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## Designing a Work-Friendly Tax System

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# Designing a Work-Friendly Tax System

JONATHAN BARRY FORMAN\*

## I. INTRODUCTION

Taxes tend to influence individual choices between labor and leisure, and high effective marginal tax rates on earned income tend to discourage work.<sup>1</sup> In particular, the empirical evidence shows that high effective marginal tax rates tend to discourage work by low- and moderate-income individuals, especially those that are trying to work their way out of the welfare system.<sup>2</sup> Unfortunately, the current federal tax system often imposes its highest effective marginal tax rates on just those individuals. The purpose of this paper is to suggest some simple ways to reduce those high effective marginal tax rates. One approach would be to replace the current earned income tax credit with a \$2,000 per worker credit and a refundable \$1,000 per child tax credit. A more comprehensive approach would be to integrate the individual income tax and Social Security tax systems into a single, comprehensive income tax system with refundable \$2,000 per worker earned income tax credits and with \$1,000 or \$2,000 per person refundable personal tax credits or demogrants. In short, this paper consid-

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1. See e.g. Gordon Richards, *The Effect of Lower FICA Taxes: A Retrospective Econometric Analysis*, Tax Notes, 245 (Jan. 11, 1999) (finding that if the Social Security payroll tax had not been raised from 1984 onward, 1. gross domestic product would have been higher, by more than \$80 billion; 2. labor supply would have been higher, by roughly 800,000; and 3. employment would have been higher, by roughly one million); see also Robert K. Triest, *Fundamental Tax Reform and Labor Supply*, Economic Effects of Fundamental Tax Reform 247 (Henry J. Aaron & William G. Gale, eds., 1996); Congressional Budget Office, *Labor Supply and Taxes* (Jan. 1996) (available at <http://www.cbo.gov/showdoc.cfm?index=3372&sequence=0>) (accessed May 13, 2004); Nada Eissa, *Tax Reforms and Labor Supply*, Tax Policy and the Economy 10, 120 (James Poterba, ed., 1996); Jerry Hausman, *Labor Supply*, How Taxes Affect Economic Behavior 27 (Henry J. Aaron & Joseph Pechman eds., 1981).

2. See e.g. Norma B. Coe et al., *Does Work Pay? A Summary of the Work Incentives under TANF*, New Federalism: Issues and Options for States, Paper No. A-28 (1998) (available at <http://www.urban.org/urlprint.cfm?ID=5960>) (accessed May 13, 2004); Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. Chi. L. Rev. 405 (1997); Sheldon Danziger et al., *Does it Pay to Move from Welfare to Work?* (Joint Center for Poverty Research, Working Paper No. 254, 2002) (available at <http://www.fordschool.umich.edu/poverty/pdf/v2workpays-danzet.pdf>) (accessed May 13, 2004).

ers how to make the federal tax system more work-friendly for low- and moderate-income workers.

## II. THE INDIVIDUAL INCOME TAX IMPOSES HIGH TAX RATES ON LOW- AND MODERATE- INCOME WORKERS

### A. *The Basic Computation*

The federal income tax is imposed on a taxpayer's taxable income.<sup>3</sup> A taxpayer may file a return as an unmarried individual, as a head of household, as a married couple filing a joint return, or as a married individual filing a separate return.<sup>4</sup>

As a starting point, a taxpayer first determines the amount of the taxpayer's gross income.<sup>5</sup> The term "gross income" means all income from whatever source derived, including, but not limited to, the wages, salaries, tips, gains, dividends, interest, rents, and royalties received by the taxpayer during the taxable year.<sup>6</sup>

A taxpayer subtracts certain deductions from gross income to get taxable income.<sup>7</sup> Most taxpayers simply claim a standard deduction<sup>8</sup> and personal exemptions.<sup>9</sup> Many taxpayers, however, claim certain itemized deductions in lieu of the standard deduction.<sup>10</sup> Also, certain other deductions are allowed without regard to whether the taxpayer chooses to itemize.<sup>11</sup>

Each year, the U.S. Department of Treasury indexes the standard deduction amounts, personal exemption amounts, maximum earned income credit, and income tax rate tables to reflect the prior year's change in the Consumer Price Index.<sup>12</sup> For 2004, the basic standard deduction amounts are \$9,700 for married couples filing jointly and surviving spouses; \$7,150 for heads of households; and \$4,850 for unmarried individuals and for married individuals filing separately.<sup>13</sup> Aged or blind taxpayers generally are entitled to claim an additional standard deduction amount of \$950, except

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3. I.R.C. §§ 1, 63.

4. I.R.C. §§ 2, 6013.

5. I.R.C. § 61.

6. *Id.*

7. I.R.C. § 63(a).

8. I.R.C. § 63(b), (c).

9. I.R.C. § 151.

10. I.R.C. § 63(d).

11. I.R.C. § 62.

12. *See e.g.* Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

13. *Id.*

that aged or blind single individuals can claim an additional standard deduction amount of \$1,200.<sup>14</sup>

The personal exemption amount for 2004 is \$3,100 for each taxpayer and dependent.<sup>15</sup> For example, a married couple with two children can claim four personal exemptions. The amount of the personal exemption is phased out for taxpayers whose adjusted gross income exceeds certain threshold amounts.<sup>16</sup> In 2004, for example, a married couple filing a joint return will start to lose its personal exemptions once its adjusted gross income exceeds \$214,050, and its exemptions will be completely phased out once its income reaches \$336,550.

A taxpayer's standard deduction and personal exemptions create a simple income tax threshold. For example, in 2004, an unmarried individual can claim a \$4,850 standard deduction and a \$3,100 personal exemption.<sup>17</sup> Consequently, she would have no taxable income until her gross income exceeded \$7,950. Similarly, a married couple with two dependent children could claim a standard deduction of \$9,700 and four \$3,100 personal exemptions. As a result, the married couple would not have any taxable income unless their gross income exceeded \$22,100.<sup>18</sup>

#### B. Tax Rates

For a taxpayer with gross income in excess of her simple income tax threshold, her regular tax liability would be determined by applying the 10, 15, 25, 33, and 35 percent rates to taxable income.<sup>19</sup> Table 1 shows the basic standard deductions, personal exemptions, simple income tax thresholds, and income tax rates applicable to some typical taxpayers in 2004. For comparison, Table 1 also shows the U.S. Department of Health and Human Services' poverty income guidelines for those taxpayers.<sup>20</sup> Also, by way of comparison, it is worth noting that the minimum wage in 2004 is \$5.15 per hour,<sup>21</sup> and an individual working full-time, year-round at the minimum wage would earn just \$10,712.<sup>22</sup>

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14. *Id.*

15. *Id.*

16. I.R.C. § 151(d)(3) (The exemption amounts are reduced by 2 percent for each \$2,500 (or fraction thereof) of adjusted gross income in excess of the applicable threshold amount.).

17. Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

18.  $\$22,100 = \$9,700 + 4 \times \$3,100$ .

19. I.R.C. § 1.

20. *Annual Update of the HHS Poverty Guidelines*, 69 Fed. Reg. 7336 (Feb. 13, 2004).

21. Also, the minimum wage has not been increased since September 1, 1997. 29 U.S.C. § 206; U.S. Department of Labor, Minimum Wage (Web Page) (available at <http://www.dol.gov/dol/topic/wages/minimumwage.htm>) (accessed May 13, 2004).

22.  $\$10,712 = \$5.15 \text{ per hour} \times 40 \text{ hours per week} \times 52 \text{ weeks per year}$ .

