ATTACKS ON A TAX: AN ALTERNATIVE TO THE EARNED INCOME TAX CREDIT TO REMEDY THE UNFAIRNESS IN THE PAYROLL TAX SYSTEM

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I. INTRODUCTION

The United States raises revenue through a variety of taxes that are fragmented or "disaggregated" into multiple components.[1] Although most Americans think of taxes primarily in terms of the income tax, its lesser known cousin, the payroll tax, produces nearly identical revenues while falling disproportionately on the poor and middle-class.[2] Disaggregating the tax system into several component taxes thus conceals the true aggregate tax burden on taxpayers. This misleading effect is exaggerated because the media and politicians focus on the income tax while ignoring the equally significant payroll tax.

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1. Edward J. McCaffery & Jonathan Baron, *The Humpty Dumpty Blues: Disaggregation Bias in the Evaluation of Tax Systems*, 91 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 230, 231 (2003), *available at* http://www.sciencedirect.com/science/journal/07495978.

2. Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1, 2–3 (2002).

In recent years, taxes have played a central role in most major political campaigns. President George W. Bush centered his campaign on tax issues,[3] and passage of his 2001 tax relief package, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), was one of the first major accomplishments of his administration.[4] Yet, despite this pronounced emphasis on reducing taxes, the media and politicians from both parties appear oblivious to the payroll tax, even though it represents the single largest tax for two-thirds of all Americans.[5] Indeed, even as President Bush made tax cuts for the working poor a priority for his administration, these cuts generally affected only income taxes.[6] His 2001 budget included extensive discussion on the income tax, but the sole mention of the payroll tax appeared in a footnote.[7]

From 1963 to 1995, the payroll tax went from producing less than half the revenues of the income tax to producing a nearly identical amount.[8] More significantly, these two taxes that once impacted economically disparate groups have converged. Although the poor and middle-class were once largely exempt from the income tax, many of the working poor are now subject to some income tax liability.[9] This expansion produced substantial inequities in our federal system of taxation. The poor and middle-class pay a much higher percentage of their income in payroll taxes than the rich.[10] This impact, however, is not limited to the poor or middle-class: The vast majority of Americans with earnings of less than $100,000 pay more in payroll taxes than they do in income taxes.[11] Moreover, because the media and politicians focused their attention almost entirely on the income tax, this substantial increase in taxation on the working poor

3. *See* McCaffery & Baron, *supra* note 1, at 231.

4. David E. Sanger, *President's Signature Turns Broad Tax Cut, and a Campaign Promise, Into Law*, N.Y. TIMES, June 8, 2001, at A22.

5. Though the rise in payroll taxes is beginning to receive some attention from academics, one of the first and most compelling arguments on the subject actually took place in a most unexpected place: comedian Al Franken's satirical commentary on American politics in his book *Rush Limbaugh Is a Big Fat Idiot and Other Observations*. *See* AL FRANKEN, RUSH LIMBAUGH IS A BIG FAT IDIOT AND OTHER OBSERVATIONS 127–29 (Dell Publ'g 1999) (1996).

6. *See* OFFICE OF MGMT. AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT OF THE UNITED STATES, A BLUEPRINT FOR NEW BEGINNINGS: A RESPONSIBLE BUDGET FOR AMERICA'S PRIORITIES 33–36 (2001), *at* http://www.whitehouse.gov/news/usbudget/blueprint/blueprint.pdf [hereinafter BLUEPRINT].

7. *See id.* at 36.

8. Andrew Mitrusi & James Poterba, *The Distribution of Payroll and Income Tax Burdens, 1979–99*, 53 NAT'L TAX J. 765, 765 (2000).

9. *See* Geier, *supra* note 2, at 24.

10. *See id.*

11. Mitrusi & Poterba, *supra* note 8, at 771–73.

and middle-class went virtually unnoticed. Some leading commentators even claimed that the poor have been the chief beneficiaries of the last twenty years of income tax cuts, ignoring the considerable increase in their aggregate tax burden.[12]

The Earned Income Tax Credit ("EITC") is the most significant response to this growing problem. Despite being designed to offset the burden of payroll taxes, the EITC operates through the income tax system and offers cash relief in the form of a refundable tax credit, determined by the recipient's income, marital status, and number of children. The EITC is a useful means for providing the working poor with relief from the heavy burden of payroll taxes; nevertheless, it is beset with problems. The EITC can discourage marriage, create a disincentive for the second spouse to enter the work force, and is vulnerable to fraud. Perhaps most importantly, the structure of the EITC potentially creates a strong disincentive to increase one's income.

There is no shortage of suggestions from both political extremes on how to deal with this situation. Conservative Senator Phil Gramm describes the EITC as "welfare,"[13] and claims that any cut in payroll taxes is "tantamount to 'giving a tax cut to people who do not pay taxes.'"[14] At the other extreme, Deborah Geier proposes eliminating payroll taxes in their entirety and making up the lost revenue by raising income tax rates.[15] This difference of opinion stems from fundamentally different views about how the tax system should be used to combat poverty. Geier seems principally concerned with supporting the working poor and middle-class by offering them tax-favored status. Gramm seems primarily concerned with encouraging work and believes programs, such as the EITC, tether the poor to their station in life and make it extremely difficult for them to escape poverty. Both are correct, but arguably incomplete in their analyses. This Note instead suggests an approach that would benefit the working poor without creating a constraint that discourages work.

The solution offered here sidesteps many of the problems associated with the EITC and makes sense from a practical standpoint. The solution is

12. *See, e.g.*, FRANKEN, *supra* note 5, at 126–32 (challenging Rush Limbaugh's claim that tax rates for the poor decreased most dramatically under President Reagan and President H.W. Bush).

13. *See* Jackie Calmes & Christopher Georges, *Senate, House Gear Up to Vote on Taxes, Budget as President Vows to Veto Cuts*, WALL ST. J., Oct. 26, 1995, at A2.

14. Geier, *supra* note 2, at 30 (quoting Heidi Glenn & Warren Rojas, *Column A, Column B: Washington Orders Up $50–$75 Billion Stimulus*, 93 TAX NOTES 167, 169 (2001)).

15. *Id.* at 8–9. Yet, recognizing the political difficulty of such an extreme measure, Geier alternatively proposes allowing an income tax deduction for payroll taxes paid. *Id.* at 9–10.

to put the relief currently offered through the EITC directly into the payroll tax system in the form of a weighted payroll tax-rate reduction based on the same factors that currently determine the size of one's EITC benefits. This solution would not be vulnerable to fraud, discourage marriage, or deter the second spouse from entering the work force. Moreover, such a program would likely prove more popular with taxpayers. An intriguing new study suggests that our disaggregated tax system is not easily reassembled in the minds of most Americans.[16] This phenomenon, dubbed the "Humpty Dumpty Blues," suggests that internal payroll tax relief will prove much more popular than using the income tax system to remedy the inequity of the payroll tax system.

At the outset, it should be made clear that this Note is not about using the tax system to redistribute wealth from the rich to the poor. It adopts no viewpoint on whether we need more, less, or any redistributive action within the tax system. Instead, it focuses on our current system of taxation, which is redistributive, and identifies the apparent flaws of the EITC.

