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January 12, 2015

Policymakers Often Overstate Marginal Tax Rates for Lower-Income Workers and Gloss Over Tough Trade-Offs in Reducing Them: Condensed Version[1]

By Robert Greenstein

Policymakers and commentators in Washington are focusing more on how tax-based and safety net program benefits for low- and moderate-income families phase down in response to higher earnings, how the phase-down translates into "marginal tax rates," and how those rates affect the work habits of beneficiaries.

The phase-down rate of program and tax benefits is often called a "marginal tax rate" because the reduction in benefits as earnings rise resembles a tax (with "marginal" referring to the effect on the next dollar of income). If, for example, a worker faces a marginal tax rate of 30 percent, that worker will lose 30 cents of each additional $1 he or she earns through a combination of reduced benefits and higher taxes.

Many policymakers focus on marginal tax rates out of concern that workers who face higher rates are likelier to not work, to work less, or not to look for higher paying jobs than if they faced lower rates. This issue deserves attention. Some, however, overstate the magnitude of these tax rates and their impact on employment, and they often overlook the tough trade-offs involved in reducing marginal rates.

Marginal tax rates from benefit phase-downs result from the interaction between two broadly agreed-upon policy goals: (1) providing needed assistance to individuals and families who face difficulties making ends meet and (2) limiting costs by not providing help to those whose incomes are more adequate. Any serious discussion of marginal tax rates must grapple with the fundamental tension between providing adequate help to those in need at a reasonable cost and avoiding high marginal rates. Reducing marginal tax rates involves very difficult policy trade-offs that policymakers must scrutinize carefully, so that in seeking to lower those rates they don't do more overall harm than good.

[1] For more on these issues, see Sharon Parrott and Robert Greenstein, "Policymakers Often Overstate Marginal Tax Rates for Lower-Income Workers and Gloss Over Tough Trade-Offs in Reducing Them," December 3, 2014, http://www.cbpp.org/cms/index.cfm?fa=view&id=4243.

Low-Income Households' Marginal Tax Rates Are Often Overstated

SNAP (formerly food stamps), the Earned Income Tax Credit (EITC), Medicaid, and health reform's subsidies help low-income families buy food, pay rent, and obtain health care. These benefits phase down as family earnings rise, imposing a "tax" that reduces the family's gain from higher earnings. The *marginal* tax rate represents the share of each additional dollar in a family's earnings that is offset by an increase in taxes or loss of government benefits. A family's marginal tax rate is affected by its income, size, number of children, benefits received and taxes owed, and the phase-down formulas for the benefit programs.

Some policymakers and analysts have expressed concern that high marginal tax rates may cause workers to choose not to work, to work less, or not to seek higher paying jobs. Some also are concerned that high marginal tax rates make it harder for families to move up the economic ladder when their earnings rise.

Unfortunately, critics often overstate the marginal tax rates that most low-income families face. For example, House Budget Committee Chairman Paul Ryan's March 2014 report on the safety net[2] highlights a statement in a Congressional Budget Office (CBO) analysis that "some low-income households face implicit marginal tax rates of nearly 100 percent," but doesn't mention data from the same CBO report showing that most low-income households face much lower marginal tax rates.[3] The report shows, for example, that 75 percent of families with incomes between 100 and 150 percent of the poverty line faced marginal tax rates of less than 45 percent in 2012, with about 90 percent of these families facing marginal rates below 60 percent.

To face marginal tax rates in the 90-100 percent range, a family must participate simultaneously in multiple benefit programs — including those that assist only a small share of those eligible. In addition, its income must be high enough that several of these benefit programs phase down at the same time but not *so* high that the benefits have phased out. That combination of factors applies to only a small share of low-income families. Less than one-third of families with children that are poor enough to qualify for cash assistance from the Temporary Assistance for Needy Families (TANF) program receive it, while only one-quarter of the low-income families eligible for housing assistance and one-sixth of children in low-income working families eligible for child care assistance receive those forms of assistance, largely because of the programs' limited funding.

Among low-income families, marginal tax rates are typically lowest among working-poor families and highest among those with incomes somewhat above the poverty line. Most working-poor families do not face high marginal tax rates largely because, at low income levels, the EITC and Child Tax Credit (CTC) *rise* with additional earnings, offsetting the marginal tax rates that phase-downs in other programs (such as SNAP) can create and providing a work incentive. In fact, families in which a parent has very low earnings or is out of work — the very families whose employment rates policymakers are generally most concerned about — often face a *negative* marginal tax rate. As their earnings rise, their after-tax incomes rise by *even more,* providing a strong incentive to work rather than not work.

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[2] House Budget Committee, "War on Poverty: 50 Years Later," March 2014.

[3] "Effective Marginal Tax Rates for Low and Moderate Income Workers," Congressional Budget Office, November 2012. See, in particular, Figure 5 on p. 24.

