NYLS Journal of Human Rights

Volume 16
Issue 1 *SYMPOSIUM: WOMEN, EQUITY AND FEDERAL TAX POLICY: OPEN QUESTIONS*

Article 9

1999

ELIMINATING THE MARRIAGE PENALTY THROUGH FLATTER TAXATION

Diana Furchtgott-Roth

believe, however, that the individual return is fairer, simpler, more efficient, and more in accord with basic tax principles than the joint return.

PROF. THOMAS: Thank you, Marjorie.

Our next panelist is Diana Furchtgott-Roth, also an economist and a Resident Fellow at the American Enterprise Institute. She is going to talk to us about a different solution to the problem of marriage penalties. Her topic is: "Eliminating the Marriage Penalty Through Flatter Taxation."

ELIMINATING THE MARRIAGE PENALTY THROUGH FLATTER TAXATION

Diana Furchtgott-Roth

MS. FURCHTGOTT-ROTH: Suppose your parents offered you $50,000 on the condition that you get married. Would you be more likely to marry? Likewise, if they offered you a similar amount not to marry, would you be more inclined to live in sin? Today Uncle Sam is bribing some of us and penalizing others for these very decisions.

The tax code is replete with marriage bonuses and marriage penalties that the Taxpayer Relief Act of 1997 worsened.[57] As we think about filing our tax returns by April 15th, it's no wonder that tax reform, again, tops the agenda, since the bribes and penalties have turned the Code into an accountant's dream. Take the marriage penalty. As we have heard today, it has been extensively documented that two working people face higher tax rates if married than if they are single (there are about 22 million such couples).[58] On the other side of the coin is the marriage bonus, which is Uncle Sam's bribe to

[57] *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

[58] See David Hess, *House Opts To Take Ax To Budget, Taxes; In Exchange for Votes, GOP Moderates Receive Promises From Party Leaders; Budget: House Votes for Big Cuts*, SALT LAKE TRIB., June 6, 1998, at A1 (discussing a House budget plan that cut federal spending by $101 million).

get married. The marriage bonus is actually more prevalent than the marriage penalty, as June O'Neill pointed out. There are about 26 million couples who are in the bonus position.[59]

Data from the Congressional Budget Office for 1996 shows that almost no low income couples receive marriage penalties, while such penalties affect more than half of the couples whose top earner makes between $30,000 and $85,000.[60] The same data shows that almost all couples whose top earner earns less than $5,000 receive the marriage bonus.[61] The present value of these bribes and penalties is significant.

I am going to discuss a series of calculations that were done by me and my colleague, Kevin Hassett, also an economist at the American Enterprise Institute. These calculations show the present value of the marriage penalties and bonuses for all tax paying couples, assuming a 2 percent real income growth on a 4 percent real interest rate. They illustrate for each income, how much money you would have to receive today to pay all future marriage penalties or cancel out future bonuses.

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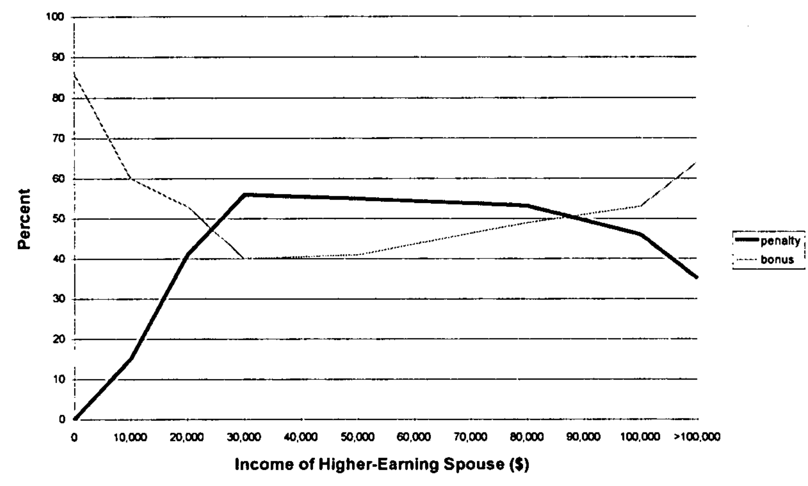
[59] *See Proposal to Reduce Taxes*, *supra* note 4.

