

Universal basic income and flat income tax: Tax justice, incentive, economic democracy

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Abstract

An important aspect of the global financial crisis is the increasing gap between rich and poor – while essential social and environmental projects struggle to find funding. The situation is complex, but we need simple solutions that do not require expensive administration and can easily be understood by politicians and voters. Examples include (i) increasing wealth and transaction taxes and redistributing proceeds through social services and environmental projects; (ii) closing tax havens and making banking more transparent; (iii) giving lower earners better incentives to work; and (iv) simplifying taxation to reduce rates of evasion and avoidance.

A combination of universal basic income UBI (e.g. 500 Euros/month) and flat income tax FIT (e.g. 40%) would address (iii) and (iv). The combination is effectively progressive (the effective tax rate increases with increasing income). Work incentive would be improved by eliminating welfare traps. Income tax could be paid, and tax deductions claimed, immediately; the transaction would then be closed - a serious blow for the familiar culture of annual attempts to trick the taxation office.

The main obstacle to such a reform may be conservative thinking on both left and right. We seem to believe that the seemingly endless complexity of welfare and taxation systems is intrinsic. In fact, it is caused by politicians repeatedly wooing target groups. In the end, there is one main parameter: the wealth gap, which is currently far too big to simultaneously optimize quality of life and productivity. Under UBI-FIT, the left could reduce the wealth gap by getting political support for more UBI and less FIT. The right would offer the usual resistance, but their success would be reduced by the new transparency.

Introduction: The global financial crisis

The recent global financial crisis is not a mysterious economic problem that only economists can understand. Nor is it a problem that public payments to private banks can fix. The absurdity of this solution becomes clear when one realizes that governments are borrowing money from private sources and paying interest on it, while at the same time bailing out bankrupt banks. Banks have been lending governments money, most of which does not exist (according to fractional reserve banking), earning interest on that money, and then being bailed out by governments. Clearly, governments must stop borrowing from private sources, and instead tax the rich. Moreover, banks must stop lending non-existent money.

The most profound symptom of the crisis is the growing wealth gap. The rich are getting richer by speculating on global markets and hiding enormous sums in tax havens. “Austerity” is not the solution, because it does not address the main problem. Of course it is always possible to make governments more efficient, but that will not make a big difference. It is also possible to regulate global markets, which is urgently necessary. But the most efficient and appropriate

solution is simply to tax the rich, because that is where the money is. That will allow national governments to pay their debts - instead of leaving them to future generations to pay.

The wealth gap has become far, far too wide for optimal productivity and quality of life. Additional revenue produced by taxing the rich must be invested in social services in rich countries and assistance to developing countries. Many governmental and non-governmental organisations are developing and applying strategies to combat poverty and sustainably improve the economic independence of developing countries. The main thing that they need is money.

We must increase global taxes in several different categories including wealth, transaction and greenhouse emissions. To work effectively and fairly, such taxes should be applied by simple rules that have few exceptions. Simpler rules are less costly in terms of administration. They are also more democratic, because they can more easily be understood by politicians and voters.

This paper presents an additional example of a clear, simple economic strategy. I will describe an approach to welfare and income tax that gives lower earners greater incentive to work by eliminating welfare traps. The approach would also improve democracy by making the system more transparent and easier for non-experts to understand.

Flat income tax: A crazy right-wing dream?

Modern income tax scales are generally progressive. People with higher incomes are supposed to pay higher proportions of their incomes in tax. There are several income brackets, within which a different rate of income tax applies. The general principle is that taxes should be primarily paid by those who are in a good position to pay them. The more you can pay, the more you should pay. Flat tax is the opposite of progressive tax. In a flat-tax system, everyone pays the same rate of tax, regardless of their income. This is fundamentally unfair and tends to increase the wealth gap.