TABLE 1  
Standard Deductions, Personal Exemptions, Simple Income Tax Thresholds, Poverty Income Guidelines, and Tax Rate Schedules for Various Taxpayers, 2004

	<i>Unmarried Individuals</i>	<i>Married Couples Filing Joint Returns with Two Children</i>	<i>Heads of Household with Two Chil- dren</i>
Standard de- duction	\$4,850	\$ 9,700	\$ 7,150
Personal ex- emptions	\$3,100	\$12,400 (4 × \$3,100)	\$ 9,300 (3 × \$3,100)
Simple income tax threshold	\$7,950	\$22,100	\$16,450
Poverty income guideline	\$9,310	\$18,850	\$15,670
<i>Tax rate (im- posed on tax- able income):</i>	<i>Rate Bracket</i>		
10%	\$0 to \$7,150	\$0 to \$14,300	\$0 to \$10,200
15%	\$7,150 to \$29,050	\$14,300 to \$58,100	\$10,200 to \$38,900
25%	\$29,050 to \$70,350	\$58,100 to \$117,250	\$38,900 to \$100,500
28%	\$70,350 to \$146,750	\$117,250 to \$178,650	\$100,500 to \$162,700
33%	\$146,750 to \$319,100	\$178,650 to \$319,100	\$162,700 to \$319,100
35%	Over \$319,100	Over \$319,100	Over \$319,100

Source: Rev. Proc. 2003-85, 2003-49 I.R.B. 1184; Annual Update of the HHS Poverty Guidelines, 69 Fed. Reg. 7336 (Feb. 13, 2004).

Of note, however, a special rule provides that the maximum tax rate on dividends and net capital gains is generally 15 percent.<sup>23</sup> Moreover, that special rule also provides for a 5 percent rate on the dividends and net capital gains received by moderate-income taxpayers (those in the 10 and 15 percent income brackets).<sup>24</sup>

23. I.R.C. § 1(h).

24. Moreover, this rate will fall to 0 percent in 2008.

The amount that the taxpayer must actually pay or, alternatively, will receive as a refund is equal to the taxpayer's regular tax liability minus allowable credits. Pertinent here, certain low-income taxpayers are entitled to claim the refundable earned income tax credit and the partially refundable child tax credit on their federal income tax returns.

### C. The Earned Income Tax Credit

The earned income tax credit is a refundable tax credit for certain low-income workers.<sup>25</sup> In 2004, for example, a family with two or more qualifying children is entitled to a refundable earned income tax credit of up to \$4,300.<sup>26</sup> The credit is computed as 40 percent of the first \$10,750 of earned income.<sup>27</sup> For married couples filing joint returns, the maximum credit is reduced by 21.06 percent of earned income (or adjusted gross income, if greater) in excess of \$15,040 and is entirely phased out at \$35,458 of income.<sup>28</sup> For heads of household, the maximum credit phases out over the range from \$14,040 to \$34,458.<sup>29</sup>

Similarly, a family with one child is entitled to an earned income credit of up to \$2,604.<sup>30</sup> The credit is computed as 34 percent of the first \$7,660 of earned income.<sup>31</sup> For married couples filing joint returns, the maximum credit is reduced by 15.98 percent of earned income (or adjusted gross income, if greater) in excess of \$15,040 and is entirely phased out at \$31,338 of income.<sup>32</sup> For heads of household, the maximum credit phases out over the range from \$14,040 to \$30,338.<sup>33</sup>

Also, in 2004, childless individuals between the ages of twenty-five and sixty-five are entitled to an earned income credit of up to \$390. The credit is computed as 7.65 percent of the first \$5,100 of earned income. For married couples filing joint returns, the maximum credit is reduced by 7.65 percent of earned income (or adjusted gross income, if greater) in excess of \$7,390 and is entirely phased out at \$12,490 of income. For heads of household and single individuals, the maximum credit phases out over the range from \$6,390 to \$11,490.

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25. I.R.C. § 32.

26. I.R.C. § 32(c)(3) (The term "qualifying child" generally includes a child under the age of 19, a child under the age of 24 who is in college, or a child of any age that is permanently and totally disabled.); Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

27. Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

28. *Id.*

29. *Id.*

30. *Id.*

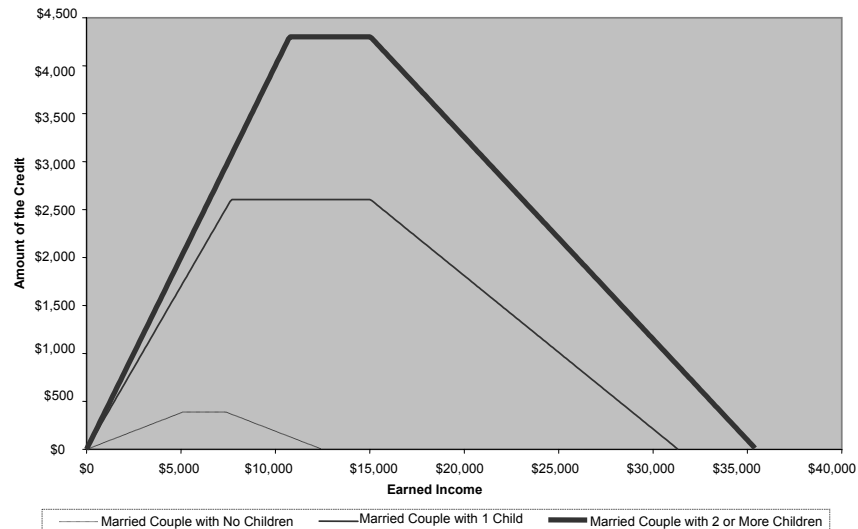
31. *Id.*

32. *Id.*

33. *Id.*

Figure 1 shows the earned income credit amounts available to various married couples in 2004.<sup>34</sup>

FIGURE 1 Earned Income Credit Amounts Available to Married Couples in 2004



#### D. The Child Tax Credit

Taxpayers with qualifying children under the age of seventeen can claim a tax credit of up to \$1,000 per child.<sup>35</sup> The child tax credit is first applied to offset a taxpayer's income tax liability, and, for taxpayers with earned income in excess of \$10,750 in 2004, a portion of the credit is refundable.<sup>36</sup> In 2004, for example, a married couple with two children and \$15,000 of earned income would be entitled to a refundable child tax credit of \$425,<sup>37</sup> and a married couple with two children and \$30,750 of earned income would be entitled to claim its full \$2,000 worth of child tax credits.<sup>38</sup>

34. All figures were created by the author using the tax law and rates applicable in 2004. See e.g. Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

35. I.R.C. § 24.

36. I.R.C. § 24(d); Rev. Proc. 2003-85, 2003-49 I.R.B. 1184. The child tax credit is refundable to the extent of 10 percent of the taxpayer's earned income in excess of \$10,750.

37. *Id.* \$425 = .10 × (\$15,000 - \$10,750).

38. Actually, a married couple with two children and at least \$26,425 of earned income in 2004 can claim the full \$2,000 worth of child tax credits: \$432.50 would offset the couple's income tax liability, and \$1,567.50 would be refundable. Recall from Table 1 that this couple has a simple income tax threshold of \$22,100 and pays tax at a 10 percent rate on its first \$14,300 of taxable income, and recall from n. 36, *supra*, that in 2004 the couple's child tax credit is refundable to the extent of 10 percent of the couple's earned income in excess of \$10,750. Consequently, the formula to solve for the income

These child tax credits are phased out once the taxpayer's adjusted gross income reaches \$110,000 for married couples filing joint returns, \$55,000 for married couples filing separately, and \$75,000 for all other taxpayers.<sup>39</sup> For example, a married couple with two qualifying children would see its 2 child tax credits phase out as its adjusted gross income increased from \$110,000 to \$130,000.

#### E. *The Alternative Minimum Tax*

Some individuals are also subject to the so-called "alternative minimum tax" which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular individual income tax liabilities.<sup>40</sup> The tax is imposed at rates of 26 and 28 percent on "alternative minimum taxable income" in excess of an exemption amount.<sup>41</sup>

#### F. *Effective Marginal Tax Rates on Earned Income under the Income Tax*

The current federal income tax system imposes relatively high tax rates on earned income. To be sure, the federal income tax system is generally progressive.<sup>42</sup> That is, taxpayers with higher incomes generally pay tax at higher rates than those with lower incomes. Because of the many phase-outs and other special rules, however, effective marginal tax rates can bounce all over the place, and the highest effective marginal tax rates are often imposed on low-income taxpayers in the phase-out range of the earned income tax credit.<sup>43</sup> In that regard, Figure 2a shows the effective marginal income tax rates imposed on unmarried individuals with varying amounts of earned income in 2004; Figure 2b shows the effective marginal income tax rates imposed on typical married couples with two minor children and with varying amounts of earned income; and Figure 2c shows the

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level (I) at which this couple gets to first claim all of its \$2,000 worth of child tax credits is:  $\$2,000 = .10 \times (I - \$22,100) + .10 \times (I - \$10,750)$ . Solving for I,  $I = \$26,425$ .