[60] *See id.*

[61] *See id.*

Figure 1: Percent of Couples with Marriage Penalty or Bonus



Source: Congressional Budget Office

Those couples whose top earner makes $20,000 and who are objects of Uncle Sam's penalties face an average lifetime loss of income of almost $70,000. Those who are the in the same bracket but who are eligible for the bonus receive an average lifetime bribe of $46,000. As incomes increase, the numbers become ridiculously high. The average lifetime penalty to couples whose highest earner makes about $100,000 is $195,000 and the average bonus is about $146,000.

The Taxpayer Relief Act of 1997 left the bribe unaffected, but worsened the penalty significantly. The allegedly family-friendly provisions in the new bill consisted of tax credits for children and education and savings incentives, which phase out over different income levels.[62] Income levels are, naturally, higher for married couples than for singles. However, even when phase-outs for singles are half of the amounts of phase-outs for married couples, divorce

[62] *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 111 Stat. 788 (1997) (to be codified as 26 U.S.C. § 24(a) and (c)).

provides a tax advantage because women tend to have lower incomes than men, allowing them to take advantage of the new programs.

The list of such family adversarial provisions is quite long. The $500 Child Credit that actually comes into effect this year (last year it was $400) starts phasing out at $110,000 for married couples, but at $75,000 for singles.[63] A family of four earning $130,000 is ineligible for that credit, but two household members making $65,000 each qualify.[64] Consider the Hope Scholarship, a $1,500 college tax credit for freshmen and sophomores and the $1,000 Lifetime Learning Credit, which can be used for substantive education.[65] These begin to phase out at $40,000 for singles and $80,000 for married couples. They amount to a gain of $2,500 in tax credits for a family with two children in college. The $1,000 deduction for interest on student loans phases out at $40,000 for singles and $60,000 for married couples.[66] In addition, as noted earlier, there are even more severe and prevalent phase-outs for the Earned Income Tax Credit.[67] The EITC, because it is so income and circumstances dependent, is difficult for me to outline here. However, the number of people in those circumstances is extremely large. $1,000 here and $1,000 there soon add up.

Several bills in the 105th Congress proposed to solve the marriage penalty problem by allowing married couples to choose whether to file as singles or as married couples.[68] This would cost

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[63] *See id.*; *see also* Heidi Glenn, *List of Tax Expenditures Grows Again, JCT Report Shows*, TAX NOTES TODAY, Jan. 2, 1998 *availble in* LEXIS, Fedtax Library, TNT file (discussing the impact of the Joint Committee of Taxation report).

[64] *See* Taxpayer Relief Act, § 24(b).

[65] *See* Gary Klott, *Your Taxes: New Credits Loom in 2000 if You Pay Tuition this Fall*, ORANGE COUNTY REG., Sept. 13, 1999 (discussing the various tax credits that may be available next year to those paying college tuition this fall).

[66] *See* Gary Klott, *Use College Write-Offs as Way to Reduce Taxes*, FT. LAUDERDALE SUN-SENTINEL, Sept. 6, 1999 (discussing the various tax credits that may be available next year to those paying college tuition).

[67] *See* Max B. Sawicky, *Plenty of Nothing in Fed Budget Plans*, NEWSDAY, Oct. 4, 1998 (noting the year's surplus budget and the effects of the suggested tax proposal by the United States House of Representatives).

[68] *See* H.R. 2462, 105th Cong. (1997) (amending Internal Revenue Code to allow married tax payers to use tax rates applicable to single filers or joint filers); *see also* S. 593, 105th Cong. (1997) (amending Internal Revenue Code to impose a flat tax only on individual earning taxable income and business taxable income).

about $29 billion annually.[69] As has been pointed out, married couples have always been allowed to file singly. What was not pointed out is that they do so at a higher rate, making this something new. This proposal would give a different rate or the same rate as before, and would cost about $29 billion. Others suggest income splitting between couples, whereby couples would divide their earnings in two akin to the old community property laws that were in place decades ago in some states.[70] Even if one spouse did not earn any income, he or she then would file as singles. Some estimate this proposal at about $36 billion a year.[71] Those proposals would eliminate the marriage penalty and the second, income splitting between couples, would result in a marriage bonus. Of course, with frequent complaints about decaying social norms, the marriage bonus may not be such a bad idea. Just as for parents, bribing youngsters to get good grades might work in some cases. We need to ask ourselves whether the goal of tax policy should be to encourage various forms of behavior or simply to allow individuals to make their own decisions. Naturally, if restoring marriage is an important social goal, then a proposal to allow income splitting between couples is a means toward that objective. However, with a price tag of $36 billion perhaps there are better ways to allocate the revenue.