A wealth gap of some kind is necessary to motivate people to work. But the gap does not have to be very big to achieve that goal. If the rich are ten times richer than the poor, by whatever measure (income or wealth), the goal has surely been achieved. After the wealth gap reaches a certain size, increasing it further does not further increase the incentive to work, because it is already near to its maximum value. In scientific jargon we would say that incentive saturates or approaches an asymptote. But in most countries today the gap is far bigger than 10:1. The rich are hundreds, thousands or millions of times richer than the poor. However you measure the ratio (by wealth or income), it is far too big. For that reason, a flat income tax of the kind proposed by the far right is completely out of the question.

Many capitalists nevertheless believe passionately in flat tax. In an attempt to avoid or reduce their tax bill, they distort the truth. A common distortion is the “rags to riches story”. Because some people manage to drag themselves out of poverty and become rich, it is claimed that everyone can. Therefore, the poor are poor because they are lazy. Therefore, they deserve to be poor. In fact, no-one wants to be poor, and most poor people are working hard and not getting much for it (“working poor”). Moreover, you can find both lazy and energetic people, and both smart and stupid people, among both rich and poor. For every Bob Marley, there are thousands of poor people who tried hard for many years to improve their situation but failed. Poverty is created by economic systems, not by individuals. We should therefore creatively consider possible reforms to economic systems.

Unconditional basic income and flat income tax: A rational centre-left dream?

In this article I will present a surprising and radical approach to flat tax. I will show that flat tax can be the solution to poverty, but only when both of the following conditions are fulfilled:

- The flat rate must be relatively high (e.g. 40 to 50% - instead of the 15 to 30% commonly advocated by flat tax fans).
- The flat income tax must be combined with an unconditional basic income that corresponds approximately to the poverty line.

I will show that the combination of unconditional basic income and flat income tax is *effectively progressive*. That is not a political claim; it is a simple mathematical observation, and the implications are enormous. The political left has the historic opportunity to eliminate poverty - not merely reduce it. The combination of unconditional basic income and flat income tax (UBI-FIT) is a path to that goal.

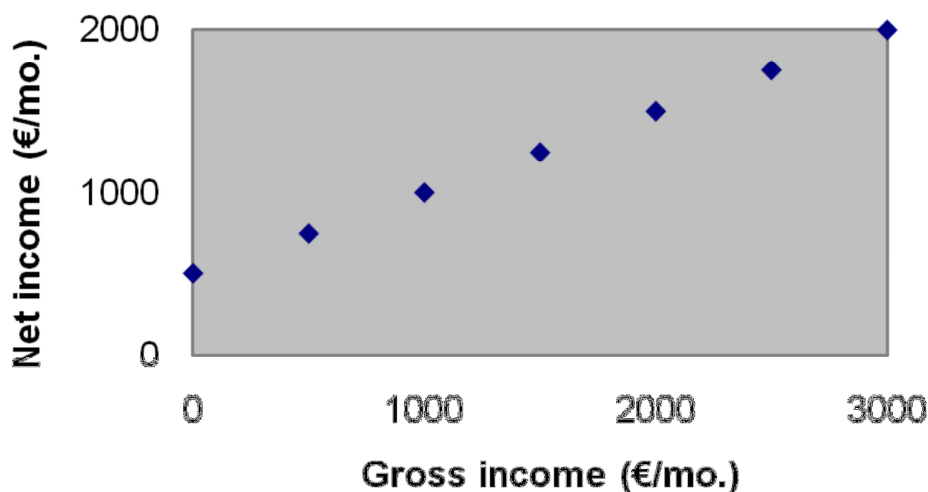


Figure 1. The basic idea of UBI-FIT: The relationship between gross and net income for a universal basic income of 500 Euros per month and a flat income tax of 50%.

UBI-FIT: The basic idea

Figure 1 shows a graph of net income against gross income. If we are genuinely interested in eliminating poverty, this is the central relationship that we need to consider. In any discussion of this proposal it is important not to get sidetracked by considerations of the separate rates of tax and welfare. In the end, the separate tax and welfare rates are not the primary issue. What matters is the final relationship between gross and net income. As one supermarket chain said in their advertisements, it is "total of the tape" that counts, not the prices of individual products.