Part II of this Note provides a brief introduction to tax terminology, payroll taxes, federal income taxes, and the EITC. Part III presents the argument that payroll taxes, which are often portrayed to the public as retirement contributions, are actually more akin to traditional income taxes than to retirement contributions. Part IV illustrates the problems caused by the EITC and then discusses how moving to a system of internal payroll tax relief would resolve many of these problems.

II. BACKGROUND

To understand fully the problems caused by our current disaggregated tax system, it is necessary to have an understanding of some basic tax terminology. Specifically, it is important to understand the difference between progressive and regressive tax rates, as well as the difference between effective and marginal tax rates and the value of each in assessing the impact of a tax. After discussing these distinctions, this part explains the current structure of the payroll tax, the federal income tax, the EITC, and the Child Tax Credit.

16. *See* McCaffery & Baron, *supra* note 1, at 231–33.

A. TAX TERMINOLOGY: THE DIFFERENCES BETWEEN PROGRESSIVE AND REGRESSIVE TAXES AND MARGINAL AND EFFECTIVE TAX RATES

The income tax system is progressive, which means that as income increases the percentage rate of taxation also increases.[17] In 2002, the income tax consisted of six rate brackets with rates increasing at higher levels of income.[18] A regressive tax rate is just the opposite. In a regressive system, the poor pay a greater percentage of their income than the rich. An example of this is Social Security, which taxes all income at a flat rate up to a predetermined ceiling, and exempts all income above that ceiling from taxation.[19] This structure essentially creates two brackets: a "taxed" bracket, which currently applies a 12.4% tax on all income up to $87,000, and a "tax free" bracket, which applies a 0% tax on all income above $87,000.[20] Thus, the more an individual earns above the ceiling, the smaller the percentage of that individual's total income is paid in Social Security taxes.[21]

The "effective" or average tax rate is computed by dividing the total amount of tax paid by earned income.[22] For instance, if a worker earned $10,000 in salary and paid $4000 in taxes, that worker's effective tax rate is 40%. The marginal tax rate is the percentage of taxation a worker faces on his or her next dollar earned.[23] In other words, the marginal tax rate tracks how much each dollar of salary is actually worth to the employee. If tax rates were flat, the marginal tax rate and the effective tax rate would be equal. Tax rates are usually graduated, which can cause a pronounced difference between the two.[24] To illustrate this, assume a tax system that imposed a rate of 25% on the first $100,000 of income and 50% on all income above that. If Aaron were a taxpayer with an annual income of $150,000, he is liable for $50,000 in taxes ($25,000 on the first $100,000 of income, and $25,000 on the $50,000 of income over that). Thus, Aaron's

17. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 4–5 (9th ed. 2002).

18. *See id.* at 5.

19. *See* Geier, *supra* note 2, at 10.

20. *See* SOCIAL SECURITY ADMIN., PUB. NO. 05-10024, UNDERSTANDING THE BENEFITS 11 (2003), *available at* http://www.ssa.gov/pubs/10024.html [hereinafter UNDERSTANDING THE BENEFITS].

21. To illustrate this, imagine two workers, Bob and David. Bob earns $10,000 per year while David earns $1,000,000 per year. Bob will pay the full 15.3% payroll tax rate on all of his wages, meaning he pays $1530 or 15.3% of his earnings in payroll taxes. Meanwhile, David is exempted from Social Security above $87,000 so he pays a total of $39,788 ($10,788 at 12.4% of $87,000 in Social Security plus $29,000 in Medicare at 2.9% of $1,000,000), or an effective tax rate of less than 4% in payroll taxes.

22. *See* CHIRELSTEIN, *supra* note 17, at 5–6.

23. *Id*.

24. *Id*. at 5–6.

effective tax rate would be 33.3%. If Aaron were to receive a raise, however, his marginal tax rate on each additional dollar of income would be 50%.

From an analytical standpoint, effective tax rates have a different use than marginal tax rates. Effective tax rates are useful for examining the fairness of a given tax system because they describe a taxpayer's aggregate tax burden. On the other hand, marginal tax rates are useful for analyzing behavior.[25] The way an individual will decide to act is not based on his or her total tax burden, but rather, on the marginal cost of carrying out that particular action.

To illustrate this, assume Joe is an actor who earns $100,000 per movie and currently appears in two movies per year. If the government imposes a flat tax of 50% on earnings, Joe will be taxed at a marginal and effective rate of 50%, resulting in Joe keeping $100,000 of his earnings and paying $100,000 in taxes. Assuming Joe does not value his leisure more than the $50,000 per movie, he will continue to appear in both movies. Now, assume that the government changes the system to one that imposes no tax on the first $100,000 in income and a 100% rate on all additional income. If Joe continued to appear in two movies per year, his effective tax rate would be precisely the same 50% that he previously found acceptable. Of course, Joe would never appear in the second movie because the marginal rate of 100% would render appearing in it nothing more than a donation of labor. As the above example illustrates, high marginal tax rates can have a dramatic effect on one's behavior. From the standpoint of efficiency, "it is a truism in economics that the distortion caused by a tax rises more than proportionately with the marginal tax rate—indeed, roughly with the square of the rate."[26]

B. THE PAYROLL TAX TODAY

The Federal Insurance Contributions Act ("FICA"), or payroll taxes, as they are more commonly referred to, actually consist of three distinct taxes: (1) Old Age and Survivors Insurance ("OASI"), which provides regular cash income to retired workers, (2) Disability Insurance ("DI"), and (3) Health Insurance ("Medicare").[27] OASI and DI ("OASDI," or more

25. *See* DANIEL N. SHAVIRO, EMPLOYMENT POLICIES INST., EFFECTIVE MARGINAL TAX RATES ON LOW-INCOME HOUSEHOLDS 8 (1999), *at* http://www.epionline.org/studies/study_shaviro_02-1999.pdf.

26. *Id.* at 16.

27. Maureen B. Cavanaugh, *On the Road to Incoherence: Congress, Economics, and Taxes*, 49 UCLA L. REV. 685, 694 (2002).

commonly, “Social Security”) are taxed together at a flat rate of 6.2% on both the employee and the employer, for a combined rate of 12.4%.[28] Social Security, however, has an annually adjusted ceiling, above which no additional Social Security taxes are paid.[29] For 2003, earnings in excess of $87,000[30] were not subject to any Social Security tax, which is an increase from a ceiling of $76,200 in the year 2000.[31] Medicare, conversely, is taxed at a relatively low flat rate of 1.45% on both the employee and employer, for a combined rate of 2.9%.[32] Unlike OASDI, Medicare has no ceiling.[33] Thus, the combined rate of payroll taxes on any employee is 15.3% for his or her first $87,000 in earnings.[34] An identical 15.3% rate is imposed on self-employed individuals.[35]

Many believe that the employee is only taxed at a rate of 7.65%, while the employer is taxed separately at a rate of 7.65%. Such a conclusion, however, is deceptive. Although economics dictates that the employer pass on the cost of this tax in the form of lower wages,[36] splitting the payroll tax burden between employee and employer still results in a small income tax advantage for the employee. If, instead, the government imposed the full 15.3% rate on the employee, the employer could raise salaries by the 7.65% share the employer once shouldered. The employee’s take-home salary would remain the same, but his pretax income would increase by 7.65%, subjecting him to a higher level of income tax. By splitting the payroll tax burden, the employee effectively receives a tax deduction in the amount of the employer’s share. Accordingly, Daniel Shaviro discounts the true marginal rate of payroll taxes to 14.2%.[37] Some economists further

28. *See id.*

29. *See* UNDERSTANDING THE BENEFITS, *supra* note 20, at 11.