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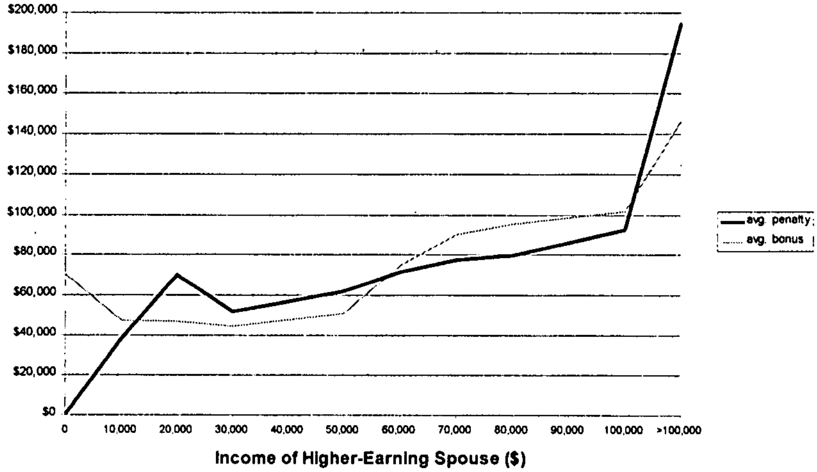
[69] *See* David Ivanovich, *Marriage Tax Twist*, HOUSTON CHRON., Jan. 11, 1998 (discussing the present "marriage penalty," history relating to it, and the costs of eradicating it).

[70] *See* Deborah Moon, *Virtual Estate Plans in the New Millennium,* J. FIN. SERVICE PROF., Sept. 1, 1999 (discussing marriage, community property laws, income splitting and taxes); *see also The Economy Perspective Marriage, Taxes, and Fairness*, INVESTOR'S BUS. DAILY, Jan. 27, 1998 (discussing the marriage penalty and income splitting).

[71] *See* Diana Furchtgottroth & Kevin Hassett, *Tax Code Penalizes Work, Not Marriage*, INVESTOR'S BUS. DAILY, Jan. 16, 1998 (discussing the marriage penalty and income splitting).

Figure 2: Present Value of Lifetime Marriage Penalties or Bonuses



Source: Congressional Budget Office and calculations of Diana Furtchgott-Roth and Kevin Hassett, American Enterprise Institute.

What should we do? If we move towards a flatter system of taxation, we would get rid of the bribes and penalties in the tax code. Then, as two earners marry, a second earner has entered the labor market and, even as primary earners have the opportunity to increase earnings, the family would not incur a penalty of a move towards a higher tax bracket. In addition, Uncle Sam would be out of the bribery business.

Thank you.

PROF. THOMAS: We now will turn to the questions. To start off, I have a couple of questions, and the panelists may also want to speak to each other.

The broad question, which I would like to ask each of you about, is whether you think that one model of taxation should be adopted for all married couples? One of the features of the current wave of legislative proposals is that everything is being offered on an elective basis. You can pick between the joint return, as it stands, or one of these other options. You can choose to file a combined return with tax computed on an individual basis or you can choose to file joint returns. Clearly, the couple is allowed to choose the cheapest tax system under these proposals, the system that would result in the lowest tax burden.[72] The question that this approach raises for me is whether there is not a correct way to tax married couples, based on our knowledge of economic behavior and ideas of equity. Should we be making taxation something about which individual couples can make their own choices?

Perhaps this is an interesting but extreme way of thinking about behavior and efficiency. If you give people the choice of designing their own marriages and then picking their own system of taxation to match it, maybe that is the most efficient and therefore the most preferable. However, is that the correct way to go about designing the unit of taxation? What happens to the concept of equity?

PROF. WHITTINGTON: One thing that I think we need to consider when we have proposals such as that, given the choice of joint versus single filing, is that it is potentially a quite costly, disruptive, and administratively inefficient. The compliance costs that we introduce is also potentially large because, essentially, people must calculate their taxes twice in order to determine under which scenario they would be better off. If we are going to think about the entire cost of a change in the tax system, we need to think not only about changes in revenues but changes in administrative and compliance costs, which would be quite large.

My bias is toward our resolving this, in terms of a society, by deciding what we think are the essential principles of the tax system. As Diana Furchtgott-Roth said, "what is the goal of the tax system?" Then we need to address that goal, rather than have a potpourri or smorgasbord approach to how we will tax families in this country. I, personally, do not have the answer for what is the correct system because that is a decision of society.

