

Flat Tax, Equity and Politics

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Abstract

We study a simple flat tax proposal that combines the federal income tax and the payroll tax. This tax reform may have a higher probability of political acceptance by treating the large middle income classes more favorably than other flat tax reform proposals. Our analysis compares the distribution of marginal and average tax rates across income groups for the current system, and two revenue neutral flat tax alternatives. Replacing the current federal income tax rate structure and the payroll tax with a flat 36 percent tax on personal and business income above a generous threshold offers significant tax relief for the lowest income classes, offers middle income earners lower average tax rates and spreads the burden of the present regressive payroll tax to the highest income classes.

Introduction

Taxation recurs as a common element in many political candidates' platforms and tax reform is always an issue for tax analysts, policy makers and academic researchers. Many recent proposals include a flat tax element, and this aspect of tax reform has gained considerable attention in speeches, newsletters, the popular media and academic publications. Indicating the extent of this interest, a bibliography with over 200 flat tax related references, nearly all of which date between 1980 and the present, now appears on the world wide web.¹

In this paper we investigate a simple flat tax system combining an income tax with the payroll tax. Although proposed before, there has been surprisingly little analysis or discussion of the idea, mainly due to the historical perception of Social Security as the "third rail" of policy. (Berger, 1985; Pechman, 1987) But growing concern over Social Security has encouraged politicians to discuss reform and entertain alternatives. In a recent *National Tax Journal* paper, Christian (1995) analyzes and compares two major tax reforms, the USA Tax, and the Hall and Rabushka proposal (discussed in more detail below, and referred to as the HR flat tax.) The USA Tax proposal allows for a tax credit of the employee-paid share of the payroll tax, but the proposal falls far short of the integration of the payroll and income taxes analyzed here. Dunbar and Pogue (1998) conduct an extensive incidence analysis of another flat tax proposal, called the Armey-Shelby proposal, which stands as the most recently published economic analysis of a flat tax proposal, and only tangentially discusses the deductibility of payroll taxes in that proposal. Berger (1985) argues for the elimination of the payroll tax as a separate tax in his analysis of flat tax proposals, but his analysis differs from ours by only integrating the employee share of the payroll tax. As simple tax incidence

analysis teaches us, with very low labor supply elasticities, the burden of the payroll tax falls almost exclusively on the employee, so the distinction between the employee and employer share of the tax is analytically artificial. The proposal to fully integrate the income tax and the payroll tax analyzed here is economically sound, and we believe can be made politically acceptable in a pro-reform environment.

While historically and politically relevant, the distinction between the payroll tax on income and the income tax is economically irrelevant other than differences in the rate structure and the taxable base. The history of Social Security describes a series of “strongly pragmatic and incremental” (Social Security Administration, 1999) changes to a system that was initially designed to ensure a minimum standard of living in retirement and for those suffering disabilities. It is this history of change that offers the potential for future reform. Although currently treated as an entitlement, Social Security exists alongside other programs, competing for federal dollars. Despite being “funded” by Federal Insurance Contributions Act (FICA) taxes, surpluses held in the Social Security Trust Fund are used to purchase federal government debt, thereby enabling the transfer of funds across expenditure accounts and proving the essential fungibility of federal tax revenues. Although still a political long shot, removal of the current from the “third rail” opens the door for tax reform to integrate Social Security.

Our purpose in this paper is to identify and analyze a federal income tax reform with an arguably higher probability of being politically acceptable when compared to many current proposals. A tax alternative is politically acceptable if it maintains the distributional qualities of the current system, but reduces complexity, increases efficiency, and appeals to voter’s sense of fairness. In our analysis we compare the distribution of the burden of

¹ This bibliography is compiled by Bruce Bartlett for the National Center for Policy Analysis and can be found

marginal and average tax rates across income groups for the current system, a standard flat tax and a proposed integrated federal income tax.

Tax Reform

National poll data indicates considerable dissatisfaction with the current tax system. A 1997 Gallop poll found only 5 percent of those polled satisfied with the federal tax system as it is (Moore, 1997). A 1999 Harris poll found 44 percent of respondents in favor of a completely different income tax system (Harris, 1999), and 60 percent of the same sample in favor of a single-rate-above-threshold flat tax. When held up to the criteria of an ideal tax system the current federal income tax performs badly—it is complex, inefficient and unfair. Tax reform aims to improve the collection of federal tax revenues with regard to all these criteria, and there is considerable interdependence among them.