30. *Id*.

31. IRS, DEP’T OF THE TREASURY, PUB. NO. 15, CATALOG NO. 10000W, CIRCULAR E, EMPLOYER’S TAX GUIDE 23 (rev. 2003), *available at* http://www.irs.gov/pub/irs-pdf/p15.pdf.

32. *See id.* at 15, 23.

33. *Id*.

34. *See* UNDERSTANDING THE BENEFITS, *supra* note 20, at 11.

35. *See id.*

36. *See* SHAVIRO, *supra* note 25, at 10.

37. *Id*. at 10. To compensate for having to pay all 15.3%, the self-employed individual is allowed to deduct one-half of his or her payroll taxes. To illustrate why this is fair, consider the following example: Sam and Eddie are both gardeners. Sam is self-employed, and Eddie works for Employment, Inc. They are equally skilled and an hour of their time is worth $5. Assume the government imposes a 40% payroll tax on self-employed workers or, in an employee-employer situation, a rate of 20% on the employee and 20% on the employer. For one hour of work, Sam will receive $5 in income and pay $2 in payroll tax. Employment, Inc., however, will lower Eddie’s salary by $1 to reflect the $1 that Employment, Inc. must send to the government, meaning Eddie will receive $4 in income and pay $1 to the government. Both men are left with $3, and are each responsible for the government receiving $2 in payroll taxes. For income tax purposes, however, Sam must recognize $5

discount the payroll tax rate to reflect the value of the future benefits derived from the payment of payroll taxes (i.e., Social Security payments and Medicare). This Note adopts 11% as a compromise between the various rates proposed by the economists who have written on the subject.[38] This breaks down to a rate of 9% for Social Security and 2% for Medicare.

Every year a taxpayer works, his or her payroll taxes pay for Social Security credits.[39] In 2003, a taxpayer earned one credit for every $890 in income, subject to a limit of no more than four credits per taxpayer per year.[40] Most people need to earn forty credits to be eligible for Social Security, but earning additional credits does not enhance one's benefits.[41]

The first step in calculating benefits is computing an average monthly salary for the taxpayer over the taxpayer's highest-paid thirty-five years of employment.[42] If the taxpayer worked less than thirty-five years, any shortcoming is made up using years with zero dollars for earnings.[43] Once the average has been calculated, a predetermined formula is applied to determine the level of benefits.[44] In 2002, this formula returned 90% of the first $592 of average monthly earnings, 32% on earnings between $592 and $3567, and a top rate of 15% on all earnings above $3567.[45] Due to the cap on Social Security taxes at $87,000, this top bracket will not take into account any wages earned in excess of $7250 per month.[46] Thus, benefits increase with additional salary and duration of employment, up to their respective statutory maximums.[47]

Benefits are paid not only to taxpayers who earned these benefits, but also to members of the taxpayer's family.[48] Each family member of a retiree may be eligible for up to 50% of the retiree's benefit.[49] Thus, if a

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in income while Eddie must only recognize $4. To prevent this imbalance, the government allows self-employed individuals, like Sam, an income tax deduction that mirrors the employer's share.

38. Depending on the methodology, the discounted rate can fall anywhere between 9.3% and 14.2%. SHAVIRO, *supra* note 25, at 10–11.

39. UNDERSTANDING THE BENEFITS, *supra* note 20, at 10.

40. *Id*.

41. *Id*. at 10–11.

42. Social Security Administration, How Your Benefit Is Figured, *at* http://www.ssa.gov/mystatement/howfigured.htm (last visited Oct. 24, 2003).

43. *Id*.

44. *See id.*

45. *Id*.

46. *Id*. This figure of $7250 per month was calculated by dividing $87,000 into twelve months.

47. *See id.*

48. UNDERSTANDING THE BENEFITS, *supra* note 20, at 16.

49. *Id*. at 17.

retiree is eligible for $500 per month in Social Security, the retiree's spouse may be eligible for up to $250 a month in addition to the benefits already received by the retiree.[50] Additionally, unmarried minor children may qualify for similar benefits.[51]

C. THE FEDERAL INCOME TAX TODAY

Unlike payroll taxes, income taxes are progressive: A taxpayer pays a higher rate of taxation at higher levels of income than at lower levels of income.[52] Distilled to its essence, the federal income tax is a tax on personal income minus various deductions and exemptions. In 2002, the standard deduction was $4700 for a single person and $7850 for a married couple.[53] Additionally, a personal exemption of $3000 was allowed to every taxpayer for himself or herself, the taxpayer's spouse if filing jointly, and the taxpayer's dependent children.[54] Thus, a traditional family of four had no taxable income until its total income exceeded $19,850.[55] Likewise, a single person with no dependent children paid no income tax until his or her income exceeded $7700.[56]

Once a taxpayer crosses the threshold created by his or her personal exemption or exemptions and standard deduction, each additional dollar earned is called "taxable income."[57] Thus, if a single taxpayer with no dependent children earned $8000 in a year, the taxpayer would have a taxable income of $300. After a taxpayer calculates his or her taxable income, a rate schedule determines the amount owed in taxes. For example, in 2002, single taxpayers paid 10% of the first $6000 in taxable income, 15% of the amount of taxable income between $6000 and $27,950, 27% of the amount of taxable income between $27,950 and $67,700, 30%

50. *See id.*

51. *Id.* at 16.

52. *See* CHIRELSTEIN, *supra* note 17, at 4–5.

53. IRS, DEP'T OF THE TREASURY, PUB. NO. 17, CATALOG NO. 10311G, YOUR FEDERAL INCOME TAX: TAX GUIDE 2002 FOR INDIVIDUALS 144 (2002), *available at* http://www.irs.gov/pub/irs-pdf/p17.pdf [hereinafter TAX GUIDE 2002]. All of the following numbers are based on the 2002 tax structure. Recently, President Bush signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"), which accelerated many of the tax cuts under EGTRRA. These cuts are not included in this Note because they are scheduled to "sunset," or revert, to their present level in 2004. Yet, where appropriate, they are indicated in the footnotes.

54. *See id.* at 26. At very high levels of income, the personal exemption is phased out.