39. I.R.C. § 24(b).

40. I.R.C. § 55.

41. For 2004, the exemption amounts are \$58,000 for married couples filing joint returns, \$40,250 for single individuals and heads of household, and \$29,000 for married individuals filing separate returns. *Id.*

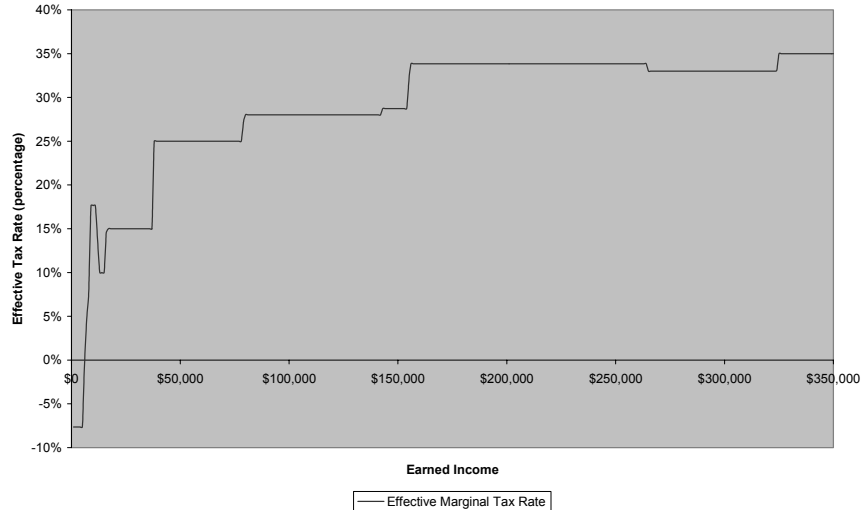
42. See e.g. Congressional Budget Office, *Effective Federal Tax Rates, 1997 to 2000* (2003) (available at <http://www.cbo.gov/showdoc.cfm?index=4514&sequence=0&from=0>) (accessed May 13, 2004).

43. See e.g. Gregory G. Geisler, *Current Year Tax Laws that Cause Low Visibility of an Individual's Effective Marginal Tax Rate*, Tax Notes, 627 (Nov. 3, 2003); Leonard Burman & Mohammed Adeel Saleem, *Hidden Taxes and Subsidies*, Tax Notes, 1437 (Sept. 15, 2003).



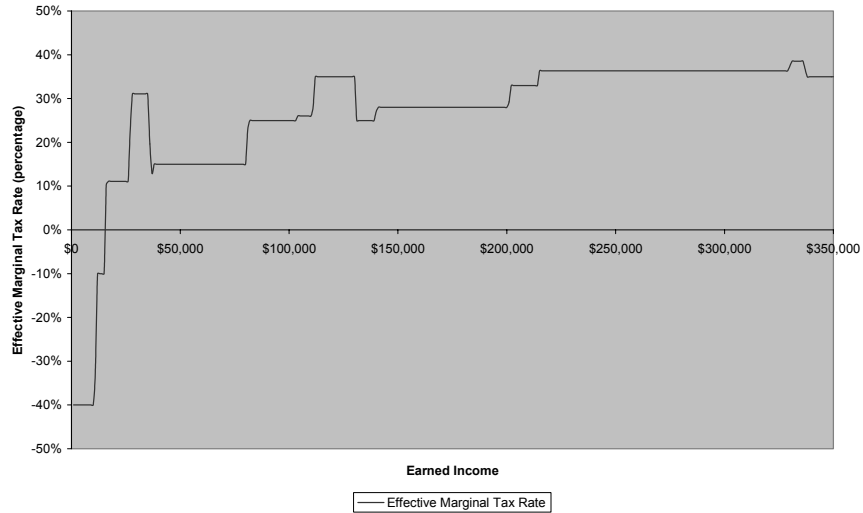
effective marginal income tax rates imposed on a typical head of household with two minor children.<sup>44</sup>

FIGURE 2a Effective Marginal Income Tax Rates on Unmarried Individuals with Earned Income Only, 2004

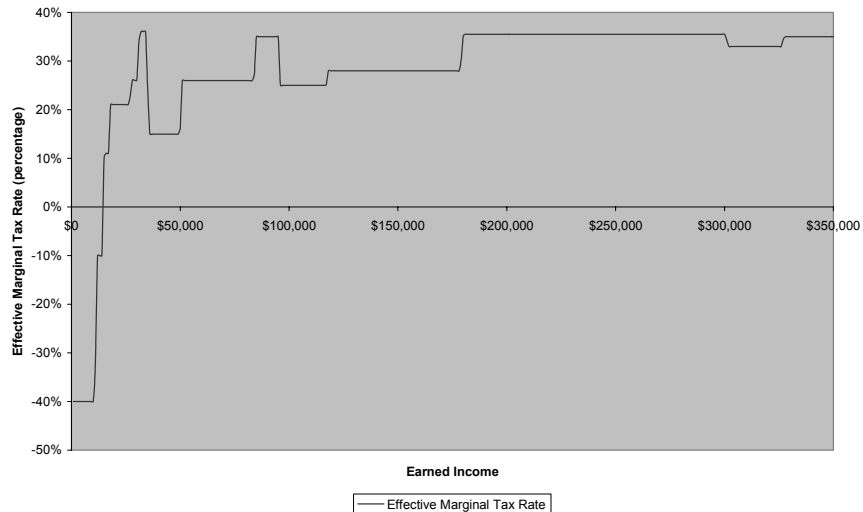


44. These and subsequent figures dealing with effective marginal tax rates under the income tax incorporate the required computations under the alternative minimum tax, as well. In that regard, however, these figures underestimate the impact of the alternative minimum tax on high-income taxpayers because all of the underlying computations assume that all taxpayers will claim the standard deduction rather than itemizing their deductions. In reality, most higher-income taxpayers would, in fact, itemize their deductions, and while those itemized deductions would be allowable in computing taxable income, some would not be allowable in computing their alternative minimum tax liability. For example, unreimbursed employee business expenses and state income taxes are deductible for income tax purposes but not for alternative minimum tax purposes. I.R.C. §§ 55, 56(b)(1)(A), 63(d), 67(b), 162(a), 164(a)(3). Pertinent here, the net effect is that itemized deductions reduce the income tax rates and liabilities faced by higher-income taxpayers, but simultaneously subject more of them to the higher effective tax rates resulting from the alternative minimum tax. For more about the impact of the alternative minimum tax, see e.g. Leonard E. Burman et al., *The AMT: Projections and Problems*, Tax Notes, 105 (July 7, 2003).

**FIGURE 2b Effective Marginal Income Tax Rates on Married Couples with Two Children and Earned Income Only, 2004**



**FIGURE 2c Effective Marginal Income Tax Rates on Heads of Household with Two Children and Earned Income Only, 2004**



Some explanation is in order. Initially, the unmarried taxpayer in Figure 2a has income below her simple income tax threshold of \$7,950 ( $\$7,950 = \$4,850$  standard deduction +  $\$3,100$  personal exemption), and she receives an earned income credit equal to 7.65 percent of her first \$5,100 of earned income. Once her earned income exceeds \$5,100, she is entitled to the maximum credit of \$390, and once her income exceeds

\$6,390, she starts to lose that credit at the rate of 7.65 percent until the credit is fully phased out at \$11,490. Also, once her income reaches her simple income tax threshold of \$7,950, she is subject to positive income tax rates, initially at the 10 percent rate and then eventually at the 15, 25, 28, 33, and 35 percent rates. Also, once her income exceeds \$142,700, she will begin to lose her \$3,100 personal exemption, and that exemption will be completely taken away when her income reaches \$265,200.