The Federal tax code is complex: the 1994 code contained 1564 sections in 1378 pages. The Internal Revenue Service (IRS) publishes 480 forms and 280 booklets explaining how to fill them in (Hall and Rabushka, 1995). Slemrod and Bakija (1996) report estimates of the costs of complying with the current income tax code of approximately \$75 billion. Fully two-thirds of those polled by the Associated Press (1999) consider the federal tax system too complicated.

The Federal income tax is unfair: a complex system of taxes and exemptions and deductions is the outcome of a political process that attempts to be “fair” to everyone, yet risks appearing unfair to very few. Unfairness often derives from the differential treatment of people considered to be equals, as well as the apparent failure of wealthier people to pay

their “fair share.”² Recognizing that fairness is a difficult concept to define and implement, it is the relative fairness of a tax system that is important, and nearly all tax reform aims to improve on the current system in terms of greater horizontal and vertical equity. Tax reform also attempts to increase compliance, another avenue by which taxpayers are viewed as avoiding paying their fair share.

The income tax is inefficient. While Slemrod and Bakija’s (1996, ch. 4) warning of the difficulty of measuring the dead weight loss of the tax system is well-heeded, there is no doubt that the efficiency loss of the current system is positive and large. When comparing alternative tax reforms, however, the most difficult question to answer empirically concerns the size of the efficiency gains from simplification and elimination of substitution incentives. We accept the maintained hypothesis that simplification of taxes and broadening of the tax base improves efficiency. We do not provide estimates of efficiency gains for the integrated flat tax proposal, but instead focus on the distribution of the burden of alternative tax systems.

A Flat Rate Income Tax

As many proposals for a flat tax are based on the plan developed by Hall and Rabushka (HR; 1985, 1995), we will briefly outline their proposal and the key elements that make a well-designed flat tax attractive. The central elements of the HR flat tax are a single rate tax and redefining the sources of income relative to the current system. The HR system classifies all income as wage income or business income rather than the current division into

² A 1999 Gallop/CNN/*USA Today* poll found 49 percent of those polled agreeing with the statement: “Do you regard the income tax which you will have to pay this year as fair?” Only 19 percent of the same respondents thought that upper income people were paying their fair share. The complexity of the tax system is one source of unfairness, and it may also contribute to a misunderstanding in the general public of exactly who pays what share of federal taxes.

personal income and corporate income. Both sources of income are to be taxed at the same flat rate of 19% and filed on separate tax returns “the size of a postcard.”

Wage income under the HR plan includes wages, salaries, and retirement benefits, while excluding interest income, dividends and capital gains. Pension contributions, whether made by the employer or individual, are not taxed until the benefits are received. Individual taxable income would be reduced by the following generous allowances (in 1995 dollars): \$16,500 for married filing jointly, \$14,000 single head of household, \$9,500 single, and an additional \$4,500 per dependent other than a spouse. This compares to the personal income tax levels (1995) of \$6,550 for married filing jointly, \$3,900 single and an additional \$2500 per family member. To offset the revenue loss from the larger personal allowances and the exclusion of investment income, all deductions would be eliminated, including mortgage interest, state and local taxes, and charitable contributions. The Earned Income Credit will also be eliminated.

The second source of income under the HR tax, business income, differs significantly from the current tax system. Rather than a tax on corporate income with personal businesses taxed as individual income, the business tax covers all business income, including sole proprietorships, partnerships, and corporations. Payments to owners, including interest and dividends cannot be deducted. Payment of fringe benefits to employees are also not deductible, bringing a large amount of income into the tax base that presently escapes taxation completely. On the other hand, and perhaps most importantly, all capital purchases, including buildings, equipment and machines, can be immediately expensed, enormously decreasing the tax base. Capital gains on rental property, plant and equipment would be taxed at the business level, causing many individuals with minor

business activities to file both returns. Capital gains on owner-occupied housing would not be taxed.