PROF. THOMAS: Marjorie?

PROF. KORNHAUSER: I think we ought to have taxation of individuals, not joint returns. As I indicated, I don't think the joint

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[72] *See* Ann F. Thomas, *Marriage and the Income Tax Yesterday, Today, and Tomorrow: A Primer and Legislative Scorecard*, 16 N.Y.L. SCH. J. HUM. RTS. 1 (1999).

return fits with our tax system, which bases taxation on ability to pay. In an income tax that determination is usually based on who controls the income. As Amy and I have both said, income is not shared equally within a family. Consequently, you have theoretical reasons to use the individual as the taxable unit. If the goal is to have the taxable unit promote "family values," then we need to examine the real meaning of that phrase. The government's role is to promote the "general welfare." In that context, family values means nurturing people, supporting them emotionally and financially, teaching moral and ethical values, and keeping them off Welfare. If you want to do that, the marriage unit is way too narrow or under-inclusive. There are all kinds of groups — such as married and unmarried couples, three elderly sisters living together, a religious commune — which can provide the support function. As such, the taxable unit should be much broader if all you are concerned about is "family values."

In fact in May 1999, the French legislature enacted a provision that would allow two people, regardless of sex, to get social and political privileges.[73] This privilege includes the privilege of filing a joint return, so long as they filed a certificate and lived a life of "common interest." This would allow two sisters, for example, who live together to file joint returns. Why they narrow it to two and not three or four, I am not sure. Most industrialized countries do not use a married couple or family as the taxable unit. Two-thirds of the Organization for European Cooperation and Development (OECD) countries use the individual as the unit. Obviously, it can be done from an administrative standpoint. In fact, even the United States allows individuals to file separately. It would be more efficient if everyone files singly than to have couples elect whether to file jointly or individually as some of the bills permit

PROF. SCHWARTZ: I agree with both of you, but my concern, about the way things are done now and about moving to a system where we have choices, is that we are now trying to do more with the tax code. When we say we would like to have marriage neutrality, horizontal equity and progressive taxation, and we are adding another series of objectives, the problem becomes that we only have one instrument. The basic solution would be to move toward

[73] *See* Daley, *supra* note 39, at 21.

individual taxation. Once we have achieved that, then think about what we are giving up by having individual taxation, and attempt to reconcile those issues directly. For example, there was a time when doing income support for poor people was not fashionable, so people did not want to do things through expenditure programs and it became attractive to do things through the tax code.[74] There are a lot of different things we are trying to do, all within one system.

MS. FURCHTGOTT-ROTH: Complexity is a heavily weighted factor with many people in filing tax returns, as you can see from the growth of H & R Block and other such services. When we talk about choices in how to file tax returns, we need to remember that we already have a lot of choices in how much tax we pay. For example, one can get a mortgage that lowers one's taxes, versus renting a house. If we have stocks and we choose to sell them, then we pay capital gains. The number of children we have affects the tax we pay as well.

Also, allowing people to file jointly or singly would change families' marginal effective tax rate, so it would not really be a choice. There would be one lowest-cost tax that they would be paying by doing one or the other and they would never choose the highest tax rate. It would be basically lowering taxes. Indeed, you would encourage a certain type of behavior. As such, we would, again, be lowering taxes for certain kinds of behavior. That is a tax policy choice. If we want to encourage marriage, then we choose a "marriage bonus" plan. It is not as though anyone chooses to pay more tax. That is not really a choice; it is just another calculation you would go through in order to choose the lowest rate for your particular set of circumstances.

What I am proposing is that we attempt to eliminate all of these bells and whistles and go to something like a flatter tax, say about 22 percent. Or simply go back to 1986, go back to the future, the 1986 system of two rates (15 and 28 percent).[75] This system

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[74] *See* Donna Shalala, *Care for Caregivers*, WASH. POST, Jan. 19, 1999 (discussing a proposed bill that would provide benefits to the disabled).

[75] *See* Leonard E. Burman, et al., *Six Tax Laws Later: How Individuals' Marginal Federal Income Tax Rates Changed Between 1980 and 1995*, 51 NAT'L TAX J. 637 (1998) (documenting the development of tax rates from 1980 to 1995).

produced a lot of income growth and reduced complexity.[76] We did it then and can do it now. It is very feasible. Such a plan would simplify the system and reduce marriage penalties and bonuses.