Under UBI-FIT, everyone would get the same basic income, regardless of any other form of income. That is where the diagonal line intersects the vertical axis. The value of 500 Euros per month is arbitrary. It is a round figure that has been chosen to simplify the calculation. Of course it would need to be adjusted in a political process; it would depend on changing democratic and financial constraints. If it was too low there would be poverty, and if it was too high the motivation to work would be reduced.

Even the rich would get basic income, because it is unconditional. For them, the amount of basic income would be small by comparison to the amount of income tax. If we want to extract more money from the rich, we must focus attention on the tax rate, not basic income. We must also simplify the taxation system to make it more transparent and increase the chance that taxes will be paid and not evaded or avoided by cunning accountants. UBI-FIT is a step in that direction, but many other simplifications are possible.

Under UBI-FIT, the amount of basic income would not be the same for everyone. The main exception would be people with disabilities that prevent them from working or reduce their ability to work. Their basic income would be increased accordingly. Some people also think that basic income should depend on age (children getting more, special deals for pensioners) but others argue it should be as simple as possible and therefore independent of age. On the whole, UBI-FIT would radically simplify social security payments. Many of the bureaucrats who currently investigate the "willingness to work" of unemployed people would need to be re-employed. They might for example investigate tax evasion and avoidance.

Everyone would pay the same rate of tax on all income ("flat tax"). That is represented by the gradient of the line in the graph. The lower the tax, the faster your net income increases as your gross income increases, and the steeper the line. For the purpose of argument and for drawing the graph, this flat rate has been set at 50%. The exact value would be determined by democratic processes and financial constraints. It could be 40%, and with significant increases in wealth, inheritance and transaction taxes it could even be 30%. The recent financial problems of Western countries suggest that if the rich continue to avoid paying wealth taxes, income tax at the highest levels of income must be increased to 50%. If we had UBI-FIT, this argument would apply to everyone.