The HR flat tax changes the tax base dramatically through changes in both the individual and business tax components. The tax base is enlarged by the elimination of personal deductions yet decreased by the more generous personal allowances and the exclusion of investment income, overall generating less revenue from the wage component than under the current personal income tax. Revenue neutrality, i.e. raising the same total tax revenue, is achieved by shifting the burden toward the business tax, which raises significantly more revenue than under the current system. In part this is due to the simple reallocation of sole proprietorships and partnerships from the individual tax to the business tax. The HR business tax relies on the elimination of loopholes and deductions to raise more revenue with its 19 percent rate than the current system does with its multiple rates (top rate of 35 percent).

Proponents and supporters of a flat tax emphasize the simplicity gained by eliminating exceptions, loopholes, phase-outs and the complex array of depreciation rules that businesses must endure. Also potentially large economic gains come from changes in the tax base. Abolishing taxation of capital income at the individual level and disallowing interest income to be deducted on the business side eliminates the double taxation on corporate income and puts debt and equity on equal ground. This should decrease the cost of capital, encouraging investment and increasing national output.

Increasing investment is often emphasized in recent proposals for tax reform and proponents stress that the flat tax, as envisioned by Hall and Rabushka, is equivalent to a progressive consumption tax. This equivalence emerges because all income is taxed once and only once and all investment is deducted only once at the business level. Therefore the

tax base is GDP less investment, which is simply aggregate consumption. Consider three simple examples (adapted from Hall and Rabushka 1995). Individual one receives \$1000 and spends it all on consumption. He will incur \$190 in taxes, which is 19% of his consumption. Individual two receives \$1000 in income and turns around and invests it in capital for a personal business. She incurs a \$190 tax bill on her individual return and receives a \$190 deduction on her business return. She pays no taxes and has had no consumption. Assuming she receives a 10% return, sells the equipment (with no depreciation) and then consumes this \$1100, she pays taxes of \$209, which is 19% of consumption, and after tax income is \$891. Individual three is similar, but he pays his tax bill and invests the remaining \$810 in the stock market. Assuming the same 10% return, and that the company pays out all of its after tax earnings, he will receive his initial investment of \$810 plus \$81 in dividends for \$891 in after-tax income. The company was able to buy \$1000 worth of equipment with the \$810 investment because of the \$190 deduction, which in turn produced \$100 in earnings and a \$19 tax bill. The individual has paid \$190 in taxes and the business \$19, and again after tax income is \$891 and the \$209 in tax payments is 19% of consumption.

Unlike traditional consumption taxes, such as a National Retail Sales Tax or a Value Added Tax, the flat tax is progressive in the sense that the average tax increases as incomes rise. This is a great advantage because although consumption taxes favor capital accumulation, they are often dismissed because of their regressive nature.³ Because of the large standard deduction and personal allowances, there are two effective marginal rates: zero and 19%. A family whose income does not exceed the basic allowance pays no taxes. Once this threshold is met the marginal rate is 19% but the average rate is low for incomes slightly over the threshold. As incomes get much higher than the personal allowance, it

becomes an insignificant share of income and the average tax rate approaches 19%. Again a simple example makes this clear. Consider four single individuals with incomes of \$9,000, \$30,000, \$75,000 and \$200,000. Their respective tax liabilities are \$0, \$3895, \$12,445 and \$36,195, producing average tax rates of 0, 13, 16.6 and 18.1 percent.

While we have left out many details, this outline of a flat tax covers the most important aspects and serves well as a basis to consider our proposal. It can be noted that even Hall and Rabushka's book length treatment leaves many questions unanswered. Those, however, are beyond our scope of interest and should not affect our results.

An Integrated Federal Earnings Tax

Our proposed income tax uses a flat rate with a standard exemption similar to the HR tax, and taxes individuals and businesses in the same manner. It differs in recognizing that political acceptability is an essential feature of any tax reform, and achieves this by integrating the payroll tax with the income tax. A tax reform will be politically acceptable if it addresses the issue of fairness by offering a redistribution of the burden of federal taxes that increases the voter support for the change, but does not represent too radical a departure from the status quo. The success of our tax reform proposal rests on the argument that increased support by middle income voters is key to the political success of any tax reform, that it is these voters who will bear the greatest increased burden under any HR-type flat tax plan, and that integrating the regressive payroll tax with the progressive HR flat tax satisfies multiple reform objectives.

³ Consumption taxes are not as popular a tax reform as the flat tax. A 1999 Harris Poll found 57 percent of respondents oppose a national sales tax to replace part of the income tax.