PROF. WHITTINGTON: I have always thought it odd that we say we want to support families so we give them a child credit. The fact that you have given a child credit does not mean that the money is going to be used on the child. It might be spent on the lottery or a vacation. If your goal is to encourage specific behavior, then you ought to do that more directly. The tax system seems to be a very inefficient way of achieving some of those goals.

MS. FURCHTGOTT-ROTH: This Child Credit is another example of yet another bell and whistle. Politicians like to say "We gave you a Child Credit; we are in favor of the family; here is $500 per child." Politicians could accomplish the same thing by changing the personal exemption, which is about $2,500 per person. They could have asserted that they would make a $3,000 exemption for a child. This would have eliminated a lot of the paper work and calculations taxpayers have to do on the tax return. Instead, they say, "Well, we want to help you; we are going to give you this amount of money per child." This whole situation should be and could be a lot simpler and more clear-cut than it is now.

PROF. THOMAS: I think, that's probably right, Diana, but there is a difference between a credit and a deduction.

MS. FURCHTGOTT-ROTH: Yes, there is.

PROF. THOMAS: The credit has a fixed value for everybody and a deduction has a greater value at higher marginal rates, although the current Child Credit has an income ceiling and does not go all the way up. I am not sure how much of a simplification it is if you had a deduction rather than a credit.[77]

My next question is whether marriage bonuses are something we should think of as part of tax expenditure. Tax expenditure budget analysis says there is a right way to tax income and that when we deviate from that, for economic, social, industrial, or whatever our non-tax purposes are, we need to keep track of it because it is a form of indirect subsidy or expenditure. Is marriage bonus, in our society,

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[76] *See id.*

[77] *See* I.R.C. § 24 (1999).

a form of social expenditure? It is a question.

PROF. KORNHAUSER: It seems that when Congress passed the amended innocent spouse rules it recognized that the assumption of the joint return that sharing occurs within the marital unit is not really so true.[78] Otherwise, Congress would not have to deal with an innocent spouse problem at all, let alone by allowing separate returns. If that is true, then there must be some element of a tax expenditure in the marriage bonus situation.

PROF. WHITTINGTON: We do not calculate tax expenditures based on all the behaviors that are created through incentives in the tax system. One would count as tax expenditures, for instance, changes in labor supply and participation among men and women in this country that are reactions to changes in their tax burden. So do we then calculate the marriage bonus as a tax expenditure when, in fact, it was, essentially, an unintended consequence? If we now want to use it also as a social tool in order to deliberately encourage or discourage marriage, I think that you have to consider it as a tax expenditure. It becomes, in some senses, like the Earned Income Tax Credit, which is deliberately structured to encourage working behavior on the part of relatively low and low middle income households as opposed to direct cash transfers to them.[79] As such, if we are going to use the tax system to encourage marriage, that is a tax expenditure, that is the explicit purpose of it.

MS. FURCHTGOTT-ROTH: Such a proposal encourages mothers to stay at home with children. As a society, we must decide if this is a good or bad thing. For example, the Dependent Care Child Credit helps working mothers.[80] It might be said that, on balance, it is not a bad idea to give stay-at-home moms a break. This is especially true since studies show that it improves academic performance in

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[78] *See* Paul F. Wright, *Taxation - Innocent Spouse Provision - of Erroneous Deductions and Decisions - From 6013 (E) to 6015 - The Knowledge Requirement and the Erroneous Deduction Quagmire of the Internal Revenue Code*, 39 S. TEX. L. REV. 845, (1998) (stating the consequences of filing jointly and the innocent spouse provision as provided within the Internal Revenue Code).

[79] *See Ignorance Can Aid Poverty*, ATLANTA J., Apr. 3, 1991, at A12 (discussing the federal earned-income tax credit).

[80] *See Child Care Tax Credits: A Supply Side Success Story*, TAX NOTES TODAY, Aug. 8, 1989 *availble in* LEXIS, Fedtax Library, TNT file (discussing the tax credit for working families).

children and reduces drug use.[81] Again, however, such a decision depends upon our country's goals.

PROF. THOMAS: That is, by the way, a tax expenditure. The new Child Credit is a tax expenditure.

PROF. SCHWARTZ: It is useful to think of it as a tax expenditure if what we are thinking about is the alternative uses for the money. If it is not going to inform a particular decision, it is not particularly interesting. On the other hand, if we are going to ask whether this is the way that we are going to work to encourage marriage and whether this is the most effective way to use this money, then that is noteworthy. If through using the research we have described this morning, you may ask if we are getting enough for the money we are spending. Then we might say it is worth it or we might say the benefits of marriage are not as great as the big price tag we are paying. I think that the reason to ask those questions is to inform particular decisions.

