Let’s Combine the Income and Payroll Taxes into a Rational Tax System

By Jonathan Barry Forman

Many of the problems of the current tax system are attributable to there being two major taxes imposed on individuals: income taxes and Social Security payroll taxes. Under current law, Social Security taxes are collected on every dollar of earned income, and the income tax system uses the earned income tax credit and a portion of the child tax credit to refund at least part of those taxes to millions of low-income workers. It would be a lot simpler if the federal tax system did not collect Social Security taxes from low-income individuals in the first place, and one approach would be to add a $10,000 per worker exemption to the Social Security system. Another approach would be to use universal earned income tax credits to offset those payroll taxes. For example, a $1,530 per worker earned income tax credit could exactly offset both the employer and employee portions of the Social Security payroll taxes on the first $10,000 of wages.

A more comprehensive approach would be to combine the individual income and Social Security taxes into a single, comprehensive tax system. That comprehensive tax system could be based on income, earnings, consumption, wealth, or some combination of these.

A Comprehensive Income Tax

For example, consider how the individual income tax and the Social Security payroll tax could be combined into a comprehensive income tax system. Individuals with incomes below some poverty threshold would be exempt from tax, and tax rates could be increased in order to raise the same amount of revenue as the current system. In effect, there would be a single, higher-yield income tax instead of the current bifurcated tax system. Such an integrated system would be simpler to administer than the current system. Literally millions of low-income individuals would no longer have to file tax returns simply to recover over-withheld taxes.

Moreover, such an integrated tax system could have a logical tax rate structure, as opposed to the roller-coaster rate structure of the current tax system. Now, an individual’s effective marginal tax rate depends upon an almost random combination of income tax rates, Social Security tax rates, and phase-outs (of the earned income credit, the child tax credit, the dependent care credit, personal exemptions, and many other tax benefits). On the other hand, an integrated tax system could be designed to impose, say, no tax on income below some poverty threshold, a 20-percent tax rate on income from that threshold up to, say, $50,000 of income, and a 30-percent tax rate on income over $50,000. Alternatively, such a system could be designed to impose no tax on income up to some poverty threshold and a 25-percent “flat” tax rate on income above that threshold. Either of these alternatives would be modestly progressive, but in a logical, easy-to-understand way.

Also, an integrated tax system could easily accommodate a few refundable tax credits. For example, one could easily imagine an integrated tax system with $1,000 per person refundable tax credits and just two tax rates: 20 percent of the first $50,000 of income and 30 percent on income in excess of $50,000. To encourage work, the system could also have a $2,000 per worker refundable earned income credit (computed as 20 percent of the first $10,000 of earned income), and there would be no need to phase out of either the personal tax credits or the worker credits.

To achieve a rate structure like this, the tax system could not afford to have many special deductions and credits. Virtually all of them would have to be repealed or capped, except perhaps the deductions for home mortgage interest and for charitable contributions. To avoid marriage penalties and bonuses, this comprehensive income tax system would have individual filing. Each worker could claim her own $1,000 personal tax credit and her own $2,000 worker credit and face the 20-percent rate before eventually hitting the 30-percent maximum tax rate. A comprehensive income tax system could also be designed as a 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.

All in all, an integrated, comprehensive income tax system would be simpler and fairer than the current system, it would lower the tax rate on earned income, and it would rationalize the rate structure for all workers. As a result, it would promote greater economic justice and minimize work disincentives – with revenue neutrality.

Corporate Tax Integration

The corporate income tax could also be folded into a comprehensive income tax system. Since people ultimately bear the burden of the corporate income tax, it is not necessary to tax corporations. The system should instead tax their shareholders.

Theoretically, this integration could be accomplished either by eliminating the corporate tax or by excluding dividends received from shareholder income. Either approach would eliminate the so-called double tax on corporate earnings that comes from taxing both corporate income and the dividends that corporations pay to their shareholders. In that regard, the Jobs Relief and Reconciliation Act of 2003 achieved a degree of partial integration by cutting the maximum tax rate imposed on dividends received by individual shareholders to just 15 percent.