Calculation of Effective Tax Rates

Tables 1 and 2 summarize calculations of tax rates with which we compare three tax systems. Calculating the tax burdens is a difficult and often controversial task, so we provide the details of how these tables were created. Table 1 presents average tax rates under the current tax system, the Hall-Rabushka Flat Tax model and the modified flat tax that we propose, labeled Integrated Federal Earnings Tax (IFET).

Table 1. Effective Tax Rates

Cash Income	Current Tax System (1999 Estimates)*				Hall-Rabushka Flat Tax (21.9%)			Integrated Fed. Earnings Tax-IFET (36.2%)	
	Income Tax	SS Tax	Corp Tax	Total	Income & Bus. Tax	SS Tax	Total	Income & Bus. Tax	Total
0 to 10,000	-4.1	6.0	0.6	2.5	0.0	6.0	6.0	0.0	0.0
10,000 to 20,000	-1.9	8.0	1.2	7.3	0.0	8.0	8.0	0.0	0.0
20,000 to 30,000	2.6	9.6	1.5	13.7	2.3	9.6	11.9	3.9	3.9
30,000 to 40,000	4.9	9.9	1.6	16.4	7.5	9.9	17.4	12.4	12.4
40,000 to 50,000	6.9	11.0	1.3	19.2	10.5	11.0	21.5	17.3	17.3
50,000 to 75,000	8.4	11.5	1.5	21.4	13.3	11.5	24.8	22.0	22.0
75,000 to 100,000	10.5	11.6	1.7	23.8	15.7	11.6	27.3	25.9	25.9
100,000 to 200,000	13.4	10.0	2.6	26.0	17.8	10.0	27.8	29.5	29.5
200,000 +	21.0	3.9	7.7	32.6	20.9	3.9	24.8	34.6	34.6
Total	11.1	9.2	3.0	23.3	14.1	9.2	23.3	23.3	23.3

* Table 6, "Estimates of Federal Tax Liabilities for Individuals and Families by Income Category and Family Type for 1995 and 1999", CBO Memorandum, May 1998.

Table 2 presents marginal tax rates for the same three systems. It is common to see the consequences of the flat tax illustrated by presenting the alternative tax bills for several representative households under both the current personal income tax and the flat tax. Thus the reader can see how a single filer, a family of four, or some other household structure will fare under the tax change and evaluate how his own position might be affected. This exercise may prove useful to the individual but does not illustrate how the economy as a whole is affected. For our purposes we present a table with the economy broken down by income levels. This makes clear how the distribution of the tax burden is shifted, even though it may not be possible to see how a specific individual will be affected.

Table 2. Marginal Tax Rates

Cash Income	Current Tax System (1998)**			Hall-Rabushka Flat Tax (21.9%)			Integrated Fed Earnings Tax-IFET (36.2%)	
	Income Tax	SS Tax	Total	Income & Bus. Tax	SS Tax	Total	Income & Bus. Tax	Total
0 to 10,000	-2.9	14.2	11.3	0.0	14.2	14.2	0.0	0.0
10,000 to 20,000	6.9	14.2	21.1	0.0	14.2	14.2	0.0	0.0
20,000 to 30,000	14.4	14.2	28.6	21.9	14.2	36.1	36.2	36.2
30,000 to 40,000	16.2	14.2	30.4	21.9	14.2	36.1	36.2	36.2
40,000 to 50,000	18.0	14.2	32.2	21.9	14.2	36.1	36.2	36.2
50,000 to 75,000	19.5	7.3	26.8	21.9	7.3	29.2	36.2	36.2
75,000 to 100,000	27.0	2.8	29.8	21.9	2.8	24.7	36.2	36.2
100,000 to 200,000	29.5	2.8	32.3	21.9	2.8	24.7	36.2	36.2
200,000 +	36.4	2.8	39.2	21.9	2.8	24.7	36.2	36.2

** Table 2, "Present Law and Analysis Relating to Individual Effective Marginal Tax Rates", Joint Committee on Taxation, February 1998.