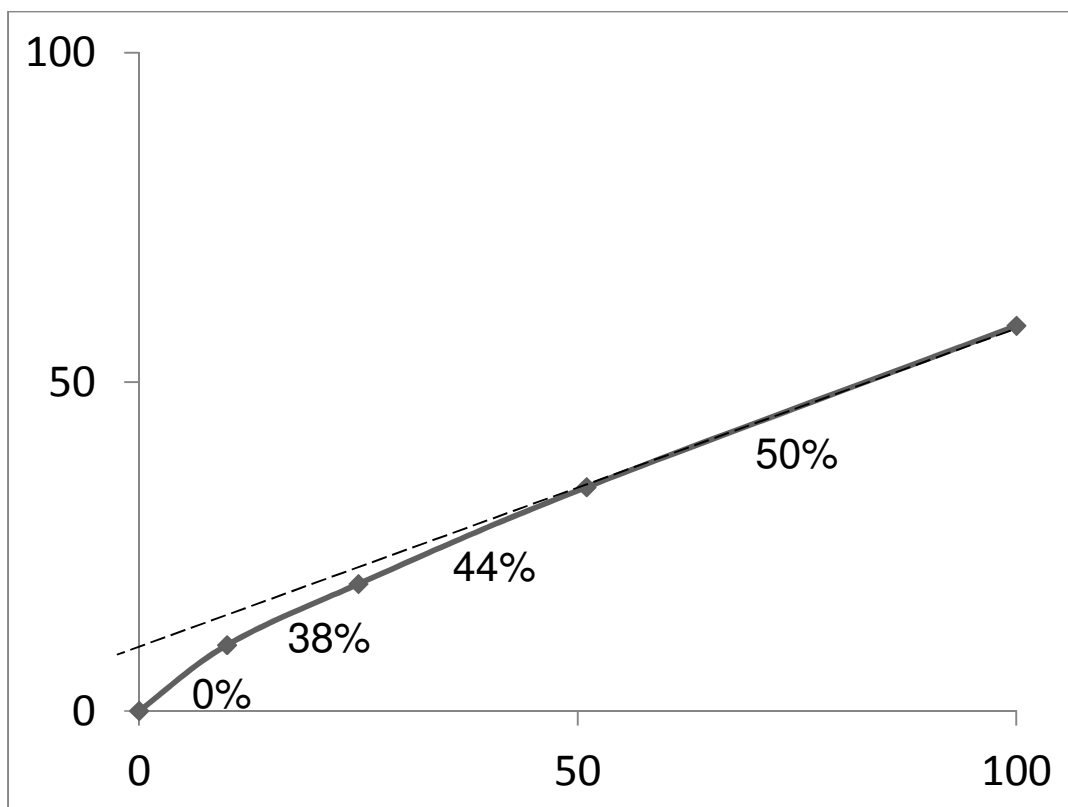


Figure 2. Progressive income tax in Austria (2005-2009) (bold line). The horizontal axis is gross income in thousands of Euros per year. The vertical axis is net income. The broken line is a proposal for UBI-FIT in which UBI = 8500 €/year (that's 708 €/month) and BIT=50%. The proposal is close to the current system but eliminates the welfare trap for low income earners.

The welfare trap

Figure 2 shows the relationship between gross and net income in Austria in the period 2005-2009 (bold line). The relationship differs somewhat from one country to the next, but the basic idea of progressive taxation is the same. The curvature of the line is a measure of progressivity: the more progressive the taxation system, the more curved the line.

Superimposed on the relationship between net and gross income is a preliminary UBI-FIT proposal (broken line). It looks something like a line of best fit. In fact, I extrapolated it from the relationship between net and gross income for high earners – the 50% portion of the line. It could be shifted up or down (which would change the UBI) or rotated (which would change the FIT). The main constraint when drawing such a line is to ensure that the budget is balanced in a similar way to the present system. Since many more people are located near the left end of the line, the left end has to be weighted more heavily when calculating a line of best fit.

What is the difference between the proposed system and the current system? In the current system of means-tested social security and progressive income tax, the gradient of the graph of gross income against net income is not constant. That is partly because of progressive tax scales, but *there is a much bigger departure from linearity near welfare cutoff points (Zuverdienstgrenzen)*. Currently, if you are on welfare and start earning money, your welfare is

reduced accordingly. During this transition, your gross income increases significantly, but your net income increases little. Depending on the system, your net income may stay the same or even fall as your gross income rises. So it is not in your interest to work. There is no incentive. You have fallen into a welfare trap.

Welfare traps are poverty traps, because they perpetuate poverty. A system that motivates people not to work is doomed to fail. Welfare traps are inherent to all modern systems of means-tested social welfare and progressive tax. This inherent fault seems to guarantee that these systems will never eliminate poverty. Eliminating this problem would be an important step forward.

Is UBI-FIT fair?

At first glance, UBI-FIT seems unfair. We are used to a system of income tax and social security in which different people are treated differently. The system is periodically twiggled before elections in order to attract votes from particular groups. People are offered tax breaks for different reasons such as to reduce poverty for a particular group, to “boost the economy”, or to attract votes from critical electorates. These changes make the system more complex.

UBI-FIT would make it impossible to win elections this way. Everyone would be treated equally. If the rate of basic income was reduced, everyone would be affected. If the rate of tax was increased, everyone would be affected.

Is that fair? Is it fair to tax low income earners at the same level as high income earners? Well, the current system is even worse. Welfare traps mean that for low incomes between typical levels of social welfare and typical levels of low-earning jobs, the *effective* rate of taxation is as high as 100%. That is because every increase in income is taken away by reducing welfare payments. From this point of view, UBI-FIT would be a big step forward for low-income earners.

Is it fair to give basic income to the rich? In UBI-FIT, that is unavoidable, because UBI-FIT avoids welfare traps. Not giving basic income to the rich would mean finding a cutoff point below which basic income is paid. But that would cause a welfare trap. In fact, giving basic income to the rich is no problem. We are talking about a tax deduction that is far smaller than tax deductions regularly granted to the rich. Moreover, the spirit of UBI-FIT runs contrary to the prevailing culture of tax deductions, and could be introduced in conjunction with a drive to generally reduce tax deductions. As I explained above, what matters in the end is the relationship between net and gross income shown on the graph. For the rich, basic income is small compared to income tax, so the best strategy to increase tax revenue is to increase the flat tax rate.

