CATO INSTITUTE
Tax & Budget BULLETIN

No. 22 • February 2005

# A Proposal for a "Dual-Rate Income Tax"

by Chris Edwards, Director of Tax Policy Studies, Cato Institute

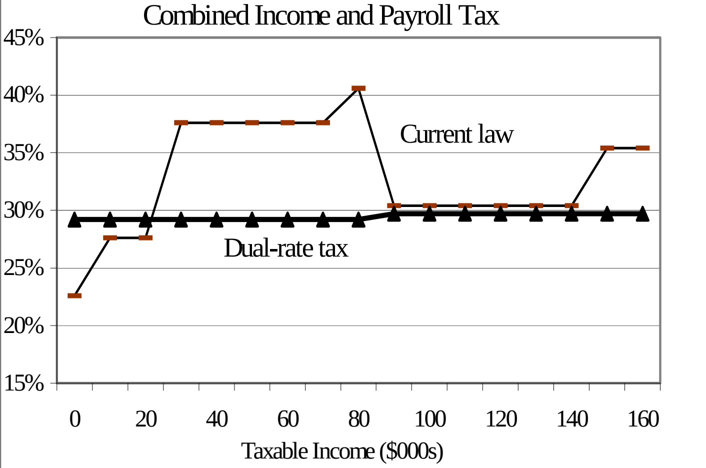
Despite recent income tax cuts, the federal tax system remains terribly inefficient and complex. President Bush recognizes that a major tax overhaul is needed, and he has established an advisory panel to study reform options. Republican leaders in Congress have also pledged their support for reform.

## A Dual-Rate Income Tax

The president's advisory panel will likely consider plans for consumption-based taxes, as well as more limited income tax reforms. A "dual-rate income tax" is a model for reform that would reduce tax rates and simplify the code, while taking steps toward a flat and neutral consumption-based system.[1]

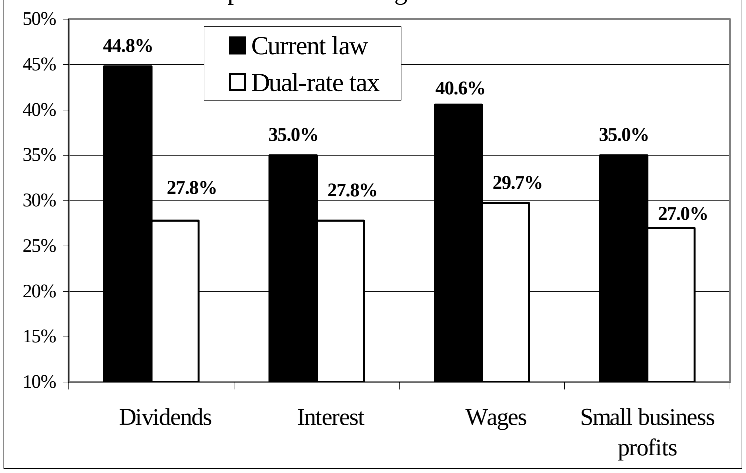
Under the plan, most deductions and credits would be eliminated, but nearly all families would pay tax at a low 15 percent rate. A 27 percent rate would kick in for earnings above the threshold that the Social Security payroll tax cuts out. The effect would be to cut tax rates on middle-income families and create a consistent marginal rate of about 29 percent on wages (Figure 1).[2]

1. Marginal Tax Rate, Single Taxpayer, Combined Income and Payroll Tax




Source: Author. Excludes EITC. Taxpayer takes the standard deduction.

2. Top Combined Marginal Tax Rates




Source: Author. Includes individual and corporate income taxes and the payroll tax.

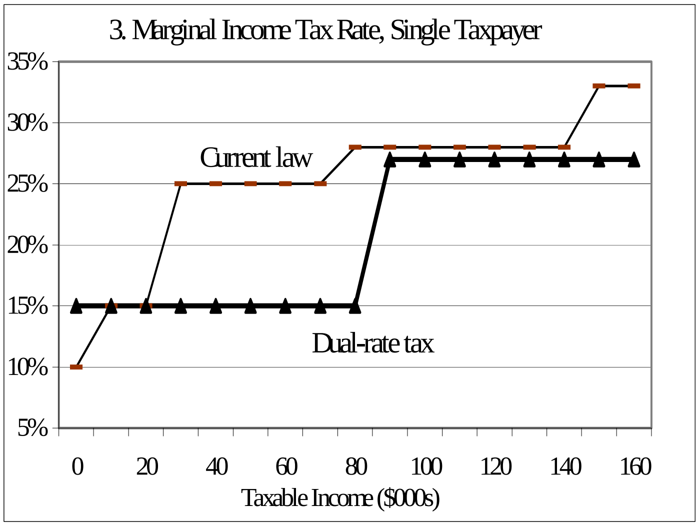
To promote savings and economic growth, the maximum individual rate on dividends, interest, and capital gains would be set at 15 percent. The corporate tax rate would be dropped to 15 percent and interest made nondeductible. These changes would equalize and cut the combined top federal tax rates on dividends, interest, wages, and small business profits to less than 30 percent, compared to 35 to 45 percent under current law (Figure 2).

