Written by Warren Mass on September 18, 2012

When a Flat Tax Is Still a Progressive Tax

The U.S. tax code is a complex and burdensome maze of rates, exemptions, exclusions, credits, deductions, phase-out levels, and exceptions. People may not agree on anything else, but the nature of the tax code is certainly something that anyone of any political persuasion would agree on.

But with the expiration of the so-called Bush tax cuts looming on the horizon, the usual cries for reforming the tax code have been temporarily muted while attention is focused on renewing or extending the tax cuts; that is, keeping taxes from increasing on January 1, 2013.

If the Bush tax cuts are not extended, the current six tax brackets of 10, 15, 25, 28, 33, and 35 percent will decrease to five, with the rates increasing to 15, 28, 31, 36, and 39.6 percent, the child tax credit will decrease from $1,000 to $500, the maximum long-term capital gains rate will increase from 15 to 20 percent, qualified dividend income will be taxed as ordinary income rather than at the lower long-term capital gains rate, the section 179 expense deduction will decrease from a maximum of $250,000 to only $25,000, and the estate tax will increase with a vengeance.

But maintaining the status quo just averts a tax increase; it still leaves us with all the problems of the tax code.

The usual tax-reform idea, and the one that has been around the longest in a variety of incarnations, is the flat tax. Under a flat tax, there are no tax brackets and few or no tax deductions. The late economist Milton Friedman first proposed a flat tax back in 1962 when the highest marginal tax rate was 91 percent. The idea was resurrected in the 1980s by Hoover Institution economists Robert Hall and Alvin Rabushka, pushed by House Majority Leader Dick Armey in the 1990s, and then in the 2000s by former Republican presidential candidate Steve Forbes.

The Heritage Foundation, a conservative think tank, thinks it has an improvement over traditional flat tax plans. In *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity*, it proposes a "unified single tax rate" tax reform plan that "is far more comprehensive than previous well-known tax reform proposals." Under the Heritage plan, the current system would be transformed into "a modern flat tax that taxes individual income only once and replaces all federal income taxes, all payroll taxes, the death tax, and virtually all excises." A new flat-rate tax would be applied to income "after deducting all savings."

What makes this flat-tax plan so unique is that it "folds today's federal payroll taxes financing Social Security and Medicare into the new system." Up until now, this was only suggested by the FairTax proposal for a national sales tax. Americans currently pay Social Security taxes of 10.4 percent (4.2 percent on employees & 6.2 percent on employers) on the first $110,100 of income plus Medicare taxes of 2.9 percent (split between employees and employers) on all income earned. But even though payroll taxes would be eliminated, "the revenues they would have raised are credited appropriately to the

Social Security and Medicare trust funds." Income tax withholding would continue as now.

The new Heritage tax system "is designed to raise a permanent revenue stream of up to 18.5 percent of the economy as measured by GDP." To meet this target, Heritage estimates that "the statutory individual and business tax rates will likely be between 25 and about 28 percent under traditional scoring methods."

The Heritage tax plan "ends the existing tax exclusion for employee compensation in the form of employer-sponsored health insurance. This means that the value of employer-paid health insurance premiums is included in the employee's total taxable compensation." The plan also includes as income not only all labor compensation, but "all net borrowings."

Under the Heritage plan, there are only three available deductions or credits: higher education (up to the average annual cost at a four-year public college or university), charitable donations and other gifts, and home mortgage interest. To encourage seniors to stay in the workforce longer (as if that were a proper function of government), "the first $10,000 of a senior's wages and salary is excluded from tax." (There is also a "senior-specific" feature called a "senior's standard exclusion" that would only apply during the transition period in the *Saving the American Dream* proposal to save and reform Social Security and Medicare.)

The Heritage intention of a tax rate between 25 and 28 percent for everyone is fiction, and not just because the deductions for education expenses, charitable giving, and mortgage interest will only be taken by select taxpayers.

The Heritage flat tax plan is a highly progressive tax plan just like our current [Marxist tax code](#) that punishes "the rich." Who said progressivity requires graduated tax rates? And who said it is just Democrats that are obsessed with making "the rich" pay their "fair share"?

According to IRS figures for tax year 2009, the top 1 percent of taxpayers (in terms of adjusted gross income) paid 36.73 percent of all federal income taxes. The top 5 percent of taxpayers paid 58.66 percent. The top 10 percent of taxpayers paid 70.47. The top 25 percent of taxpayers paid 87.3 percent of the taxes, and the top 50 percent paid a whopping 97.75 percent.

Nothing in the Heritage plan will change this disparity because it includes "protections for low-income working households." Even though, as mentioned previously, "the value of employer-paid health insurance premiums is included in the employee's total taxable compensation" (which primarily hurts middle and upper income taxpayers), taxable income "excludes all other cash and noncash benefits provided by the federal government through its anti-poverty programs, such as food stamps" (which primarily helps lower income taxpayers). The Heritage tax plan includes the Earned Income Credit (EIC) "as part of the overall system of financial support for low-income Americans." There is no mention of what the amount of the EIC will be under the Heritage plan. Currently, for tax year 2012, the maximum amount is $5,891 (for three or more children) and the maximum income level is $45,060 ($50,270 for married filing jointly).

And then there is the new health insurance tax credit. Under the Heritage plan, there would be a credit of $2,000 for individuals and $3,500 for families used to "offset the cost of coverage offered through the workplace or to buy insurance outside the workplace." However, "for upper-income households, the new credit is typically less and is reduced as income rises." The phase-out range is from $50,000 to $90,000 for an individual and from $100,000 to $170,000 for a family. But what if a household has no tax liability? Never fear, "Financial assistance for purchasing insurance, equivalent to the tax credit, is made available to households with no tax liability and prorated to those households with a tax liability less than the value of the available credit."

And is gets even worse for "the rich" who are on Social Security or Medicare. Under the *Saving the American Dream* proposal to save and reform Social Security, benefits are means tested. Those making between $55,000 and $110,000 ($110,000 and $165,000 for married couples) will receive a reduced benefit amount. Those making more than the income ceiling "will receive no Social Security payments." The figures are the same for Medicare. Yet, because the Heritage plan "folds today's federal payroll taxes financing Social Security and Medicare into the new system," those who receive no Social Security or Medicare benefits will still pay the same 25 to 28 percent tax rate as those who don't.

The government forcing "the rich" to pay more because of their ability and subsidizing "the poor" because of their need is simply putting into the practice the Marxist dictum: "From each according to his ability, to each according to his needs."

If you want an example of a real flat tax, look no further than the 2.9 percent Medicare tax. Everyone pays 2.9 percent (split between employer and employee), on every dollar earned, no matter one's marital status, number of dependents, or income level. Any flat tax not structured like this is still a progressive tax.

The progressive U.S. income tax system is a vast income redistribution and social engineering scheme. In his powerful pamphlet *Common Sense*, Thomas Paine remarked: "Government, even in its best state, is but a necessary evil; in its worst state, an intolerable one." Although the federal government in the early years of the American republic may not have been government at its best state, the federal government as it exists today is certainly an intolerable one. It is intolerable because it embodies the role of government as described by Voltaire: "The art of government is to make two-thirds of a nation pay all it possibly can pay for the benefit of the other third."

But of course, if government spending were strictly limited to only what is constitutionally authorized, there would be no need for an income tax in the first place, progressive or otherwise.