How can UBI-FIT be adjusted to reduce the wealth gap? The solution is to increase basic income and at the same time increase the tax rate to finance it, in a democratic process. This can only be done to a limited extent, because both these actions reduce the incentive to work, which ultimately reduces the total productivity and wealth of the country. To increase productivity, it is necessary to reduce basic income and the tax rate, but this again can only be done to a limited extent, otherwise the incidence of poverty will increase. Between these extremes there is a happy medium in which poverty is eliminated but a moderate wealth gap remains. If the electorate understands how UBI-FIT works (and it is certainly much simpler than the present system), that happy medium can be found by regular democratic processes.

Its simplicity and transparency mean that UBI-FIT is fairer than the present system. People understand what they are voting for. Everyone is treated equally and with dignity, and everyone is encouraged to work. The rules are clearer, and it is harder to break them.

Historical context

It is common for right-wing voters to claim or believe that the poor are poor because they are lazy. In fact, the poor want to work just as hard as the rich - probably more so, because they need the money more. It is the system that is causing poverty, not any assumed differences in personality between the rich and the poor.

The idea that poverty is the fault of the poor is an old one. Before the French revolution in the 18th Century, it was common to believe in innate differences between rich and poor people, or between nobility and ordinary people. The aristocracy had aristocracy in their blood. The French philosopher Rousseau was one of those who exposed this idea as nonsense (e.g. in his "Discourse on inequality"), and it was objections of this sort that provoked the French revolution, which of course changed the world. But crazy ideas do not disappear overnight. The modern version of the nobility fallacy is the idea that the poor are poor because they are lazy. Many still seem to believe that if the poor only took advantage of the opportunities that a free society offers them, they could drag themselves out of poverty. We forget that everyone is born with different opportunities and for this reason it is much easier for some people to make money than others. Statistically, there will always be large numbers of people who fail to break through the poverty line - unless we radically change the system.

Social security and progressive income tax belong to the greatest achievements of the workers' movements of the early 20th century. The appalling poverty produced by the industrial revolution was finally brought under control, without resorting to communism. Poverty still existed, but it was more tolerable. Today, poverty is no longer tolerable. New technologies of all kinds are gradually increasing the wealth of the entire human race. If this wealth were shared, it would be easy to eliminate poverty while at the same time maintaining free enterprise. Moreover, the rich would still be rich. They have little to fear from proposals such as UBI-FIT.

Given this historical context, it is now possible to see that current systems of means-tested social security and progressive income tax are maintaining poverty. They are based on the assumption that there will always be poverty. They incorporate welfare traps that guarantee that a certain proportion of the population will not enjoy the same incentive to work that most people enjoy, so a certain proportion of them will automatically stay or become poor. UBI-FIT offers a solution.

The stigma of unemployment

The welfare trap is not only a financial problem - it is also a psychological and social one. Current systems of means-tested social welfare and progressive income tax create two classes of people: employed and unemployed. The employed have many freedoms that the unemployed do not have. The unemployed are stigmatised. They get "handouts", which are embarrassing. They are made to feel like failures. They are given the impression that they must be lazy or stupid or both. If they don't feel like working, or lack confidence in their ability - no wonder.

UBI-FIT aims to eliminate these fundamental psychological and social problems. Everyone would be treated equally. Everyone would have the same rights and obligations. Everyone would be equally motivated to work. Everyone would also be free not to work, and take responsibility for the consequences. The poor would be free to do what the rich always expected them to do, namely to drag themselves out of poverty. Just imagine: a system that treats everyone equally, but at the same time eliminates poverty.

Effectively progressive income tax

Progressive income tax means that the rate of income tax increases as income increases. The more you earn, the higher the proportion of income that is taken away in tax. UBI-FIT is not progressive, because the tax rate is flat. But Table 1 shows that it is *effectively* progressive. The calculations are very simple, based on a basic income of 500 Euros per month and a tax rate of 50%. These round figures that have been chosen for convenience and they figures would of course be changed if UBI-FIT were introduced.