Full corporate tax integration could be accomplished, for example, by repealing the corporate income tax and taxing the dividends received by shareholders at the ordinary progressive tax rates. More specifically, we could repeal the corporate income tax, and
tax shareholders on their proportionate share of corporate earnings each year, whether those earnings were distributed in the form of dividends or retained as corporate investments.

An alternative way to achieve full corporate tax integration would be to tax all corporate income at a flat rate of, say, 30 percent, and exclude 100 percent of dividends received by individual shareholders. Adjustments could be made for shareholders in tax brackets lower than 30 percent.

Presumably, individual income tax rates would need be increased somewhat to make up for the loss of corporate income tax revenues. For example, to accommodate full corporate tax integration, the top rate might have to be increased to, say, 35 percent or, alternatively, the point for the proposed 30-percent top bracket might have to be lowered to, say, $40,000.

**Comprehensive Consumption Tax Alternative**

Another comprehensive tax reform alternative would be to replace the current income and payroll tax systems with a progressive personal consumption tax along the lines of the cash flow tax described in the U.S. Department of Treasury’s *Blueprints for Tax Reform* (TAX ANALYSTS, 2d ed., revised 1984).

Under a personal consumption tax, all forms of savings would be entitled to the tax-deferred status currently available for retirement savings. Basically, each individual would total her income from wages, dividends, interest, gains, and other sources; and subtract her net savings to get to taxable consumption. In short, all types of savings would be tax-favored.

Most investments would be kept in so-called “qualified accounts” that would be handled in much the same way that Individual Retirement Accounts (IRAs) are utilized under current law. A taxpayer would deduct any amount deposited into a qualified account; the earnings on deposits would be tax-exempt; and the taxpayer would include the amount of any withdrawals in the tax base. To capture consumption out of borrowed funds, taxpayers would also include loan proceeds in the tax base, but they could deduct payments of loan principal and interest.

The so-called tax prepayment approach would apply to investments in housing and other consumer durables. Under this approach, investments would not be deductible, but the investment proceeds would not be included in the tax base when consumed. For example, the purchase price of an automobile would not be deductible, but the subsequent sales receipts would be excluded from the tax base. Also, if a loan were used to help buy the car, the loan proceeds would be excluded from the tax base, but no deduction would be allowed for repayment of the loan principal and interest.

Unfortunately, because a consumption tax base is smaller than an income tax base, tax rates would have to be higher under a consumption tax than under an income tax to raise the same amount of revenue. For example, according to the Council of Economic Advisors’s *Economic Report of the President 2006*, while the total personal income of all Americans in 2005 was $10.2 trillion, total personal consumption expenditures totaled just $8.7 trillion. Consequently, to raise the almost $2.4 trillion that the federal government spent that year, the average consumption tax rate would need to be around 27 percent, compared with an average income tax rate of just 23 percent.

**Conclusion**

Ultimately, the federal government may adopt a value-added tax (VAT) system for a large portion of its revenue needs, while retaining some form of progressive income, consumption, or wealth tax on high-income individuals. Such a system would collect all of its value-added tax revenues from just 10 or 20 million producers and sellers, and the government could collect additional revenues from progressive income, consumption, and/or wealth taxes imposed on just 20 or 30 million high-income families.

In the near term, however, it is more realistic to think about restructuring the current tax system, rather than replacing whole portions of it with new and untried taxes. This approach follows that old maxim of tax design that “an old tax is a good tax.” A good place to start is by integrating the individual income tax, the Social Security payroll tax, and the corporate income tax into a comprehensive income tax system.

All in all, such a restructured tax system would be simpler to administer than the current system, and it would both minimize work disincentives and promote greater economic justice than the current system. Low- and moderate-income individuals would have every incentive to get out there and work, and even high-income individuals would face smaller work disincentives than under the current tax system.

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**Editor’s Note:** The views in this article represent those of the author but not either the University of Oklahoma or Tax Executives Institute.