Similarly, the married couple in Figure 2b initially has income below its \$22,100 simple income tax threshold and receives an earned income tax credit equal to 40 percent of its first \$10,750 of earned income. Once the couple's earned income exceeds \$10,750, the couple is entitled to the maximum earned income tax credit of \$4,300, and once the couple's income exceeds \$15,040, the couple starts to lose that credit at the rate of 21.06 percent, until the credit is fully phased out at \$35,458. Also, once the couple's earned income reaches \$10,750, the couple's two \$1,000 child tax credits become refundable to the extent of 10 percent of the couple's earned income in excess of \$10,750, until the full \$2,000 is allowed. Once the couple's income reaches its simple income tax threshold of \$22,100, the couple is subject to positive income tax rates, initially at the 10 percent rate and then eventually at the 15, 25, 28, 33, and 35 percent rates. Also, once the couple's income exceeds \$110,000, the couple will begin to lose its two \$1,000 child tax credits, and those credits will be completely taken away when the couple's income reaches \$130,000. Finally, once the couple's income exceeds \$214,050, the couple will lose its four \$3,100 personal exemptions, and those exemptions will be completely taken away when the couple's income reaches \$336,550.

A similar explanation could be offered for the effective marginal income tax rates applicable to the head of household with two children portrayed in Figure 2c.

Finally, it is also worth noting that the current tax system often imposes significant marriage penalties on low-income workers who claim the earned income tax credit.<sup>45</sup> In 2004, for example, if a single father with two children and \$15,000 of earnings marries a single mother with two children and \$15,000 of earnings, the couple will face a hefty marriage penalty. Before the marriage, each would be entitled to an earned income credit of \$4,098,<sup>46</sup> for a total of around \$8,200. After the marriage, the couple would have a combined income of \$30,000, which is far into the phase-out range of the earned income tax credit. Together, they would be

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45. I.R.C. § 32.

46.  $\$4,097.82 = \$4,300 - .2106 (\$15,000 - \$14,040)$ .

entitled to a single earned income tax credit of just \$1,149<sup>47</sup> for an earned income tax credit marriage penalty of \$7,047.<sup>48</sup> Their total marriage penalty would be a little bit smaller, however, as the couple would now be entitled to claim a larger portion of their child tax credits.<sup>49</sup>

### III. THE SOCIAL SECURITY PAYROLL TAX IMPOSES HIGH TAX RATES ON LOW- AND MODERATE- INCOME WORKERS

#### A. *The Basic Computation*

Social Security taxes are levied on earnings in employment and self-employment covered by Social Security, with portions of the total tax allocated by law to each of the Old-Age and Survivors Insurance trust fund (OASI), the Disability Insurance trust fund (DI), and the Medicare Hospital Insurance trust fund (HI).<sup>50</sup> For 2004, employees pay Social Security taxes of 7.65 percent of the first \$87,900 of wages and 1.45 percent of wages over \$87,900.<sup>51</sup> The lion's share of these payroll taxes is used to finance the OASI program (5.30 percent of wages), and the rest is used to pay for Disability Insurance (0.90 percent) and Medicare (1.45 percent).<sup>52</sup>

Employers pay a matching Social Security tax of 7.65 percent of up to \$87,900 of wages of each covered employee.<sup>53</sup> Employees are not allowed to deduct their portion of Social Security taxes for income tax purposes.<sup>54</sup>

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47.  $\$1,149.42 = \$4,300 - .2106 (\$30,000 - \$15,040)$ .

48.  $\$7,047 = \$4,098 + \$4,098 - \$1,149$ .

49. For example, the couple would now be eligible for four child tax credits, of which \$1,925 would be refundable, up from just \$850 before the marriage. After marriage:  $\$1,925 = .10 \times (\$30,000 - \$10,750)$ . Before marriage:  $\$850 = 2 \times \$425$ ;  $\$425 = .10 \times (\$15,000 - \$10,750)$ . The couple would get a refund of \$3,074, computed as follows: the couple would have taxable income of \$1,700 ( $\$1,700 = \$30,000 - \$9,700 - [6 \times \$3,100]$ ); their regular tax liability would be \$170 ( $.10 \times \$1,700$ ); their earned income tax credit would be \$1,149; and their child tax credits would be \$2,095 ( $\$170$  nonrefundable +  $\$1,925$  refundable).

50. I.R.C. §§ 1401, 3101, 3111.

51. *Cost-of-Living Increase and Other Determinations for 2004*, 68 Fed. Reg. 60437, 60437-60, 442 (Oct. 22, 2003).

52. Comm. Ways and Means, U.S. House of Representatives, *2004 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means* Section 1, Social Security: The Old-Age, Survivors, and Disability Insurance (OASDI) Programs, 1-39 tbl. 1-1 (updated March 17, 2004) (available at <http://waysandmeans.house.gov/Documents.asp?Section=813>). The Old-Age and Survivors Insurance program provides monthly cash benefits to retired workers and their dependents and to survivors of insured workers. *Id.* The Disability Insurance program provides monthly cash benefits for disabled workers under age 65 and their dependents. *Id.* Medicare is a federal health care program for the aged and certain disabled persons. *Id.* at Section 2, Medicare (updated March 17, 2004).

53. *Cost-of-Living Increase and Other Determinations for 2004*, *supra* n. 51.

54. I.R.C. §§ 275(a)(1)(A), 3502(a); Treas. Reg. § 1.164-2(a) (1960).

The employer's portion of Social Security taxes, however, is excluded from the employee's income for income tax purposes.<sup>55</sup>

Similarly, self-employed workers pay an equivalent Social Security tax of 15.3 percent on the first \$87,900 of self-employment earnings and 2.9 percent of self-employment earnings over that amount. Self-employed individuals may deduct half of these taxes for both Social Security and income tax purposes.<sup>56</sup> This puts self-employed individuals in a position that is approximately equivalent to that of employees.

Social Security and Medicare taxes have grown significantly over the years. In 1940, for example, an employee and her employer each paid a Social Security payroll tax of just 1 percent of the first \$3,000 in wages, for a total of 2 percent of wages.<sup>57</sup> In 2004, however, an employee and employer must pay 7.65 percent of the first \$87,900 of wages, and 2.9 percent on wages over \$87,900.<sup>58</sup> Not surprisingly, social insurance taxes rose from just 19 percent of federal revenues in 1965 to 37.8 percent of federal revenues in 2002, and from just 3.2 percent of gross domestic product in 1965 to 6.8 percent of gross domestic product in 2002.<sup>59</sup> In effect, from 1965 to 2002, workers saw their payroll tax burden double.

#### B. *Effective Marginal Tax Rates on Earned Income Under the Social Security Payroll Tax*

Figure 3 shows the effective marginal Social Security payroll tax rates imposed on workers with varying levels of earned income. In that regard, most economists believe that the burden of most payroll taxes paid by employers actually falls on the employees themselves.<sup>60</sup> In effect, workers bear the brunt of the employment taxes paid by their employers. Overall, the payroll tax is a regressive tax; workers pay roughly 15.3 percent of their first \$87,900 of earned income and 2.9 percent on earnings in excess of \$87,900. As is common in this type of analysis, Figure 3 ignores the value of any future Social Security and Medicare benefits that might result from these payroll taxes.<sup>61</sup>

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55. H. R. Rpt. 98-47 at 125-126 (Mar. 24, 1983) (reprinted in 1983 U.S.C.C.A.N. 404, 414-15).