The dual-rate tax plan takes a cue from the "dual income tax" systems of some European countries. These systems feature lower flat tax rates on capital income and higher, graduated rates on labor income. Capital income is taxed at a lower rate to improve efficiency and to respond to rising global tax competition—countries are learning that if taxes on capital income are not cut, capital will flow abroad and economic growth will suffer.

## Individual Tax Rates of 15 and 27 Percent

Under the dual-rate tax, individuals would be taxed at 15 percent on income up to $90,000 (singles) and

$180,000 (married), and 27 percent above that. About 95 percent of all taxpayers would be in the 15 percent bracket, and millions would enjoy a marginal rate cut. For example, the marginal rate on singles with taxable income between about $30,000 and $80,000 would fall from 25 and 28 percent to just 15 percent (Figure 3).




Source: Author. Excludes EITC. Taxpayer takes the standard deduction.

The dual-rate tax would retain the standard deduction of $5,000 (singles) and $10,000 (married), and would increase the personal exemption from $3,200 to $4,500. The plan would also retain the earned income tax credit and all pro-savings features of the code, including 401(k)s, individual retirement accounts, and Health Savings Accounts. Other deductions and credits would be ended. The changes to the individual tax would be roughly revenue-neutral, based on a preliminary estimate from the Tax Foundation's microsimulation tax model for 2004.

**Corporate Tax Rate Cut from 35 to 15 Percent**

The dual-rate plan would cut the corporate tax rate from 35 to 15 percent. Interest would be excluded from the corporate tax base to create equal treatment of debt and equity. The combined individual and corporate top tax rate for dividends and interest would be 28 percent, down from 45 and 35 percent, respectively, today.[3]

The change to the tax treatment of interest would help offset the revenue loss of the corporate rate cut. Another offset would be to end or limit the business deduction for health insurance premiums. That would increase efficiency by moving the health care system toward individual coverage and control. Alternatively, the tax benefit for employer-provided health insurance could be ended or limited at the individual level.[4] Changes might also include adding tax benefits for individually based health coverage.

A further step to offset the revenue loss of the corporate rate cut would be to end the deduction for state and local taxes. Without the federal deduction, businesses would be more sensitive to taxes in making their location decisions, thus increasing interstate tax competition and providing a restraint on state and local fiscal policy.

These corporate tax base changes would offset more than half of the revenue loss from the rate cut.[5] For a further offset, some of the $90 billion of federal business subsidies could be cut.[6] Also note that cutting the corporate tax rate would create macroeconomic feedback effects that would offset a large share of the revenue loss.

The dual-rate tax plan takes steps toward the Hall-Rabushka or Dick Armey "flat tax." The business portion of the flat tax has a low rate, excludes interest from the tax base, and ends the business deduction for health care. To fully switch to an Armey-style business tax would require four further steps. First, investment would be expensed (deducted in the first year) rather than depreciated. Second, cash accounting would replace accrual accounting. Third, a "territorial" system that taxed domestic profits only would replace the current "worldwide" system. Fourth, the tax would be extended from corporations to all businesses.

**Conclusion**

The dual-rate tax plan would cut tax rates on wages, income from savings, and small businesses. It would simplify the tax code and increase horizontal equity, while providing low-income tax relief. The corporate tax rate would be cut sharply. The dual-rate tax would increase fairness and spur growth, while taking a big step toward a simple consumption-based tax system.

---

[1] Full details of the plan in Chris Edwards, "Options for Tax Reform," Cato Institute Policy Analysis, forthcoming.
[2] Note that half of the payroll tax is deductible by businesses, thus somewhat reducing the effective tax rate.
[3] Combined rate calculated as 15+(1-0.15)*15.
[4] See Robert B. Helms, "Tax Reform and Health Insurance," American Enterprise Institute, February 2005.
[5] Author's estimate based on data for nonfinancial "C" corporations. See Internal Revenue Service, *Corporate Income Tax Returns 2001*, Table 12. Special rules would be needed for the financial services industry.
[6] For information on business subsidies, see Chris Edwards and Tad DeHaven, "Corporate Welfare Update," Cato Institute Tax & Budget Bulletin no. 7, May 2002.