Both tables use a comprehensive measure of cash income rather than adjusted gross income. This includes adding in tax exempt interest and other excluded income such as

employer contributions to FICA, health and life insurance and other miscellaneous items. For exact and detailed descriptions the interested reader should consult to the original sources. The most important feature of our calculations is the attempt to measure the total tax burden rather than simply that of the personal income tax. Some studies compare the average tax rates under the current system and the flat tax but we want to emphasize the crucial effects of the payroll tax and the burden of all taxes. Therefore emphasis is on the total tax rates of each tax system rather than the individual components. In fact, the specific columns of each system are not comparable for several reasons. First, the CBO examines the effective tax rates for the current corporate income tax and the personal income but they do not separate business income from individual income. Because the flat tax proposals use all business income rather than simply corporate income we cannot separate the two from the CBO's data for the current tax system. Presentations for both flat tax proposals include a single column combining wage income and business income, whereas the current system is divided into individual income and corporate income. Second, our proposal has no social security tax because it is included with individual and business income. Therefore our tax only has one column, the flat rate tax covering business and wage income. Third, while the effective average corporate tax under the current system is calculated by the CBO there are no equivalent figures for effective marginal rates that individuals face from the corporate tax. Thus there is no column under the current system for marginal corporate income tax facing individuals.

Effective rates for the current tax system, Table 1 columns 2-5, are taken directly from the Congressional Budget Office (CBO, 1998) and have the following structure: the individual income tax is quite progressive with negative effective rates for the lowest brackets due to the earned income credit. The average social security tax rate is relatively

constant, dropping off in the higher brackets because of the cap on taxable income. The average corporate tax rates are low except for the highest brackets where a large part of capital income is concentrated.

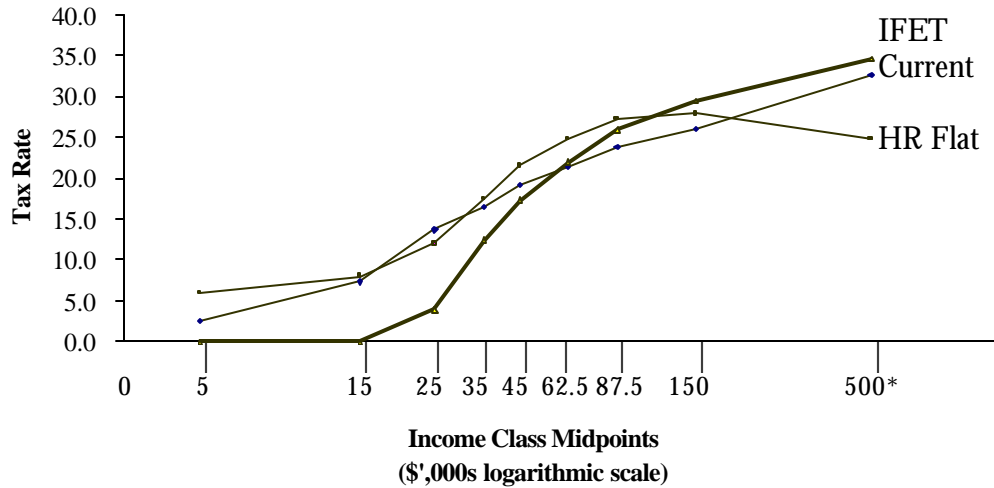
The tax rate under the Hall and Rabushka Flat Tax is calculated to raise the same tax revenue as the current system total from the personal and corporate taxes. The total revenue figure is based on the CBO data using the number of families and the average pre-tax income per income bracket. The 21.9% rate is close to the revenue neutral rate that has been estimated in other studies. (Slemrod and Bakija, 1996, p.163) The average tax paid by each bracket is based on the average family cash income less the standard allowance under the Hall Rabushka proposal.⁴ No other deductions and no Earned Income Tax Credit (EITC) would be available under the Hall Rabushka proposal. The effective Social Security Tax is unchanged from the current system. Looking at the HR flat tax rates in Table 1 we see that the lowest two brackets face a higher effective rate than currently because of the loss of the EITC. Thus Hall and Rabushka's (1995) claim that for "earnings in the range of \$10,000 to \$30,000, the flat tax is substantially less than the current tax" does not hold when considering the effects of eliminating the EITC. Also middle income families from 30,000 to over 100,000 face higher effective rates because of the increase in tax rates from 15% on much of their income to 21.9%. This is similar to HR's results of small increases for the \$30,000 to \$90,000 ranges. The only groups that actually incur a decrease in their average tax liabilities are those in the \$20,000 - \$30,000 bracket and the highest bracket, over \$200,000.