56. I.R.C. §§ 164(f), 1402(a)(12).

57. Comm. Ways and Means, U.S. House of Representatives, *supra* n. 52 at 1-39 tbl. 1-1.

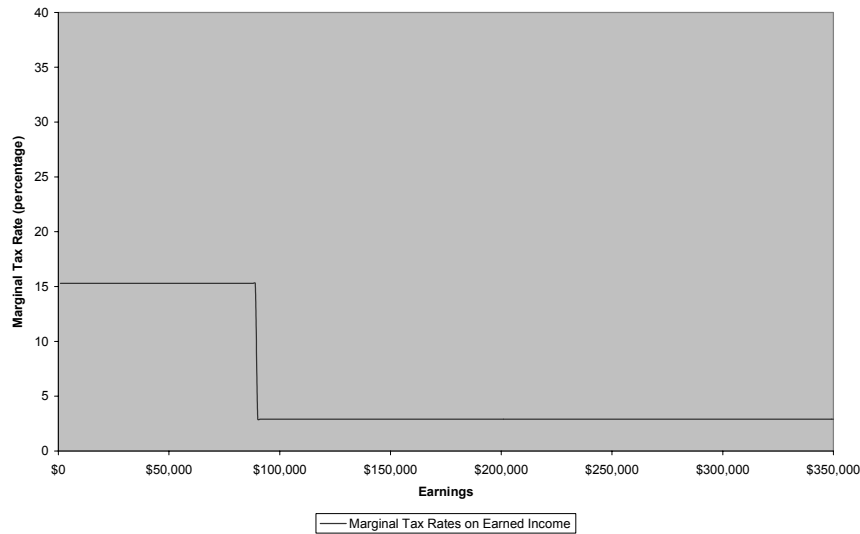
58. See *supra* n. 51 and accompanying text.

59. Comm. Ways and Means, U.S. House of Representatives, *supra* n. 52, at app. I, Budget Tables, I-16 tbl. I-10, I-17 tbl. I-11 (posted Oct. 31, 2003); see also Michael J. Graetz, *The Decline (and Fall?) of the Income Tax*, 21 (W.W. Norton 1997) (to the same effect).

60. See e.g. Congressional Budget Office, *supra* n. 42, at 2-3.

61. See e.g. *id.* at 5.

FIGURE 3 Social Security: Effective Marginal Tax Rates on Earned Income



Most households pay more Social Security payroll taxes than income taxes.<sup>62</sup> For example, in the year 2000, 70.6 percent of households paid more payroll taxes than income taxes. This figure drops to 41.3 percent if only the employee's share is considered.<sup>63</sup> Moreover, low-income households are much more likely than higher-income households to pay more payroll taxes than income taxes. For example, in the year 2000, almost 98 percent of households in the lowest income quintile paid more payroll than income taxes, while only 26 percent in the top quintile paid more in payroll taxes than they did in income taxes.<sup>64</sup> This relationship is not surprising given the lack of a tax threshold before the Social Security payroll tax kicks in, the \$87,900 cap on the Old-Age and Survivors and Disability Insurance taxes, and the progressivity of the income tax rate structure.<sup>65</sup>

62. *Id.* at 2; Dan R. Mastromarco, *What's so Fair about a Tax on Income?*, Tax Notes, 217 (Oct. 11, 1999) (to the same effect).

63. Congressional Budget Office, *supra* n. 42, at 17 tbl. 2.

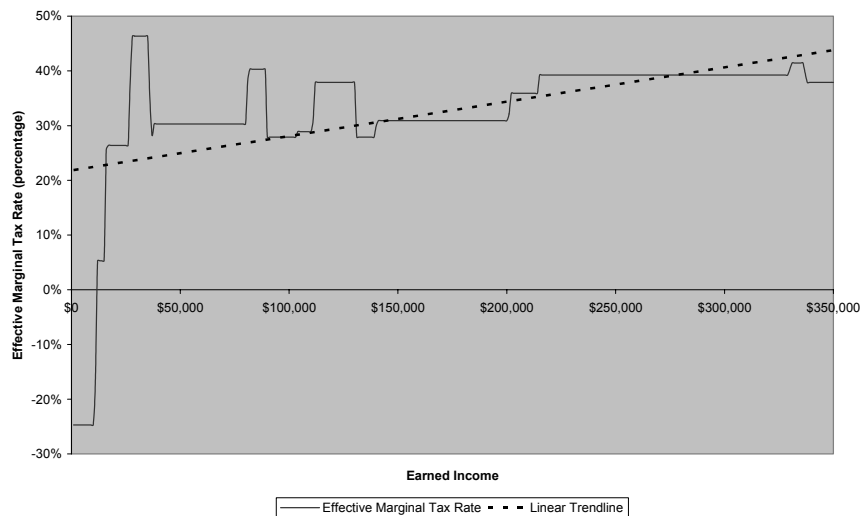
64. *Id.*

65. For example, because of standard deductions and personal exemptions, a married couple with two children and \$20,000 of earned income would owe no income tax. See Table 1 and accompanying explanation. On the other hand, because the Social Security payroll tax lacks personal exemptions and standard deductions, that couple would owe \$1,530 in payroll taxes ( $\$1,530 = .0765 \times \$20,000$ ), and the couple's employer(s) would owe a matching amount. See *supra* n. 51 and accompanying text.

#### IV. EFFECTIVE MARGINAL TAX RATES ON EARNED INCOME AS A RESULT OF INCOME AND PAYROLL TAXES COMBINED

When both income and payroll taxes are considered, the effective marginal tax rates on earned income can be extraordinarily high, especially on low- and moderate-income workers with children. Once again, effective marginal tax rates fluctuate, rather than increase steadily as earned income increases. For example, Figure 4a shows the effective marginal tax rates on earned income imposed on married couples with two children. Figure 4a is the result of combining the income tax and payroll tax data underlying Figures 2b and 3.<sup>66</sup> Figure 4a shows that the highest marginal tax rates are imposed on moderate-income couples earning around \$30,000 a year. Figure 4a also includes a linear trendline, so that the reader can see what a more rational, progressive tax rate structure would look like.

FIGURE 4a Combined Effective Marginal Tax Rate (income and payroll taxes), Married Couples with Two Children and Earned Income Only, 2004

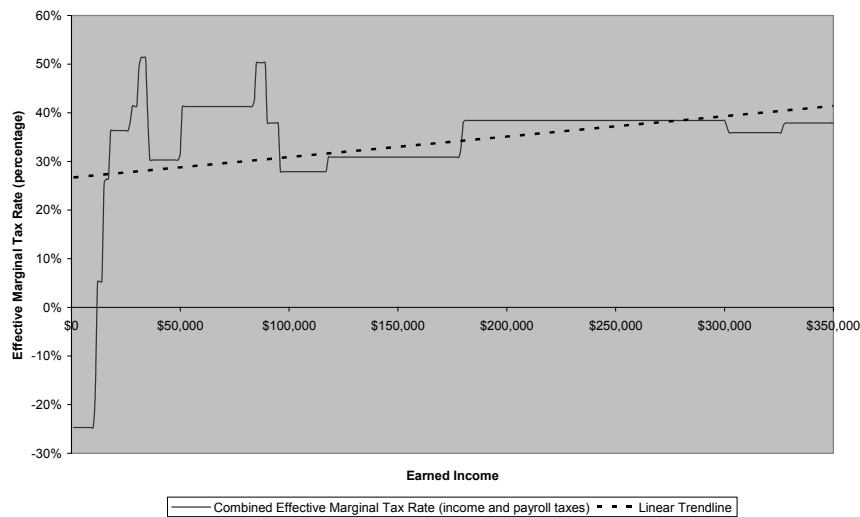


Similarly, Figure 4b shows similar results for heads of household with two children and earned income only. Figure 4b shows that some moderate-income heads of households face effective marginal tax rates of over 50 percent. Indeed, the highest effective marginal tax rates are imposed on heads of household earning around \$30,000 a year. Once again, a linear

66. See *supra* n. 55 and accompanying text. Using the Social Security payroll tax rates of 15.3 and 2.9 percent slightly overstates their impact, as the employer's portion (one-half) of the applicable Social Security payroll taxes is excluded from income for income tax purposes.

trendline is included, so that the reader can imagine what a more rational, progressive tax rate structure might look like.