55. This was computed by adding the standard deduction of $7850 to four personal exemptions of $3000 each.

56. This was computed by adding the standard deduction of $4700 to the single personal exemption of $3000.

57. *See* CHIRELSTEIN, *supra* note 17, at 2.

of the amount of taxable income between $67,700 and $141,250, 35% on the amount between $141,250 and $307,050, and a top rate of 38.6% on all taxable income in excess of $307,050.[58]

D. THE EARNED INCOME TAX CREDIT

The EITC was adopted in 1975 to help offset the burden of payroll taxes on the poor.[59] Although it was designed to counteract the impact of payroll taxes, it is administered through the federal income tax system.[60] The EITC operates by giving low-income taxpayers a refundable credit against their income tax liability,[61] with any excess credit returned to the taxpayer as a cash refund.[62] The amount of this credit is determined by the taxpayer's earned income, marital status, and number of dependent children.[63] One of the EITC's more controversial features is the relationship between the amount of earned income and the size of the credit. The credit increases with income up to a certain level, where the credit plateaus and then phases out. For example, in 2003, the EITC for a married taxpayer with two children increased steadily from $10 for $1 in earned income up to a credit of $4140 for $10,350 in income. After remaining level at a credit of $4140 for incomes between $10,350 and $14,550, it slowly begins to phase out until it is completely eliminated at $34,178.[64]

E. THE CHILD TAX CREDIT

The Child Tax Credit allows a $600 credit for each child under the age of seventeen.[65] Under EGTRRA, this will gradually increase to $1000 per child by 2010.[66] Like the EITC, the credit phases out at specified levels of income but at levels that are much higher than the EITC, beginning at

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58. TAX GUIDE 2002, *supra* note 53, at 275. It is important to recognize that these are marginal tax rates, meaning that taxpayers pay a set rate on any given level of income regardless of their total amount of taxable income. For example, Bill Gates pays the same amount of taxes on his first $6000 of taxable income ($600) as someone who has only $6000 in taxable income.

59. Michael J. Caballero, *The Earned Income Tax Credit: The Poverty Program that Is Too Popular*, 48 TAX LAW. 435, 435 (1995).

60. *See* IRS, DEP'T OF THE TREASURY, PUB. NO. 596, CATALOG NO. 15173A, EARNED INCOME CREDIT (EIC) 1–4 (2002), *available at* http://www.irs.gov/pub/irs-pdf/p596.pdf [hereinafter EARNED INCOME CREDIT].

61. *See id.* at 1.

62. *See id.*

63. *See id.* at 42–47.

64. *See id.*

65. CHIRELSTEIN, *supra* note 17, at 194. This amount is increased under JGTRRA for 2003–04.

66. *Id.*

$75,000 for single parents and $110,000 for married couples.[67] Also like the EITC, the Child Tax Credit is refundable, meaning funds exceeding the amount necessary to eliminate tax liability are returned to the taxpayer in cash.[68] The Child Tax Credit diverges from the EITC, however, by capping any refundable credit at 10% of the taxpayer's earned income in excess of $10,000.[69] This structure means the credit cannot be refunded to taxpayers with income of less than $10,000 who have two or fewer children. For a taxpayer with three or more qualifying children, the credit is refundable up to the greater of the excess credit (subject to the same 10% in excess of $10,000 of earned income limit) or the amount of Social Security taxes paid minus any EITC received.[70]

III. ARE PAYROLL TAXES REALLY RETIREMENT CONTRIBUTIONS?

Most commentators perceive Social Security as a form of retirement insurance;[71] however, some believe it is best conceptualized as a form of taxation.[72] If Social Security is not a retirement contribution, then its regressive structure is harder to justify and remedying its flaws becomes more politically feasible.

To help determine whether Social Security most closely resembles a retirement-insurance program or a tax, this Note will first identify the defining characteristics of each. *Black's Law Dictionary* defines a tax as being "[a] charge, usu[ally] monetary, imposed by the government on persons, entities, or property to yield public revenue."[73] Accepting this definition, the key elements of a tax are (1) a charge, generally in money;

67. *Id*.

68. *See id.*

69. *Id*. For example, a taxpayer with $11,000 in earned income could not receive a refund greater than $100 (10% of [$11,000 minus $10,000]). Any refund is also necessarily limited by the size of the credit itself. Thus, if a taxpayer had an income of $100,000 but only $300 in refundable credit, the refund would be $300, not $9000.

70. Internal Revenue Service, Department of the Treasury, *Tax Topics: Topic 606—Child Tax Credits*, *at* http://www.irs.gov/taxtopics/page/0,,id=16259,00.html (last visited Oct. 24, 2003). In this case, having the employer pay half of the Social Security tax becomes a marked burden. Not only is that cost passed along to the employee in the form of lowered salary, but the employee is not credited with paying that half for the purposes of receiving a Child Tax Credit refund.

71. *See* Geier, *supra* note 2, at 31 (arguing that the popular perception of Social Security as a contribution to a retirement plan is misleading).

72. *See generally id.* at 31–43 (discussing works by several authors who criticize the traditional Social Security analogy).

73. BLACK'S LAW DICTIONARY 690 (2nd Pocket ed. 2001).

(2) that is imposed by the government on the taxpayer; and (3) that yields public revenue.

Retirement plans come in two forms: defined contribution plans, like the popular 401(k), and defined benefit plans.[74] Defined benefit plans are prevalent among government employees, whereas defined contribution plans cover a majority of private employees.[75]

Defined contribution plans allow employees to determine how much, if anything, they wish to contribute to a retirement plan.[76] In a typical 401(k) plan, the employer deposits an employee-determined amount of salary, which is not subject to federal income taxation, into an individual investment account for the worker.[77] The employer often makes some matching level of contribution, which is deductible to the employer but not taxable to the employee.[78] The funds contributed to a 401(k) exclusively benefit the contributor.[79]

Defined benefit plans typically operate by awarding employees a benefit based on their salary and length of service with the employer.[80] Although the employees do not make annual determinations of how much salary to contribute to their defined benefit plans, it is elective to the extent that employees choose to accept lower base salaries in exchange for enhanced retirement benefits.

Thus, the fundamental characteristics of a retirement plan are (1) that employee participation is elective; (2) that only the employees benefit from their contributions; and (3) that the benefits are paid in proportion to the employee's contribution (be it salary in a defined contribution plan or years of employment in a defined benefit plan).

74. James F. Geld, *Distribution from Qualified Plans: The Basic Rules*, *in* UNDERSTANDING ERISA 2002: AN INTRODUCTION TO BASIC EMPLOYEE RETIREMENT PLANS, at 433, 477 (PLI Tax Law & Estate Planning Course, Handbook Series No. 536, 2002).

75. Jonathan Barry Forman, *Public Pensions: Choosing Between Defined Benefit and Defined Contribution Plans*, 1999 L. REV. MICH. ST. U. – DETROIT C. L. 187, 188–90 (1999).

76. Pamela Perun, *Phased Retirement Programs for the Twenty-First Century Workplace*, 35 J. MARSHALL L. REV. 633, 637 (2002).

77. Thus, the employee is not subject to income taxes for the contributions to his or her plan.

78. *See* Forman, *supra* note 75, at 188 n.3. This is subject to certain statutory limits. *See* I.R.C. § 401(k) (2000).

79. I.R.C. § 401(k)(2).

80. *See* Forman, *supra* note 75, at 188 n.2. For example, a typical plan might return 2% of an employee's average salary multiplied by the number of years of employment. Thus, an employee who worked thirty years would receive a pension of 60% of the employee's average salary over his or her highest-paid three years.

The debate over whether Social Security is best conceptualized as a tax or an insurance contribution will likely continue over the following decades. Nevertheless, this Note will offer a few brief examples to illustrate that Social Security is best conceptualized as a traditional tax.

First, Social Security is mandatory, not elective, on the part of the taxpayer. Moreover, it is unlikely that anyone would voluntarily choose to participate in the Social Security program unless the government mandated participation. A 401(k) plan is not subject to taxation until funds are withdrawn, and as a result, it offers a significant advantage in the time value of money over Social Security, where the income is taxed immediately.

