450	6.9%
	Difference	($2)	$7,647	($725)	$1,664	$939	($8,594)	($7,655)	-3.4%
$50,000	Common Sense Tax	$528,910	$497,732	$31,178	$0	$31,178	$0	$31,178	5.9%
	Existing Federal Tax	$528,911	$468,520	$34,086	$11,746	$45,833	$14,559	$60,392	11.4%
	Difference	($1)	$29,212	($2,908)	($11,746)	($14,655)	($14,559)	($29,214)	-5.5%
$250,000	Common Sense Tax	$2,368,937	$1,915,154	$155,892	$297,885	$453,777	$0	$453,777	19.2%
	Existing Federal Tax	$2,368,936	$1,700,610	$101,549	$353,733	$455,281	$213,047	$668,328	28.2%
	Difference	$1	$214,544	$54,343	($55,848)	($1,504)	($213,047)	($214,551)	-9.1%
$1,000,000	Common Sense Tax	$9,568,204	$6,292,418	$623,570	$2,652,212	$3,275,782	$0	$3,275,782	34.2%
	Existing Federal Tax	$9,568,206	$6,079,654	$376,616	$2,117,236	$2,493,852	$994,708	$3,488,560	36.5%
	Difference	($2)	$212,764	$246,954	$534,976	$781,930	($994,708)	($212,778)	-2.2%
$25 Mil Assets	Common Sense Tax	$13,674,313	$10,237,394	$0	$3,436,923	$3,436,923	$0	$3,436,923	25.1%
	Existing Federal Tax	$13,674,313	$10,376,821	$298,608	$1,008,518	$1,307,126	$1,990,364	$3,297,490	24.1%
	Difference	$0	($139,427)	($298,608)	$2,428,405	$2,129,797	($1,990,364)	$139,433	1.0%

Table 5. 30 Year-Old Married Couple Assuming Full Capital Mobility

Income	Tax System	Total Resources	Total Spending	Total FICA Taxes	Income Taxes	Total Personal Taxes	Imputed Corporate Taxes	Total Taxes	Total Taxes / Resources
$12,500	Common Sense Tax	$307,634	$361,064	$32,782	($86,212)	($53,430)	$0	($53,430)	-17.4%
	Existing Federal Tax	$287,260	$329,145	$33,180	($75,074)	($41,893)	$0	($41,893)	-14.6%
	Difference	$20,374	$31,919	($398)	($11,138)	($11,537)	$0	($11,537)	-2.8%
$50,000	Common Sense Tax	$1,133,295	$1,024,542	$131,129	($22,375)	$108,753	$0	$108,753	9.6%
	Existing Federal Tax	$1,051,749	$912,173	$132,739	$6,829	$139,568	$0	$139,568	13.3%
	Difference	$81,546	$112,369	($1,610)	($29,204)	($30,815)	$0	($30,815)	-3.7%
$250,000	Common Sense Tax	$5,231,069	$3,697,589	$655,643	$877,837	$1,533,480	$0	$1,533,480	29.3%
	Existing Federal Tax	$4,857,478	$3,650,930	$405,173	$801,384	$1,206,558	$0	$1,206,558	24.8%
	Difference	$373,591	$46,659	$250,470	$76,453	$326,922	$0	$326,922	4.5%
$1,000,000	Common Sense Tax	$20,361,293	$12,383,289	$2,622,570	$5,350,430	$7,937,003	$0	$7,937,280	39.0%
	Existing Federal Tax	$18,866,957	$11,985,823	$1,025,739	$5,855,397	$6,881,135	$0	$6,881,135	36.5%
	Difference	$1,494,336	$397,466	$1,596,831	($504,967)	$1,055,868	$0	$1,055,868	2.5%
$25 Mil Assets	Common Sense Tax	$25,000,000	$18,417,796	$0	$6,582,202	$6,582,202	$0	$6,582,202	26.3%
	Existing Federal Tax	$25,000,000	$21,138,676	$949,359	$2,911,964	$3,861,323	$0	$3,861,323	15.4%
	Difference	$0	($2,720,880)	($949,359)	$3,670,238	$2,720,879	$0	$2,720,879	10.9%