FIGURE 4b Combined Effective Marginal Tax Rates (income and payroll), Heads of Household with Two Children and Earned Income Only, 2004



## V. HIGH EFFECTIVE MARGINAL TAX RATES CAN DISCOURAGE WORK

Taxes tend to influence individual choices between labor and leisure, and high effective marginal tax rates on earned income tend to discourage work.<sup>67</sup> Taxes on earned income reduce the rewards from work and so tend to make leisure relatively more attractive than work.<sup>68</sup> This is the substitution effect: high tax rates will cause individuals to substitute leisure for work.<sup>69</sup> On the other hand, the lower relative wages after taxes mean that workers will get less after-tax income from the same amount of work effort and so will have less ability to consume all goods, including leisure.<sup>70</sup> This is the income effect: high tax rates or benefit-reduction rates will cause individuals to work harder in order to restore that lost income.<sup>71</sup> As the substitution and income effects work in opposite directions, the net effect on work can be ambiguous: theory alone cannot an-

67. See references in n. 1, *supra*.

68. Harvey S. Rosen, *Public Finance* 20-23, 374-376 (6th ed., 2002).

69. *Id.*

70. *Id.* Leisure is a “normal good – consumption increases when income increases and vice versa.” *Id.* at 22.

71. *Id.* at 20-23, 374-376.



swer the question of how labor force behavior is affected by changes in the tax system. In that regard, however the empirical evidence suggests that taxes and benefit-reductions tend to discourage work by low-skilled workers and secondary earners but do not have as much of an impact on other workers.<sup>72</sup>

In general, if the government wants to minimize work disincentives, it should keep the effective marginal tax rates on earned income as low as possible.<sup>73</sup> Moreover, it is especially important to have low effective marginal tax rates on low- and moderate-income workers as these workers are likely to have large behavioral responses to high rates.<sup>74</sup> In that regard, Figures 4a and 4b reveal one of the fundamental problems with the current federal tax system – some of the highest effective marginal tax rates are imposed on moderate-income taxpayers. These high effective marginal tax rates invariably discourage heads of household from working more hours or improving their skills and discourage secondary earners from even bothering to enter the work force.<sup>75</sup>

Worse still, these high effective marginal tax rates in the federal tax system often combine with similarly high benefit-reduction rates in the welfare system to result in virtually confiscatory effective tax rates on the earned income of many low- and moderate-income taxpayers trying to work their way out of the welfare system.<sup>76</sup> A recent study by Dan R. Mastromarco came to similar conclusions:

Such steeply progressive marginal tax rates punish lower-middle-class workers. Once state taxes are considered, many lower-middle-income single parents keep only 40 cents of each dollar they earn. Once the costs of commuting, child care, and other

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72. See e.g. *id.* at 377; Richards, *supra* n. 1; Eissa, *supra* n. 1.

73. We know that the distortions that result from taxes increase as effective marginal tax rates increase. Indeed, economists suggest that the distortions increase exponentially with increases in the effective tax rate. Daniel N. Shaviro, *Effective Marginal Tax Rates on Low-income Households*, Tax Notes, 1191, 1198 (Aug. 23, 1999). For example, a 90 percent payroll tax rate is likely to induce nine times (not three times) as much distortion as a 30 percent payroll tax rate.

74. See e.g. *id.* at 1198; Rosen, *supra* n. 68, at 377; Eissa, *supra* n. 1. So-called “optimal tax” theory also suggests that it is important to keep marginal tax rates low. See e.g. James Mirlees, *An Exploration into the Theory of Optimal Income Taxation*, 38 Rev. Econ. Studies 175 (1971); Joel Slemrod et al., *The Optimal Two-bracket Linear Income Tax*, 53 J. Pub. Econ. 269 (1994); M.A. Sillamaa, *How Work Effort Responds to Wage Taxation: An Experimental Test of a Zero Top Marginal Tax Rate*, 73 J. Pub. Econ. 125 (1999). Interestingly, however, much of the optimal tax literature suggests that there would be efficiency gains from having marginal tax rates that fall at *higher* income levels. This approach could “induce greater labor supply from the most productive segment of society, with the increased tax revenue used to lower the tax burden of the least productive segment.” Slemrod et al., *supra* at 285-286.

75. See e.g. Eissa, *supra* n. 1.

76. See e.g. Coe et al., *supra* n. 1.

work-related expenses are considered, choosing to work makes very little economic sense for single-parent families.<sup>77</sup>

In short, the high effective marginal tax rates imposed by the current federal tax system contribute to the often confiscatory effective marginal tax rates faced by many low- and moderate-income workers struggling to leave welfare. Consequently, reducing the applicable federal tax rates would help reduce the work disincentives in the combined tax and transfer system.

## VI. A MODEST REFORM: RESTRUCTURE THE EARNED INCOME TAX CREDIT

### A. *A Social Security Payroll Tax Exemption*

One way to reduce effective marginal tax rates on low- and moderate-income workers would be to restructure the earned income tax credit. One approach would be to replace the credit with a \$10,000 exemption from Social Security taxes and a \$1,000 per child refundable tax credit – a work benefit and a child benefit.<sup>78</sup>

Consider a single parent with two children. Under current law she can claim an earned income credit of up to \$4,300, but that credit phases out at the rate of 21.06 percent of her income in excess of \$14,040. Replacing the current credit with a \$10,000 per worker exemption and a \$1,000 per child tax credit, our hypothetical parent would receive \$2,765 worth of tax benefits, but those benefits would not phase-out as her income increased. A \$10,000 exemption from Social Security payroll taxes would be worth \$765 per worker (or \$1,530 if the credit applied to the employer portion as well), and the two child tax credits would be worth \$2,000. As there would be no reason to phase out either of these tax benefits, millions of low-income workers would no longer face the extraordinarily high effective marginal tax rates that can result from the current phase-out of the earned income tax credit.

Alternatively, it could make sense to allow taxpayers to claim standard deductions and personal exemptions under the Social Security tax system, as well as under the income tax system. In 2004, for example, a single

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77. Mastromarco, *supra* n. 62, at 235.

78. See e.g. Jonathan B. Forman, *Simplification for Low Income Taxpayers: Some Options*, 57 Ohio St. L.J. 145 (1996); George K. Yin & Jonathan B. Forman, *Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor*, Tax Notes, 951 (May 17, 1993); see also George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Credit Program*, 11 Am. J. Tax Policy 225 (1994).

parent with two children can claim a \$7,150 standard deduction and three \$3,100 personal exemptions under the income tax, for a simple income tax threshold of \$16,450.<sup>79</sup> If she were allowed to claim a \$16,450 tax threshold for the Social Security payroll tax as well, she would save \$1,258 in payroll taxes, and the earned income credit could be reduced accordingly.<sup>80</sup> Again, the benefit could be twice as large if the tax threshold also applied to the employer portion of the Social Security tax. Refundable child tax credits could once again be used to give her another \$1,000 per child. Again, under this approach, taxpayers would no longer face extraordinarily high effective marginal tax rates like those that result from the phase-out of the current earned income tax credit.

B. *A \$2,000 Per Worker Earned Income Credit*

Another approach for keeping marginal effective tax rates low would be to replace the current earned income tax credit with a universal \$2,000 per worker earned income tax credit and a \$1,000 per child refundable tax credit.<sup>81</sup> The \$2,000 per worker earned income tax credit could be computed as 20 percent of the first \$10,000 of earned income, and it might not phase-out at all, or phase-out only very slowly at the rate of 10 percent of income from \$20,000 to \$40,000. Figure 5 shows how such a \$2,000 per worker earned income tax credit could work, with, or without, a phase-out.