⁴ For the representative household in each bracket we calculated the standard allowance as a weighted average of the allowance for single filers (\$9500) and married filers (\$16500). The CBO tables did not have exact numbers for type of filers, so the percentage as single is estimated from the sum of one adult households and other individuals divided by the total returns for that bracket. There also was no data on the average number of dependents for each bracket, so calculations were based on an average of two dependents for all brackets. The IRS has data for brackets based on Adjusted Gross Income, but it is not clear how this data corresponds to the brackets based on Cash Income.

The Integrated Federal Earnings Tax rates are calculated in a way similar to the HR flat tax, except it is calibrated to raise total revenue equal to the current system's personal income tax, corporate income tax, and the Social Security tax. The revenue neutral rate of 36.2% is obtained. As mentioned earlier, there is only one column for the effective tax rates because all tax revenue would be raised by the wage and business tax. As can be seen, the two lowest brackets, covering \$0 to \$20,000, face lower total effective tax rates than under the current system even after canceling the EITC because of the elimination of the social security tax. Those in the brackets from \$20,000 to \$50,000 also face lower average tax rates than under the current system. The effective rates for the brackets between \$50,000 and \$100,000 are higher than the current system but lower than under the HR flat tax. For those over \$100,000 the average rates under the IFET are higher than both the current system and the HR plan, due mainly to the removal of the cap on FICA contributions.

Figure 1 plots the average tax rates from Table 1, to allow a visual comparison of the progressiveness of the “rate profile” of each tax alternative, with due recognition that the horizontal axis is a logarithmic scale. Compared to the current system, the HR flat tax increases the tax burden on the lowest income bracket, and the middle income brackets while lowering the burden on the highest income earners considerably. The IFET has lower average tax rates for all earners up to \$60,000 compared to the current system, and over \$100,000 compared to the HR flat tax. While average rates fall substantially for the lower groups compared to the current system, the rise in rates for the higher income groups averages about 2 percentage points only. It is this relatively small change in effective tax rates that underlies our argument for the political attractiveness of the IFET.

Figure 1: Average Tax Rates



*Note: Midpoint is arbitrarily chosen since class is open-ended.

Since economists are usually more concerned with marginal rates because of their effects on incentives, we have calculated marginal tax rates for each alternative. Table 2 gives the effective marginal rates that households face under the current income tax and the Social Security tax, for their corresponding income bracket as reported by the Joint Committee on Taxation (1998). They are "effective" marginal rates and differ from the statutory rates because of phase-outs, income exclusions, and other considerations. Again the lowest bracket faces a negative marginal rate under the income tax because of the EITC but faces a significant marginal rate under the Social Security tax.

The marginal rates under the Hall Rabushka flat tax are simply the flat rate of 21.9%, once the standard deduction is met and the same marginal Social Security rates as under the current system. As shown in Table 2, the total marginal rate for those making between \$0 and \$10,000 actually increase under the HR proposal due to the elimination of the EITC

while those between \$20,000 and \$30,000 will face a significantly lower marginal total tax rate. For incomes ranging between \$20,000 to \$75,000 the current tax system actually provides lower marginal rates than the HR plan. For all incomes greater than \$75,000 the HR tax provides lower marginal rates than the current system.

The marginal rate under the proposed IFET is the flat rate of 36.2% for all brackets, once the standard allowance is met. Since the lowest two income groups no longer pay a separate social security tax, their marginal rate is zero. Between \$20,000 and \$50,000 the HR plan and our IFET are nearly identical and both are greater than the current system's marginal rates. From \$50,000 to \$200,000 the IFET entails higher marginal rates than both the current system and the HR flat tax. For incomes greater than \$200,000 the IFET's marginal rates are higher than the HR flat tax but less than under the current system.

Discussion and Conclusion

The IFET that we have proposed keeps intact the key features of the HR flat tax. It relies on the same simple structure of a single flat rate with no deductions that can be filed on a post card. Simplifying the tax code in this manner has been conservatively estimated by the IRS (Hall and Rabushka, 1995) to save \$50 billion a year in tax compliance costs. Eliminating the payroll tax as a separate tax may save many times more than this because of decreased handling and management costs to businesses. The IFET shares with the HR flat tax the expensing of all investment meaning it too is equivalent to a progressive consumption tax. Thus the economic gains attributed to the HR flat tax are also captured by the IFET.