Second, contributions to Social Security benefit society as a whole, not solely the contributing taxpayer. Current payroll tax receipts are *not* set aside for the benefit of the contributor, but go to pay current retirees.[81] In addition, there is a large annual surplus in Social Security because of the large wage base and relatively small number of Social Security recipients.[82] These excess funds are not set aside to pay for the impending crisis in Social Security when the "baby boom" generation retires, but instead are used to fund general federal government programs.[83]

Additionally, several examples demonstrate that there is little proportionality between the amount of Social Security taxes paid and the benefits received. First, because the taxes a worker pays today are used to pay benefits, retirees benefit from the large wage base and high payroll tax rates while receiving more than they paid into the system, even adjusting for interest and inflation.[84] Conversely, due to slowed population growth, the current labor force will likely receive much less in benefits than it paid into the system.[85]

A second illustration of the lack of proportionality in the Social Security system becomes evident when one spouse earns significantly more than the other. In the traditional family, one spouse, usually the wife, spends the majority of her time raising the children while the other spouse is the "breadwinner." If the wife belatedly enters the work force, she may incur significant payroll tax liability, yet is unlikely to enhance her benefits as a result.[86] This is because the Social Security system calculates benefits

81. Geier, *supra* note 2, at 37.
82. *Id*. at 37–38.
83. *Id*.
84. *Id*. at 38.
85. *Id*. at 31–38.
86. *See id.* at 36–37.

based on a weighted thirty-five year average, and offers the wife the greater of her own benefits or 50% of her husband's benefits.[87] Thus, even if the wife earned as high a salary as her husband—an unlikely occurrence as she would be joining the work force much later—she would have to work more than seventeen years before her own benefits exceeded 50% of her husband's benefits. If we assume both husband and wife earned a salary in excess of the current maximum of $87,000, the wife could pay nearly $200,000 in payroll taxes over those seventeen years and not receive one cent more in benefits than if she had never worked a day.[88] This might indeed be classified as a "contribution," but it looks more like a charitable contribution than an insurance contribution.

A third illustration of this lack of proportionality involves the system of "credits" used to determine eligibility. To be eligible for Social Security, a worker needs a minimum of forty credits.[89] A worker receives one credit for every $890 in earned income, up to a maximum of four per year.[90] Consequently, someone must work at least ten years before becoming eligible for Social Security, regardless of how much they pay into the system. Imagine two workers, Daniel and Michael. Daniel works for nine years, consistently earning a salary in excess of the Social Security ceiling. Presuming that the ceiling does not rise from its current level of $87,000, Daniel would pay a total of $97,092 over those nine years in Social Security taxes.[91] Meanwhile, Michael works for ten years, earning $3600 per year. Michael would pay only $4464 in Social Security taxes over that ten-year span. Ironically, this results in Michael receiving benefits and Daniel receiving none, despite the fact that Daniel contributed more than twenty times as much to the Social Security fund.

This is not necessarily an undesirable result. There may be no reason to feel sorry for Daniel, who amassed enough resources to retire after only nine years of work. The point is that if Social Security were a genuine retirement-insurance contribution, Daniel should receive benefits proportional to his contribution of nearly $100,000. Instead, he receives nothing while Michael receives benefits despite contributing less than $5000.

87. *See* UNDERSTANDING THE BENEFITS, *supra* note 20, at 16–17; Geier, *supra* note 2, at 37.

88. At the current Social Security tax rate of 12.4% and the current wage cap of $87,000, an individual working seventeen years with a salary at or in excess of the current wage cap would contribute $183,396 to the Social Security fund.

89. UNDERSTANDING THE BENEFITS, *supra* note 20, at 10.

90. *Id*.

91. If the ceiling were to rise, as it almost certainly would, Daniel's contribution would be even greater.

It is true that there is some relation between the Social Security taxes paid and the benefits received. Generally, one who pays more in Social Security taxes will receive more in benefits. On the other hand, this relationship is weakened by the progressive payout system that returns a much greater percentage of one's average monthly salary at low salary levels than at a high salary level. As such, those who pay the least in Social Security taxes receive the highest level of benefits on a per dollar contributed basis.

Even the Internal Revenue Service ("IRS") now seems to concede that Social Security is a tax and not a retirement contribution:

> At first, payments into Social Security were considered "contributions," not taxes. The program appeared to be self-funded—as workers contributed, they received credits toward retirement benefits. However, too many people needed help, so the program was expanded to include the families and survivors of retired and disabled workers, the unemployed, and federal workers.[92]

Based on all the above, it seems reasonable to characterize Social Security as a tax instead of a retirement contribution.[93] As such, it would stand out as a regressive tax, which most regard as unfair. Even if one does not accept this analogy of Social Security as a tax, however, there are still ample reasons to revamp the system.

IV. WHY PAYROLL TAX RELIEF FOR THE POOR IS SUPERIOR TO INCOME TAX RELIEF

If one believes that Social Security is not fundamentally different from income taxes, its regressive structure becomes harder to justify. More pressing justifications for altering the system may lie in the excessive burden it imposes on the working poor. Although the government has tried to offset this burden through the EITC, as the following section discusses, this solution has created as many problems as it has solved.

92. Internal Revenue Service, Department of the Treasury, *Understanding Taxes, Theme 2: Taxes in U.S. History, Lesson 4: The Social Security Act of 1935*, *at* http://www.irs.gov/app/understandingTaxes/servlet/IWT2L4ol (last visited Oct. 24, 2003).

93. One interesting hypothesis discussed by Geier is the work of Patricia Dilley, who argues that Social Security can best be conceptualized as a tax program designed to protect the public's interest in encouraging timely retirement and maintaining consumption among the elderly. *See* Geier, *supra* note 2, at 35–36.

A. THE PROBLEMS WITH INCOME TAX-BASED RELIEF FOR THE WORKING POOR

As the primary tax relief program for the working poor, the EITC has the peculiar distinction of being both one of the most popular[94] and most criticized[95] government programs. The EITC is popular because of what it is supposed to do: offset the regressive effects of payroll taxes, encourage work, and reduce the number of individuals on traditional welfare programs.[96] It is criticized because it has not been terribly successful at any of these goals[97] and, in fact, has created a number of additional problems for the working poor.

1. The Marriage Penalty

The EITC imposes severe "marriage penalties" that discourage the working poor from marrying.[98] A marriage penalty occurs because the tax brackets for married couples are not twice the size of those for single individuals.[99] To illustrate this, imagine a hypothetical situation of two single individuals: Mike and Carol. Mike and Carol live together and each has two children from a prior marriage. Both Mike and Carol work and each earns $10,000 per year. As long as they remain single, each would be eligible for an EITC of $4010,[100] neither would be liable for income taxes, and each would pay $765 in payroll taxes, resulting in an aggregate income of $26,490.

Assume that they decide to marry. Once married, they must file jointly, with an aggregate income of $20,000. Although this would not trigger any federal income tax liability, their combined EITC benefit would drop to only $2981.[101] They would, however, become eligible for a Child

94. *See* Caballero, *supra* note 59, at 436; Albert R. Hunt, *One Government Program that Really Works*, WALL ST. J., Oct. 28, 1999, at A27.

95. *See generally* Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995) (critiquing the many problems raised by the EITC); Caballero, *supra* note 59 (arguing that a system of payroll tax relief is superior to the EITC).

96. *See* Caballero, *supra* note 59, at 435.