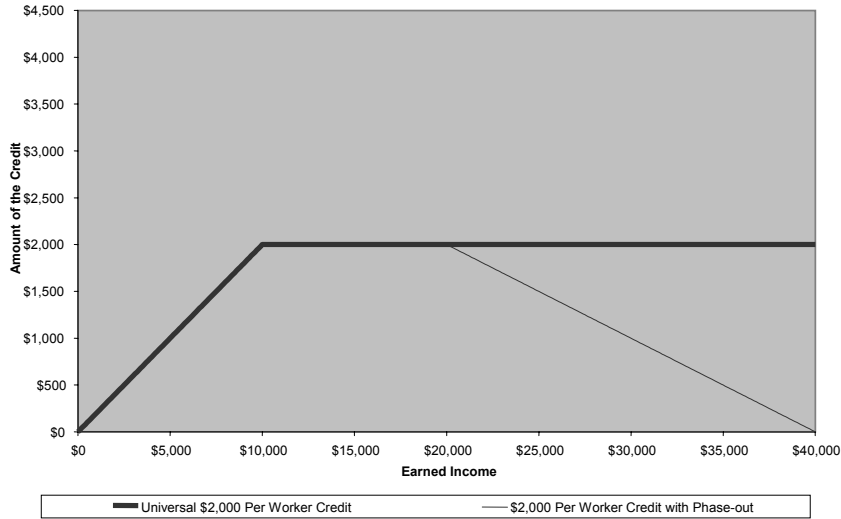
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79. See tbl. 1, *supra*.

80.  $\$1,258.425 = .0765 \times \$16,450$ .

81. Along the same lines, some have suggested replacing the earned income tax credit with a \$1,530 payroll tax credit, to offset the payroll taxes incurred on the first \$10,000 of earnings, and with a \$2,000 per child "simplified family credit." See e.g. H.R. 3655, 108th Cong. (Dec. 8, 2003) (introduced by Dennis J. Kucinich, Barbara Lee, and Bernie Sanders); Timothy Catts, *Kucinich Launches Tax Plan for Capital Hill and Campaign Trail*, Tax Notes, 1264-1266 (Dec. 15, 2003); Max B. Sawicky, *And Now for Something Completely Different: Doing a Fiscal U-Turn*, Tax Notes, 1353-1354 (Dec. 15, 2003).

FIGURE 5 Hypothetical \$2,000 Per Worker Earned Income Tax  
With or Without a Phase-out



Under this approach, a single parent with two children would be entitled to almost \$4,300 in refundable tax credits. She could claim two \$1,000 refundable child tax credits, and if she worked full-time, year-round, even at the minimum wage she could pick up another \$2,000 from the \$2,000 per worker earned income credit, for a total of \$4,000.

In fact, there would be no particular reason for either of these tax credits to phase out. Under current law, child tax credits are available to heads of household earning up to \$75,000, but it would make sense to eliminate even that phase-out and recover the lost revenue through otherwise broadening the tax base or through a modest increase in tax rates. In 2004, the current earned income credit phases out as a head of household's income increases from \$14,040 to \$34,458. Even if the \$2,000 per worker credit were phased out over that range, the phase-out rate would need to be just 9.8 percent, far less than the current credit's 21.06 percent phase-out rate.<sup>82</sup> Of course, it could also make sense to raise the phase-out range. For example, Figure 5 shows how a \$2,000 per worker earned income tax credit could be phased out at the rate of 10 percent of income from \$20,000 to \$40,000.

Marriage penalties would also be smaller in a system of \$2,000 per worker earned income tax credits. If two workers got married, each would

82.  $.0979527 = \$2,000 \div (\$34,458 - \$14,040)$ . See *supra* n. 28 and accompanying text for an explanation of the earned income tax credit and its 21.06 percent phase-out for taxpayers with two or more children.

still be entitled to an earned income credit of up to \$2,000. They might lose little or no credit by getting married depending on how the phase-out (if any) worked.

### C. Use of Demogrants Instead of Child Tax Credits

Instead of refundable child tax credits, it could make sense to have a system of refundable personal tax credits or demogrants. A demogrant is a cash transfer paid to every person without regard to income level.<sup>83</sup> For example, consider a simple demogrant that guaranteed every person \$1,000 a year. Under such a system, an unmarried individual would receive \$1,000, a parent with two children would receive \$3,000, and a married couple with two children would receive \$4,000.

Demogrants could be paid out in the form of refundable personal tax credits; and these personal tax credits could replace personal exemptions, standard deductions, child tax credits, and the child-related component of the earned income credit. For example, every person could receive a \$1,000 or \$2,000 refundable personal tax credit and then they could be taxed at relatively low rates on all their income.<sup>84</sup> Also, some of the revenue needed to pay for these personal tax credits could come from cashing out food stamps and other means-tested and non-means-tested transfer programs.<sup>85</sup>

Refundable tax credits have an equal value for all individuals, whereas deductions are more valuable to individuals facing higher tax brackets. For example, the current personal exemption (\$3,100 in 2004) is worth \$868 to taxpayers in the 28 percent tax bracket but just \$310 to taxpayers in the 10 percent bracket.<sup>86</sup> On the other hand, a \$1,000 refundable personal tax credit would have the same value for all individuals.

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83. See e.g. Shaviro, *supra* n. 73, at 1198.

84. Alternatively, some have suggested replacing many of the current family benefits with a \$2,000 per child "simplified family credit." See e.g. Sawicky, *supra* n. 81.

85. In 2002, for example, the federal government spent almost \$20 billion on food stamp benefits. Comm. Ways and Means, U.S. House of Representatives, *supra* n. 52, at Section 15, Other Programs (Food Stamps), 15-FOODSTAMPS-5 tbl. 15-FOODSTAMPS-1 (posted Dec. 17, 2003). See e.g. Jonathan B. Forman, *Time to Cash Out Food Stamps*, Legal Times: Law and Lobbying in the Nation's Capital, 36 (Feb. 22, 1993); David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs* 50-67 (John M. Olin Program in Law & Economics Working Paper No. 194, 2d series, 2003) (available at <http://www.law.uchicago.edu/Lawecon/>) (accessed May 17, 2004).

86. The value of a tax deduction is equal to the amount of the deduction times the taxpayer's marginal tax bracket. So a taxpayer in the 28 percent bracket will save \$868 from a \$3,100 personal exemption, while a taxpayer in the 10 percent bracket will save just \$310.  $\$868 = .28 \times \$3,100$ ;  $\$310 = .10 \times \$3,100$ .

Like most other transfer programs, demogrants would result in some reduction in work effort by beneficiaries.<sup>87</sup> The reduction in work effort, however, should be much less than under welfare-type transfer programs with their high benefit-reduction rates. Demogrants, by definition, are universal and do not phase out. Facing *only* normal tax rates and no phase-out or benefit-reduction, the recipients of demogrants would face low effective marginal tax rates and so should have virtually every incentive to get out and work to earn more money to support themselves and their families.

## VII. A MORE COMPREHENSIVE SOLUTION

Beyond simply restructuring the earned income tax credit, it could be even more advantageous to fundamentally restructure the current tax system, for example, by integrating the current income and Social Security taxes into a single, comprehensive income tax system.<sup>88</sup> That integrated tax system could have just a few progressive tax rates, and it could easily accommodate a few refundable tax credits.

For example, imagine an integrated tax system with \$2,000 per worker refundable earned income tax credits (computed as 20 percent of the first \$10,000 of earned income), \$2,000 per person refundable personal tax credits, and two tax rates: 20 percent of the first \$100,000 of income and 30 percent on income in excess of \$100,000. Assume further that there is no phase-out of either the personal tax credits or the worker credits. Table 2 and Figure 6 show how this integrated, comprehensive income tax system would work for single parents with two children making from \$0 to \$200,000, and Figure 7 shows the effective marginal tax rates imposed by this tax system at various income levels.

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87. See e.g. Robert A. Moffitt, *Economic Effects of Means-tested Transfers in the U.S.*, Tax Policy and the Economy vol. 16, 1 (James Poterba, 2002).