One major drawback of the IFET is the high flat rate of 36.2% compared to the 21.9% of the HR flat tax. In fact the original HR plan calls for a 19% flat rate "to avoid

breaking through ... a politically important psychological barrier of 20%."⁵ Overcoming this, or any other, rate barrier is a matter of educating taxpayers to the illusion they (one presumes if this statement has validity) currently languish under. The HR flat tax can only claim a 21.9% flat rate by ignoring payroll taxes. Yet these make up the second largest source of revenue to the government, and furthermore, many low and lower-middle income tax filers actually pay more in payroll taxes than income taxes.⁶ Of course, it can be argued that many other taxes are levied on U.S. residents, so the focus on the federal income tax and payroll tax is arbitrary. However, these two taxes collect the lion's share of revenues for the federal government and dominate the economic and political landscape. Any tax reform will necessarily concentrate on these two tax structures and must confront the issue of their current separation.

As is nearly always the case, comparing alternative tax structures to the *status quo* identifies income groups who are better off, in terms of lower tax rates, and others who are worse off. The lowest income groups are made worse off by the HR flat tax because of the elimination of the EITC. They are made unequivocally better off, and the benefit extends much further up the income distribution, under the IFET because while the EITC is eliminated, the regressive payroll tax is also eliminated as a separate tax, and the tax-free threshold gives low income tax payers zero marginal and average tax rates. At the other end of the income distribution, the highest income earners are made substantially better off under the HR flat tax through the elimination of the progressive tax rate structure and the cut-off for the payroll tax. These tax payers are exposed to higher rates under the IFET, but only by approximately 2 percentage points, a relatively small increase especially since it is

⁵ Hall and Rabushka (1995) p.122

associated with the elimination of the regressive payroll tax. And an increase in the taxation of the highest income groups will address the concerns of many Americans that these groups are not paying their fair share of taxes.

By far the most important group, as represented by their numbers and their political power, is the middle income groups ranging from \$30,000 to \$100,000 annual income. Compared to the current system, the HR flat tax, and any flat tax alternative that fails to address the regressive payroll tax, increases the effective tax rates for these middle income groups. Even ignoring the payroll tax, average rates for these groups increase under the HR flat tax. When these voters realize that the increased tax rates come with a substantially enlarged tax base through the elimination of nearly all the deductions and exemptions they have used to underscore their economic security (homes, healthcare, charitable contributions, for example), the political support for the flat tax erodes. In addressing the tax rate increase on the middle class Hall and Rabushka (1995 p.93) counter "if we are right that improved incentives will actually raise real incomes by 6 percent after seven years, then it won't take long for the taxpayers who lose at the outset to come out ahead." Yet these long run effects are far from certain, as the case of the Laffer Curve continues to remind us, and voters are always wary of promises that in the long run they'll be better off from a policy that makes them worse off at present.

We propose that the Integrated Federal Earnings Tax is politically more viable than any other flat tax proposal since its impact on the middle income voters is less than that of the alternatives. Although more progressive than the current system, it presents lower average tax rates than the HR flat tax alternative to all income earners below \$100,000. In

⁶ According to The Brookings Institute (Gale, 1999) 74 percent of all families pay more in payroll taxes than income taxes, and only in the highest 20 percent of income earners group does more than half pay less in payroll taxes (employee and employer contributions combined) than in income taxes.

fact, the HR flat tax and its derivatives, such as the proposal of House representatives Arme y and Shelby, are not as progressive as the current system, a feature identified by Dunbar and Pogue (1998) in their extensive incidence analysis of the Arme y-Shelby proposal. While there is arguably no optimal progression in tax rates, a tax rate structure in which average rates increase monotonically may be viewed as more fair than one with a noticeable hump as depicted in Figure 1 for the HR flat tax.

The IFET offers all the positive attributes of flat tax reform, and also unmasks the illusion that the payroll tax is a separate, and unrelated, tax on earnings. The current political climate makes an integrated income tax a viable alternative at the very least. On the basis of our analysis here, an integrated tax will offer significant tax relief to the lowest income classes, offer the middle income groups lower average rates, although higher marginal tax rates, and spread the burden currently carried by the payroll tax to the highest income earners with their greater ability to pay.

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