PROF. THOMAS: Questions?

THE AUDIENCE: My first question goes to Professor Kornhauser: What does a woman's money in the marriage have to do with eliminating the marriage penalty? If we go back to having married couples file single returns, we create the ability for those couples to avoid taxes, maybe even evade taxes, through their relationship as husband and wife.

PROF. KORNHAUSER: I do not think so. If the tax system uses individual returns, all earned income would be taxed to the person who earned it. Consequently, couples could not evade tax on their earned income, which for most couples is the vast majority of their income. An earner spouse would still be taxed on what he or she earned, regardless of whether she gives it to the non-earner spouse and regardless of how the non-earner uses it. As to unearned income, that is a little more complicated. There are a couple of things I can say. One, look at the estate and gift tax area; an area in which evasion often occurs. The argument is that people lower their estate taxes by giving away assets to their spouses. My response is that statistics

[81] *See* Bella English, *You Can Go Home Again*, BOSTON GLOBE, June 23, 1998, at E1 (stating that research shows one-on-one attention benefits a baby's developing brain).

show that not as much of that transference happens as you would think. This is because people want to retain control and want to retain title to assets. The reason for this, as I indicated before, is that complete sharing does not occur. Not as much evasion happens as you would expect.

There are ways to deal with it to the extent it does occur. For example, minimal amounts of assets transferred for tax purposes do not matter. The code could allow shifting assets up to a certain ceiling. Alternatively, the code could allocate unearned income in the same proportion as earned income. For example, if the husband earned 70 percent of the income, then 70 percent of the unearned income would be attributable to him. Therefore, there are administrative ways you can deal with tax motivated transfers and still have a system based on the individual taxable unit. It would be more respectful of the idea of ability to pay. There are also certain provisions of the code that would still be in effect, such as Section 267 that deals with transactions between related parties to prevent false losses.

THE AUDIENCE: My issue was flat tax. From what I understand, you are advocating a flat tax. What happened in 1986 as a social issue, both low income and poor were more affected by the 1986 Act than those who were in the position to pay the income tax.[82]

PROF. SCHWARTZ: Under the flat tax system, advocated in some bills, such as the bill by Congressman Armey, a family of four who earns less than $36,000 would not pay any tax at all.[83] In addition, depending on who you wanted to exempt from these taxes, you would set that at different levels so a number of people under the flat tax proposal would be off the tax rolls completely. That is how that particular aspect would be dealt with. One could certainly make arguments for progressivity at different income levels. In that way you can say that someone who earns $50,000 should pay more than someone who earns $20,000, and that someone who earns $100,000 should pay more than someone who earns $50,000. The rationales for

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[82] *See* Heidi Glenn, *Flat Tax Would Sting Low-Income Families, Study Finds*, 72 TAX NOTES 275 (1996) (explaining that a flat tax would disproportionately hurt low-income taxpayers).

[83] *See* H.R. 2060, 104th Cong. § 101 (1995).

increasing progressivity vanish at increasing income levels. As such, it does not seem to be a good theoretical argument as to why someone who earns $200,000 should pay a lot more than someone who earns $150,000. This assumes that we have dealt with the poorest members of society, which is the goal of a progressive tax system in terms of providing services and making sure that people at the bottom are taken care of.

THE AUDIENCE: With the flat tax system there does not seem to be any equity across the Country.

MS. FURCHTGOTT-ROTH: That is right and that is also true of our Federal Tax system now. Our current Federal Tax system does not take into account that different kinds of exemptions use different rates that are worth a lot more in certain geographical areas, such as Mississippi for example. An ideal tax code would adjust for those geographical differences, but such adjustments are very difficult to calculate and so far, have not been done.

PROF. THOMAS: I think there may be different views among us, about progressivity among other things. But I would also like to point out that there is an argument that even the flat tax is a two rate system, if there is a zero bracket amount and most of the proposals include a personal exemption or a family exemption.[84]

MS. FURCHTGOTT-ROTH: And it is a *de facto* progressive rate structure.

PROF. THOMAS: It may be, in fact, more progressive then some other explicitly progressive systems. As such, we have to be a little careful in thinking about how progressive a flat tax might be and, even in this marriage penalty area, whether there are marriage penalties built into the way the exclusion is constructed. Thank you.

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[84] *See id.*