97. *See generally* Alstott, *supra* note 95 (demonstrating the shortcomings of the EITC).

98. *See id.* at 559–60. As explained below, the EITC still creates a significant disincentive for the second spouse to enter the work market, even among the working poor who are already married.

99. JGTRRA substantially reduced marriage penalties caused by the asymmetry in standard deductions for married and single taxpayers. Nonetheless, many other marriage penalties remain.

100. *See* EARNED INCOME CREDIT, *supra* note 60, at 43.

101. *See id.* at 45. There is, however, a flip side to this. Assume, instead, that Mike had earned $20,000 and Carol was a stay-at-home mother with no income. In that case, marriage would actually produce a surplus, raising Mike's credit from $2770 to $2981. Nevertheless, in dual-income families, marriage will almost always result in a substantial penalty.

Tax Credit of $1000, resulting in an aggregate benefit of $3981. Each would remain liable for $765 in payroll taxes. Thus, solely due to marriage penalties, Mike and Carol's aggregate family income will drop more than 15%, from $26,490 to $22,451.[102]

This penalty can clearly discourage marriage among poor, two-income couples. A second, less obvious effect is discussed in Edward McCaffery's *The Burdens of Benefits*.[103] To illustrate, assume Mike and Carol consider marriage a necessity regardless of the tax consequences and are married. When they marry, the value of one spouse's labor has been significantly discounted. Before marriage, each spouse accounted for $13,245 in earnings among their wages, payroll taxes, and the EITC. Now, instead of earning the same amount, one spouse effectively makes $9206 due to the marriage penalty.[104] In other words, as a special wedding present from the government, one spouse received a 30% pay cut. This may result in that spouse—more often than not the wife—exiting the work force to stay at home. McCaffery sees this as ultimately reinforcing antiquated notions of gender roles, which dictated that a woman's place was in the home.[105] Even if it were conceded that one parent should stay home and raise the children, it is unlikely that we would want this decision forced on poor families solely due to an imperfection in the tax code.

2. Incentive or Disincentive: The Marginal Phase Out Cost

Many present the EITC as an "incentive to work" program.[106] This makes sense to a certain degree in that one must work in order to receive benefits from the EITC.[107] Moreover, up to a certain salary level, the size of the worker's credit increases along with his or her salary.[108] Anne Alstott refers to this period as the "earnings-subsidy range."[109] Once an

102. This figure consists of $20,000 in salary, $3981 in benefits between the EITC and the Child Tax Credit, and $765 each ($1530 combined) paid in payroll taxes.

103. Edward J. McCaffery, *The Burdens of Benefits*, 44. VILL. L. REV. 445 (1999).

104. This is because, if only one spouse worked, he or she would still earn the $13,245 in wages, payroll taxes, and EITC. Thus, the labor of the second spouse, once worth $13,245, is now worth only $9206 (the difference between the first spouse's earnings and $22,451, the total amount of income they would receive as a married couple filing jointly).

105. *See* McCaffery, *supra* note 103, at 490.

106. *See* Hunt, *supra* note 94.

107. *See* EARNED INCOME CREDIT, *supra* note 60, at 8, 42.

108. *See id.* at 42–44.

109. Alstott, *supra* note 95, at 548. Additionally, Alstott points out that even though this earnings-subsidy phase would seem to be a clear incentive to work—with the government effectively giving the employee a salary raise within this range—in reality, it may cause some disincentive to work. Workers may opt to work fewer hours because they could now work less while earning the same amount. Alstott also points out, however, that they may use their additional free time to care for

employee's salary passes this salary level, however, the size of the employee's credit briefly plateaus and then must be "paid back" as his or her salary increases.[110] This is because the EITC phases its benefits out until they disappear completely.[111] For example, a single father with two children earning $12,000 per year receives the maximum EITC of $4140.[112] If the father increases his salary to $20,000, however, his EITC drops to $2770.[113] If he continues working until he earns $33,150, he receives no EITC whatsoever.[114] The phase out of the EITC thus functions as an additional tax, with the worker losing benefits as his or her salary increases. As shown in Table 2, during this phase out range, federal marginal tax rates can reach 47%,[115] leaving a worker only fifty-three cents better off for every dollar he or she earns.[116]

Alstott notes that many more EITC recipients fall in the EITC phase out range than are in the earnings-subsidy phase, where the credit acts as a work incentive.[117] She concludes that the EITC probably reduces aggregate work effort, although to a lesser extent than the traditional welfare programs it has largely supplanted.[118]

3. Fraud

Another problem with the EITC's distribution of benefits is the incentive it creates for individuals to file falsified tax returns in order to receive the maximum benefit.[119] Although the IRS is well-equipped to audit the underreporting of income, the EITC can create an incentive for a recipient in the earnings-subsidy stage to over-report income.[120] For example, a single worker with two children and $5000 in earnings would benefit greatly from filing a falsified tax return claiming to have earned

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children or the sick, which is generally viewed as a choice benefiting society as a whole. *See id.* at 554–55.

110. *See* McCaffery, *supra* note 103, at 484.

111. *See* EARNED INCOME CREDIT, *supra* note 60, at 47.

112. *See id.* at 44.

113. *See id.* at 45.

114. *See id.* at 47.

115. A family of four would pay at a 47% marginal tax rate on income between $31,850 and $34,178. This presumes the discounted 11% rate for payroll taxes. *See infra* Table 2.

116. This does not include state and local taxes, as well as other federal and state benefits such as Temporary Assistance for Needy Families, housing subsidies, and food stamps. If those are considered, marginal tax rates can exceed 100%, resulting in a loss of income due to an increase in salary. *See* SHAVIRO, *supra* note 25, at 14.

117. *See* Alstott, *supra* note 95, at 553 (noting the argument of economist Marvin Kosters).

118. *Id*. at 550–51.

119. *See* Caballero, *supra* note 59, at 462–64.

120. *Id*. at 463.

$10,400 because, although not liable for federal income taxes, the worker's EITC would increase from $2010 to $4140.[121] An EITC recipient in the phase out range would have a similar incentive to underreport his or her income in order to receive the maximum amount of credit, although, in this case, the IRS is better prepared to spot such acts of fraud.[122] Based on its own studies of EITC compliance, the IRS estimates that between one-quarter and one-third of all funds paid out through the EITC are the result of fraudulent filings.[123]

4. The "Humpty Dumpty Blues"

Although the income and payroll taxes are separate tax systems, no distinction is made between income and payroll tax receipts. As mentioned above, surpluses within Social Security regularly go to pay for general revenues, and there is no reason the reverse could not be true as well. Money, by definition, is inherently fungible. Therefore, what should matter to individuals in assessing tax burdens is the total amount of tax paid.[124] McCaffery and Jonathon Baron, however, discovered that the result of splitting the tax burden into the two separate systems was very different in practice.[125] People analyze each tax separately, and as a result, their perceptions of fairness are not based on the aggregate amount of tax paid but rather on the levels of taxation within each tax system.[126]

This presents a problem for the EITC, which offsets the payroll tax burden by returning money through the income tax. McCaffery and Baron observed that even among those who support the poor paying nothing in taxes, considerable apprehension prevails about "negative" taxes, like the EITC, which actually refund money to the poor.[127] To illustrate, imagine a worker who pays $5000 in payroll taxes and receives an EITC of $3000. This worker's total tax liability is $2000. Contrast this with an employee who receives no EITC but is liable for only $2000 in payroll taxes. As long as the worker pays the government $2000, it should not matter what form the taxes take because the parties end up in exactly the same situation.