Table 6. 45 Year-Old Married Couple Assuming Full Capital Mobility

Income	Tax System	Total Resources	Total Spending	Total FICA Taxes	Income Taxes	Total Personal Taxes	Imputed Corporate Taxes	Total Taxes	Total Taxes / Resources
$12,500	Common Sense Tax	$317,481	$311,251	$24,943	($21,204)	3,739	$0	3,739	1.2%
	Existing Federal Tax	$303,885	$298,986	$25,246	($20,346)	$4,900	$0	$4,900	1.6%
	Difference	$13,596	$12,265	($303)	$858	($1,161)	$0	($1,161)	-0.4%
$50,000	Common Sense Tax	$993,752	$895,833	$99,773	($1,855)	$97,919	$0	$97,919	9.8%
	Existing Federal Tax	$927,380	$795,933	$100,998	$30,440	$131,438	$0	$131,438	14.2%
	Difference	$66,372	$50,886	$1,588	($32,302)	($30,714)	$0	($30,714)	-4.4%
$250,000	Common Sense Tax	$4,486,973	$3,334,809	$498,866	$653,298	$1,152,164	$0	$1,152,164	25.7%
	Existing Federal Tax	$4,202,715	$3,160,089	$306,118	$736,506	$1,042,624	$0	$1,042,624	24.8%
	Difference	$284,258	$174,720	$192,748	($83,208)	($115,102)	$0	($115,102)	0.9%
$1,000,000	Common Sense Tax	$16,764,127	$10,091,817	$1,995,464	$4,676,846	$6,672,310	$0	$6,672,310	39.8%
	Existing Federal Tax	$15,627,120	$9,862,725	$866,256	$4,898,147	$5,764,403	$0	$5,764,403	36.9%
	Difference	($6)	$325,499	$981,396	($363,010)	($325,512)	$0	($325,512)	2.9%
$25 Mil	Common Sense Tax	$18,828,930	$14,326,662	$0	$4,502,268	$4,502,268	$0	$4,502,268	23.9%
Assets	Existing Federal Tax	$18,828,934	$16,221,501	$634,913	$1,972,528	$2,607,441	$0	$2,607,441	13.8%
	Difference	$0	($1,894,839)	($634,913)	$2,529,740	$1,894,827	$0	$1,894,827	10.1%

Table 7. 60 Year-Old Married Couple Assuming Full Capital Mobility

Income	Tax System	Total Resources	Total Spending	Total FICA Taxes	Income Taxes	Total Personal Taxes	Imputed Corporate Taxes	Total Taxes	Total Taxes / Resources
$12,500	Common Sense Tax	$314,597	$306,780	$9,148	($1,330)	$7,817	$0	$7,817	2.5%
	Existing Federal Tax	$303,082	$295,596	$9,259	($1,768)	$7,491	$0	$7,491	2.5%
	Difference	$11,515	$11,184	($111)	$438	$326	$0	$326	0%
$50,000	Common Sense Tax	$758,091	$721,500	$36,591	$0	$36,591	$0	$36,591	4.8%
	Existing Federal Tax	$711,970	$662,143	$37,041	$12,788	$49,829	$0	$49,829	7.0%
	Difference	$46,121	$59,357	($450)	($12,788)	($13,238)	$0	($13,238)	-2.2%
$250,000	Common Sense Tax	$2,826,146	$2,349,960	$182,957	$293,229	$476,186	$0	$476,186	16.8%
	Existing Federal Tax	$2,721,894	$2,154,148	$110,599	$457,151	$567,750	$0	$567,750	20.9%
	Difference	$104,252	$195,812	$72,358	($163,922)	($91,564)	$0	($91,564)	-4.1%
$1,000,000	Common Sense Tax	$10,649,967	$7,151,809	$731,827	$2,766,330	$3,498,158	$0	$3,498,158	32.8%
	Existing Federal Tax	$10,232,980	$7,277,744	$445,355	$2,509,891	$2,955,246	$0	$2,955,246	28.9%
	Difference	$416,987	($125,935)	$286,472	$256,439	($542,912)	$0	($542,912)	3.9%
$25 Mil	Common Sense Tax	$13,674,310	$10,749,861	$0	$2,924,449	$2,924,449	$0	$2,924,449	21.4%
Assets	Existing Federal Tax	$13,674,313	$11,990,475	$389,235	$1,294,600	$1,683,835	$0	$1,683,835	12.3%
	Difference	($3)	($1,240,614)	($389,235)	$1,629,849	$1,240,614	$0	$1,240,614	9.1%

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