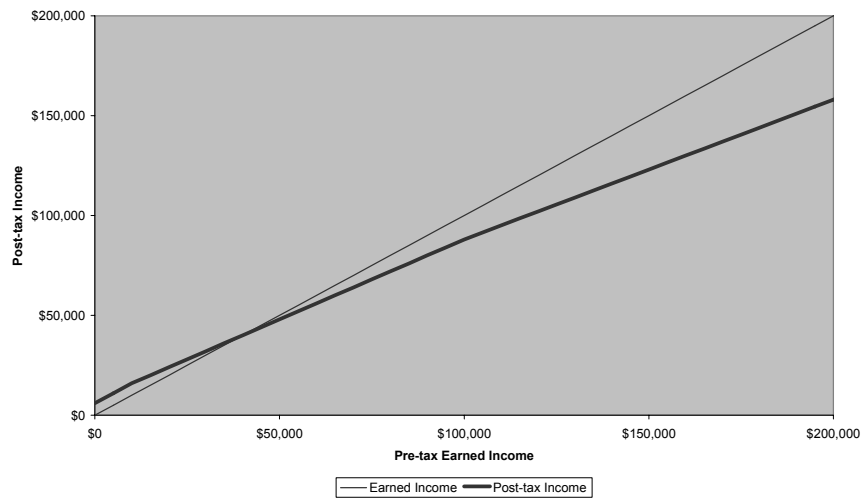
88. The alternative minimum tax would also disappear.

TABLE 2

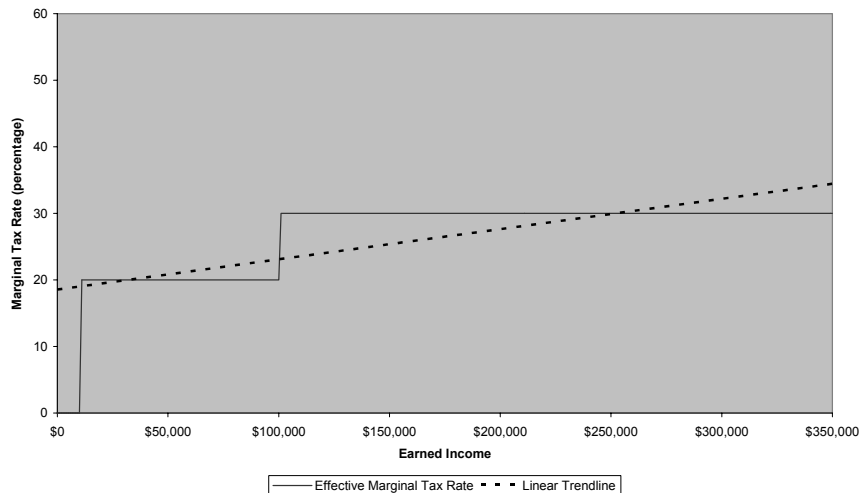
How an Integrated, Comprehensive Income Tax System Would Affect a Single Parent with Two Children (\$2,000 Demogrants, \$2,000 per Worker Credits, and 20 and 30 Percent Tax Rates)

<i>Pre-transfer Earnings</i>	<i>Plus Demo-grant Amount</i>	<i>Plus Worker Credit</i>	<i>Less Tax Imposed</i>	<i>Equals After-tax Income</i>
0	\$6,000	0	0	\$6,000
\$5,000	\$6,000	\$1,000	\$1,000	\$11,000
\$10,000	\$6,000	\$2,000	\$2,000	\$16,000
\$20,000	\$6,000	\$2,000	\$4,000	\$24,000
\$30,000	\$6,000	\$2,000	\$6,000	\$32,000
\$40,000	\$6,000	\$2,000	\$8,000	\$40,000
\$50,000	\$6,000	\$2,000	\$10,000	\$48,000
\$100,000	\$6,000	\$2,000	\$20,000	\$88,000
\$150,000	\$6,000	\$2,000	\$35,000	\$123,000
\$200,000	\$6,000	\$2,000	\$50,000	\$158,000

FIGURE 6 How an Integrated, Comprehensive Income Tax System Would Affect a Single Parent with Two Children (\$2,000 Demogrants, \$2,000 Per Worker Credits, and 20 and 30 Percent Tax Rates)



**FIGURE 7 Effective Marginal Tax Rates for a Parent with Two Children and Earned Income Only in a World with an Integrated, Comprehensive Income Tax System (\$2,000 Demogrants, \$2,000 Worker Credits, and 20 and 30 Percent Tax Rates)**



Together, Table 2 and Figures 6 and 7 show how this simple tax and demogrant system could help meet the income needs of low-income families without undermining the incentive to work. In sharp contrast to the current tax system (as portrayed in Figures 2c and 4b), Figure 7 shows that marginal tax rates would not fluctuate, nor would the highest effective marginal tax rates be imposed on low- and moderate-income taxpayers.

To avoid marriage penalties and bonuses, it would also make sense for this integrated, comprehensive income tax system to have individual filing, rather than joint filing for married couples.<sup>89</sup> Then, each worker could claim her own personal tax credit and her own worker credit and face the 20-percent rate before hitting the 30-percent maximum tax rate. Also, this comprehensive income tax system could easily be designed as a return-free, final withholding system. The amounts withheld from employers and other income sources would be the tax. Consequently, few taxpayers would ever need to file tax returns.<sup>90</sup> Such a return-free system could significantly reduce burdens on both taxpayers and the IRS.<sup>91</sup>

89. See e.g. Jonathan B. Forman, *What Can Be Done About Marriage Penalties?*, 30 Family L. Q. 1 (1996).

90. See e.g. U.S. Dept. of Treas., *Report to the Congress on Return-Free Tax Systems: Tax Simplification is a Prerequisite* (U.S. Dept. of Treas. 2003); William J. Turnier, *PAYE as an Alternative to an Alternative Tax System* 23 Va. Tax Rev. 205 (2003).

91. The Treasury report estimates that up to 52 million taxpayers (41 percent) could be freed from having to file income tax returns with an exact withholding system. U.S. Dept. of Treas., *supra* n. 90, at 24. Most of these people no longer would have to gather information, become familiar with tax



All in all, an integrated, comprehensive income tax system with refundable credits would be simpler to administer than the current tax system, and it would minimize work disincentives on low- and moderate-income workers with children. In short, this approach would make the tax system work-friendly.

### VIII. CONCLUSION

The current federal tax system imposes some of its highest effective marginal tax rates on low- and moderate-income workers. These high effective tax rates result primarily from the combination of income taxes, Social Security taxes, and the phase-out of the earned income tax credit. The problem is that these high effective tax rates tend to discourage work effort and skill development by many of the very individuals who are trying to work their way out of the welfare system.

One way to reduce these high effective marginal tax rates on low- and moderate-income workers would be to restructure the earned income tax credit. For example, one approach would be to replace the current credit with a \$10,000 per worker exemption from Social Security taxes and a \$1,000 per child refundable tax credit. A similar approach would be to replace the current earned income tax credit with a universal \$2,000 per worker earned income tax credit and a \$1,000 per child refundable tax credit.

A more comprehensive approach would be to fundamentally restructure the current system by integrating the current income and Social Security tax systems into a single, comprehensive income tax system. That system could have just a few progressive tax rates, and it could easily accommodate a few refundable tax credits. For example, an integrated, comprehensive income tax system might have \$2,000 per worker refundable earned income tax credits, \$2,000 per person refundable personal tax credits, and just two tax rates: 20 percent of the first \$100,000 of income and 30 percent on income in excess of \$100,000. Such a system would be easier to administer than the current system, and it would minimize work dis-

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laws, or prepare and file returns. The burden on the IRS also would be greatly reduced. Moreover, even more taxpayers could be freed from having to file returns if Congress were to restructure the tax system. In that regard, the Treasury report notes that exact withholding would work best if we had fewer tax rates; fewer deductions, allowances, and credits; and if interest and dividend income were taxed at a flat rate and withheld at the source. It would also make sense to get rid of joint tax returns and instead have the unit of taxation be the individual, not the family. *Id.* at 2. Of note, pursuant to Section 2004(a) of the Internal Revenue Service Restructuring and Reform Act of 1998, the Secretary of the Treasury is required to develop procedures for implementing a return-free system by the year 2007. *Id.* at 1.

2004                    *DESIGNING A WORK-FRIENDLY TAX SYSTEM*                    155

incentives on low- and moderate-income workers with children. In short, this approach would make the tax system work-friendly.