121. *See* EARNED INCOME CREDIT, *supra* note 60, at 43–44.

122. *See id.* at 44–47.

123. *See* IRS, DEP'T OF TREASURY, COMPLIANCE ESTIMATES FOR EARNED INCOME TAX CREDIT CLAIMED ON 1999 RETURNS 3 (2002), *at* http://www.irs.gov/pub/irs-utl/compesteitc99.pdf (Feb. 28, 2002) [hereinafter COMPLIANCE].

124. *See* McCaffery & Baron, *supra* note 1, at 230–31.

125. *See generally id.* (demonstrating the unbalanced effects of splitting the total tax burden into payroll and income taxes).

126. *See id.* at 241.

127. *Id.*

Yet, McCaffery and Baron demonstrate that even among those who would agree that $2000 is a fair tax burden for a worker with that level of income, there was much less support when this result was reached through a segregated negative and positive tax.[128] Once the tax system has been split into two parts, people seem unable to put it back into one aggregate tax again. Fittingly, McCaffery and Baron dub this phenomenon "the Humpty Dumpty Blues."

The net result of this disaggregation bias is felt by both the poor and middle-class, who often face marginal tax rates in excess of those imposed on the wealthy. In fact, as the following tables illustrate, when one aggregates the two tax systems, the illusion of progressivity disappears. Instead, we are left with variable and inconsistent tax rates as income increases.

TABLE 1. Federal marginal tax rates on a single worker with no children[129]

$0 – $4,900	3.5%
$4,900.01 – $6,150	11%
$6,150.01 – $7,700	18.5%
$7,700.01 – $11,050	28.5%
$11,050.01 – $13,700	21%
$13,700.01 – $35,600	26%
$35,600.01 – $75,400	38%
$75,400.01 – $87,000	41%
$87,000.01 – $148,950	32%
$148,950.01 – $314,750	37%
Above $314,750	40.6%

128. *See id.*

129. This table reflects only federal income tax, payroll tax, the EITC, and the Child Tax Credit. Any additional federal taxes or subsidies are not included. This table assumes a rate of 9% for Social Security and 2% for Medicare. These numbers do not include the recent tax cuts under JGTRRA.

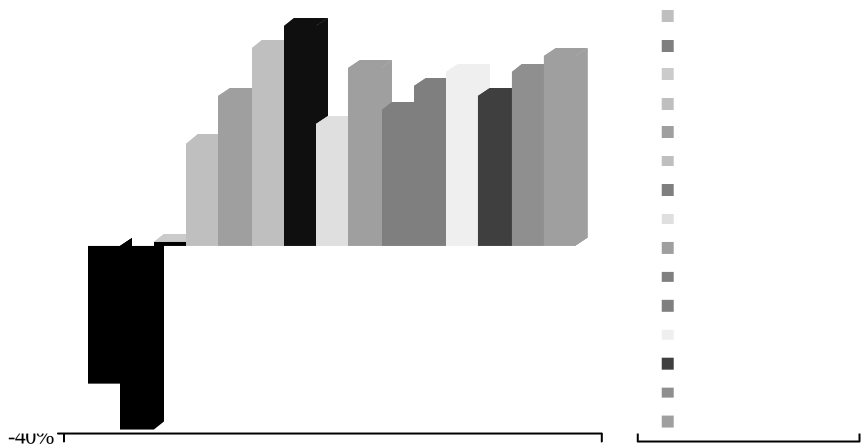
GRAPH 1. Federal marginal tax rates on a single worker with no children

TABLE 2. Federal marginal tax rates on a married couple with two children[130]

$0 – $10,000	-29%
$10,000.01 – $10,350	-39%
$10,350.01 – $14,550	1%
$14,550.01 – $19,850	22%
$19,850.01 – $22,000	32%
$22,000.01 – $31,850	42%
$31,850.01 – $34,178	47%
$34,178.01 – $66,550	26%
$66,850.01 – $87,000	38%
$87,000.01 – $110,000	29%
$110,000.01 – $132,700	34%
$132,700.01 – $134,000	37%
$134,000.01 – $191,800	32%
$191,800.01 – $326,900	37%
Above $326,900	40.6%

130. This table reflects only federal income tax, payroll tax, the EITC, and the Child Tax Credit. Any additional federal taxes or subsidies are not included. This table assumes a rate of 9% for Social Security and 2% for Medicare. These numbers do not include the recent tax cuts under JGTRRA and they presume that there is only one wage-earner. Having the second spouse working as well would not alter the chart below $87,000, but presuming the spouses have equal salaries increases all rates between $87,000 and $174,000 by 9%.

GRAPH 2. Federal marginal tax rates for a married couple with two children



Note that the result appears to be the random and arbitrary rise and fall of tax rates at various levels of income. For example, due in large part to the phase out of the EITC, the marginal tax rates for a married couple with two children and income between $22,000 and $34,178 are much greater than those for an identical couple earning between $34,178.01 and $66,550. These tables demonstrate how a disaggregated tax system can produce inconsistent and inequitable tax burdens.

B. A MODEL FOR INTERNAL PAYROLL TAX RELIEF

The problems raised as a result of the Humpty Dumpty Blues make it difficult to structure a program to offset the burden of payroll taxes in the income tax system. Thus, the solution may lie in restructuring the payroll tax system differently to avoid over-taxation of the poor. In fact, a system of payroll tax relief would resolve not only the problems raised by the Humpty Dumpty Blues, but many of the other problems with the EITC identified above.

So, how would such a program be structured? First, the EITC would be eliminated. Next, the payroll tax system would be modified to allow a full or partial exemption from payroll taxes up to a predetermined level of income. For the purposes of this model, this Note adopts $20,000 as the threshold. The size of the exemption would be keyed to the number of dependent children the taxpayer has, just as the EITC is currently. For example, instead of paying the current 15.3% combined rate, a taxpayer with no children would pay at a combined rate of 12% on his or her first $20,000 of income, a taxpayer with one child would pay at a combined rate of 6% on his or her first $20,000 of income, and a taxpayer with two or more children would pay no payroll taxes on his or her first $20,000 of income.[131] Any revenue lost by the rate reduction below the first $20,000 threshold could be recovered through eliminating the EITC and, if necessary, raising or eliminating the $87,000 ceiling on Social Security.

Furthermore, the Child Tax Credit should be expanded and the restrictions on refunds should be relaxed. In an effort to help the working poor avoid the high marginal tax rates as the EITC is phased out, President Bush expanded the Child Tax Credit, an important part of EGTRRA.[132] Under EGTRRA, the credit will double from $500 to $1000 between 2001 and 2010.[133] With the elimination of the EITC, the Child Tax Credit should immediately be expanded to $1500 to help completely offset any loss to working parents that results from the switch to payroll tax relief.

EGTRRA also marked the first time the Child Tax Credit was made refundable, although these refunds are subject to restrictions.[134] As part of the proposal to replace the EITC, this Note also proposes increasing the limit on Child Tax Credit refunds to the full amount of the excess credit or 15% of the taxpayer's total income, whichever is less.