Gross income (K€/mo)	Net income (K€/mo)	Effective tax rate
0	0.5	- ∞
1	1	0
2	1.5	25%
3	2	33%
4	2.5	37.5%
5	3	40%
10	5.5	45%

Table 1. The relationship between gross and net income for UBI=500 €/mo and BIT = 50%.

The table shows that when you look at the relationship between gross and net income, the tax rate *effectively* increases with increasing income. The higher your gross income, the higher the effective proportion of your gross income is paid in tax. In this regard, UBI-FIT is no different from the present system. For example, if your net income is 1000 €/mo, you pay half of that (500) in tax but get the same amount back in basic income. So your gross income is the same as your net income. This is called the break-even point. At this point, the effective tax rate is zero. If you earn 2000 €/mo, you pay 1000 in tax and get 500 back in basic income. Effectively, you pay 500 out of 2000 which is 25%. The effective tax rate gradually increases as your gross income increases.

The social benefits of flat tax

We are used to right-wingers talking about the advantages of flat tax, for selfish reasons. But UBI-FIT shows that flat taxes can also have important advantages from a left-wing viewpoint. A flat tax can be paid immediately, as soon as the money is earned, or as soon as it changes hands. So it is possible to require that it must be paid immediately, just as consumption tax (value-added tax) is paid immediately. Once it is paid, the transaction is complete. There is no chance of a refund at the end of the financial year. That not only saves a lot of time preparing tax returns (for both taxpayers and accountants), it also reduces the rate of tax evasion and avoidance. The rich are constantly evading or avoiding tax by playing tricks with their annual statements,

e.g. shifting income from one person to another, or putting it into different categories - not to mention the use of trusts, private equity funds and hedge funds.

In a complex taxation system, there is always the possibility of finding loopholes that others have missed and using them in creative ways. The more complex the system, the more loopholes. In general, only people with enough money to pay to the best accountants and lawyers (they must be well informed, creative, and discrete) have the opportunity to search for and take advantage of loopholes. The more money you give to creative expert advisers, the more ways you can find to avoid or evade tax. There are no official figures about this, because it is generally secret or covered up. But the little information we have suggests that these practices cost governments enormous amounts of money, because the contributions that they lose tend to be large contributions from the rich. UBI-FIT would significantly reduce opportunities for avoiding and evading tax.

Discussion

In the past century, modern democracies have made significant progress toward reducing poverty. Today the left has, or should have, a new goal. The new goal should be to eliminate poverty completely. Steady improvements in technology and associated steady increases in total wealth mean that this new goal is easier to achieve today than it has ever been in the past.

The ideas I have presented here suggest that poverty can be eliminated if we take a new look at the idea of "flat tax". Flat tax is not necessarily about laissez-faire capitalism. If and only if it is combined with unconditional basic income, it is a powerful force to generate the income that governments need to eliminate poverty.

I have written about truth distortion by the political right. But sometimes the left is no better. I have spoken to many well-meaning left-wing friends and colleagues about UBI-FIT, and many times I never got past their automatic negative reaction to the term "flat tax". I could not utter these words without them freaking out. The left will have to start thinking more rationally and objectively if we are to make progress toward eliminating poverty. Good politics is not about clichés, it is about constructive proposals.

A final word of warning: In Britain, something like UBI-FIT is being proposed by the British Freedom and Responsibility party. While I am all for freedom and all for responsibility, and I essentially agree with their version of UBI-FIT, I disagree with their other policies and would never vote for such a party. In my view there is a serious flaw in their philosophy: they blame their country's problems on inefficient government and quietly forget the main reason behind those increasing government deficits. That main reason is simply that the rich are not paying enough tax. This is especially true in Britain, a rich country with a high rate of poverty and surprisingly poor infrastructure. The crass difference between rich and poor is obvious. Publicity of this kind is bad for UBI-FIT, because it associates UBI-FIT with angry, arrogant right-wing politics. I have argued instead that UBI-FIT is the best way to eliminate poverty in modern industrial democracies. It should therefore be considered a left-wing proposal.