The working poor would not be the only group to benefit from such a system. All workers would share the benefits of the payroll tax reduction, and all eligible families would share in the expanded Child Tax Credit. The public would not perceive it as a form of welfare because the entire population would share in the benefits of this program. All workers would benefit from the reduced rate of taxation on the first $20,000 in payroll taxes and all would be subject to a flat 15.3% tax rate on all wages earned above that level. This reform would go a long way toward correcting the excessive marginal tax rates on poor and middle-class families. Even if it became necessary to raise the $87,000 ceiling on Social Security, any increase would largely be offset by the rate reduction on low levels of income. Thus, the program described above could only increase payroll

131. To prevent any biases against workers based on the amount of payroll tax they would be required to pay, employers should either receive a credit or continue to pay a flat rate on salaries below $20,000. The flat rate would frustrate or hurt the employees because the cost would be offset on them, but it may prevent discrimination against workers earning more than $20,000.

132. *See* BLUEPRINT, *supra* note 6, at 34.

133. CHIRELSTEIN, *supra* note 17, at 194.

134. *See id.*

taxes on childless workers earning more than $91,313, workers with a single child earning in excess of $99,156, or workers with two or more children earning more than $107,000.[135] This system would not only be more progressive than the current payroll tax system, but would also resolve many of the problems that plague the EITC.[136]

C. WHY INTERNAL PAYROLL TAX RELIEF WOULD SOLVE THE PROBLEMS CAUSED BY THE EITC

1. The Marriage Penalty

The marriage penalty in the EITC creates a strong disincentive for the second spouse to work because it discounts the value of the spouse's additional labor. All marriage penalties stem from the tax code's asymmetrical treatment of married and single taxpayers. Unlike the income tax, which creates separate schedules for married and single taxpayers, the payroll tax treats all taxpayers as individuals.[137] As a result, taxpayers are not discriminated against based on their marital status.

Recall Mike and Carol, the married couple each of whom earned $10,000 per year. Due to marriage penalties in the EITC, they were left with $22,451 after payroll taxes. With the payroll tax-rate reduction and increased Child Tax Credit, they can keep all $20,000 in salary plus $3000 in additional Child Tax Credit for a total of $23,000. Moreover, there would not be any disincentives that would discourage the second spouse from working.

Without any features that discourage the second spouse from entering the workplace, there would be no contribution to the stereotypes discussed in *The Burdens of Benefits*.[138] In fact, there would be a considerable incentive for the second spouse to enter the work force because the second spouse would be able to keep a larger percentage of his or her income. Elimination of marriage penalties among the working poor should prove popular. Many organizations, such as the Christian Coalition, have been vocal in their support for eliminating marriage penalties wherever they exist in the tax code.[139] One would expect strong support from the

135. This is because the liability for payroll taxes above $87,000 would be partially offset by the full or partial exemption they received on their first $20,000 of income.

136. *See supra* Part IV.A.

137. *See* Caballero, *supra* note 59, at 467.

138. *See* McCaffery, *supra* note 103, at 461–66.

139. *See* Press Release, Christian Coalition of America, Christian Coalition Applauds Congress for Family Tax Relief (Mar. 28, 2001) (on file with author).

religious right for this program because the marriage penalties are most dramatic among the working poor, especially among EITC recipients;[140] and further, the poor are statistically the least likely to marry.[141]

2. Marginal Phase Out Disincentives

Another problem with the EITC is the disincentive to continue working once an individual has surpassed the credit plateau range of the EITC. This is when the taxpayer must, in effect, "pay back" the credit he or she has already earned.[142] This would not be present in the proposed system of payroll tax relief. Although marginal rates would increase above the level of the payroll tax threshold, there would be no need to "pay back" the benefit already received. The effect would be somewhat muted because this would occur at a level of income that generates little or no income tax liability.[143] This stands in sharp contrast to the large marginal increases under the EITC, which combine the costs of the phase out with a potentially higher income tax bracket and, of course, the burden of payroll taxes. Most importantly, from a policy point of view, increased labor would generate increased income without the loss of any tax benefits.

3. Fraud

One of the most significant problems with the EITC is fraud. The size of the EITC fluctuates with employees' wages, and as a result, there is a tremendous incentive to over- or underreport income in order to receive the maximum possible benefit. As noted above, up to one-third of the funds paid out through the EITC were obtained fraudulently.[144] This potential for fraud, however, would not be present with the proposed payroll tax-rate reduction. Over-reporting would not be a risk because payroll taxes are deducted at the time employees actually receive their wages. Thus, unlike the EITC, there would be no advantage in claiming more income to receive a larger refund from the government. Likewise, underreporting income would provide no benefits, other than standard income tax avoidance, which the IRS is well-equipped to detect. Thus, the problem of rampant

140. *See* Frederick J. Bradshaw, IV, *The Earned Income Tax Credit and the Marriage Penalty: New Proposals in Light of the Economic Growth and Tax Relief Reconciliation Act of 2001*, 54 TAX LAW. 701, 701 (2001).

141. Abigail Trafford, *A Poor Excuse for Marriage*, WASH. POST, Mar. 26, 2002, at F1.

142. McCaffery, *supra* note 103, at 485.

143. *See* TAX GUIDE 2002, *supra* note 53, at 263–65.

144. *See* COMPLIANCE, *supra* note 123, at 3.

fraud in the EITC is effectively eliminated by moving to a system of payroll tax relief.

4. The Humpty Dumpty Blues

The problem raised by the Humpty Dumpty Blues exists because the public is unable to reconstruct one aggregate tax from the separate structures of the payroll and income taxes. Thus, the public's aversion to negative taxes makes the EITC politically unpopular, even with those who would support an identical distribution of tax liability in the aggregate system. This problem is completely averted by a payroll tax-rate reduction. By relieving the burden of the existing regressive payroll tax system internally, there is no need to put the two taxes back together in order to reach an acceptable result. In the end, those looking to offset tax burdens on the poor should be able to meet their goals through a system of payroll tax exemptions without necessarily implicating the income tax at all.

V. CONCLUSION

Our current system of taxing the working poor is overwhelmed with problems. It has become so inconsistent that, in certain circumstances, a family may increase its gross income from $10,000 to over $30,000 and yet find itself worse off financially.[145] Our tax system is disaggregated, and as a result, it disguises the true burden imposed on poor and middle-class families.[146] It is unfortunate, in this era of heightened tax consciousness, that these problems are largely ignored.

Payroll tax-rate reduction addresses the numerous flaws of the EITC and would restore the progressivity of the entire tax system. Revenue lost from lowering rates below a threshold can easily be recovered through the elimination of the EITC, or by raising or eliminating the ceiling on payroll taxation.

Although a payroll tax-rate reduction seems to be a more effective manner of reducing the burden on the working poor than the system currently in place, political rhetoric will likely prevent it from becoming a reality. Politicians have long referred to Social Security as the "third rail" of politics, because to touch it would be to get burned.[147] This philosophy

145. *See* SHAVIRO, *supra* note 25, at 14.
146. *See* McCaffery & Baron, *supra* note 1, at 230–32.
147. Claudia Deane & Dan Balz, *GOP Puts Stock in Investor Class*, WASH. POST, Oct. 27, 2003, at A1.

will only ensure that we remain unable to make effective changes in the Social Security system until after the train has gone off the tracks.