How Core Safety Net Programs Affect Marginal Tax Rates

Of all types of federal benefits, refundable tax credits, SNAP, and health insurance (through Medicaid, the Children's Health Insurance Program or CHIP, and health reform's new insurance exchanges) have the biggest impact on the marginal tax rates of low-income households. They are the largest benefit programs for low-income working families and are available to all eligible families that apply.

The EITC and CTC help ensure that, overall, the safety net rewards work over *not* working for families with children. In addition, health reform has significantly *reduced* work disincentives for many low-income parents.[4] All told, the conversion of the safety net over the past few decades primarily into what analysts call a "work-based safety net"[5] represents a major change in U.S. social policy.

In particular, a substantial body of research has found that the EITC is highly effective as a work incentive and increases employment rates among low-income parents. For example, one notable study found that the positive work incentive provided by the EITC expansion of the mid-1990s did more to induce people to go to work than did welfare reform policy changes such as time limits and work requirements.[6]

(We limit the discussion here to families with children because they are eligible for significantly more government benefits than able-bodied adults without children. Those without children do not face steep marginal tax rates because they do not receive many benefits that phase down.[7] Similarly, because they generally have access only to a very small EITC, they do not experience significant *negative* marginal tax rates if they take a job.)

Today's safety net does relatively little for families in which able-bodied adults are not working. Basic cash assistance programs for families with children help only about one-third of families with children that meet the program's eligibility criteria in their state — and an even smaller share of all poor families with children.[8] (Only 25 of every 100 poor families with children received TANF cash

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[4] Before health reform, Medicaid eligibility for working parents ended in the typical (or median) state when the parent's income reached 61 percent of the poverty line, creating a substantial work disincentive "cliff." Under health reform, that has changed markedly, especially in states that adopt its Medicaid expansion. In those states, working parents remain eligible for Medicaid until their income reaches 138 percent of the poverty line, and those whose earnings rise above that level qualify for subsidies to purchase health coverage in the new insurance marketplaces if they don't have access to affordable employer-based coverage.

[5] While work incentives are stronger today than 20 years ago, the safety net is significantly weaker for families with children in which a parent is unsuccessful in the labor market, including families in which parents have substantial barriers to employment such as low skill levels, mental or physical impairments, addiction, or the need to care for family members who are ill or have disabilities.

[6] CBPP analysis of results from Jeffrey Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income among Female-Headed Families," *Review of Economics and Statistics*, May 2003 and data from the March 1999 Current Population Survey.

[7] Adults without children are generally ineligible for SNAP, except for three months out of three years, unless they are working (or in a work program, which few states offer for this population on a significant scale) for at least 20 hours a week. Hence, taking a low-wage job can make them eligible for SNAP rather than cause a loss of benefits.

[8] Department of Health and Human Services, *Welfare Indicators and Risk Factors, Thirteenth Report to Congress,* http://aspe.hhs.gov/hsp/14/indicators/rpt_indicators.pdf.

assistance in 2012, down sharply from 82 of every 100 such families in 1979 and 68 out of every 100 in 1996 under the Aid to Families with Dependent Children, or AFDC, program, TANF's predecessor.) Similarly, as noted above, only about one-quarter of eligible low-income families with children receive housing assistance.

Most poor families with children in which a parent isn't working can count only on SNAP, Medicaid, and child nutrition benefits (school meals or WIC — the Special Supplemental Nutrition Program for Women, Infants and Children). These benefits do not provide cash income and leave many families hard pressed to pay for basics such as rent. If, however, the parent can get a job, the family receives not only earnings but also the EITC and CTC, which are available *only* to families with earnings. While SNAP benefits begin phasing out at fairly low earnings levels, the EITC and CTC typically more than make up for that loss. Johns Hopkins University's Robert Moffitt, one of the leading experts in the field, found in his recent research that among families with children receiving SNAP and other income supports, the vast majority "face cumulative negative marginal rates."

Moreover, while families with earnings in the $17,830 to $25,000 range often face a relatively high marginal tax rate (the rate on the next dollar earned), their *average* tax rate (the rate on all of their pre-tax income) remains low and, in some cases, negative. That's because the EITC and CTC can cancel out some, all, or more than all of the cumulative loss in benefits and increase in other taxes that occur when a family's earnings rise. This low *average* tax rate means that families are significantly better off financially if they take a job than if they don't work, even if their earnings put them in a range where their *marginal* tax rate is high. While the *marginal* tax rate on the next dollar of earnings could affect a worker's decision about whether to try to increase her hours of work or seek a high-paying job, the *average* tax rate that an individual faces on all of her pre-tax earnings has a far greater impact on her decision about whether to go to work in the first place.

Given the strong incentive to work (rather than not) from wages that are accompanied by low or negative *average* tax rates, no one should be surprised to learn the following: research suggests the actual reduction in hours worked or wages earned by low-income people due to *marginal* tax rates (including benefit phase-downs) is small. The research also suggests the small behavioral response may, in part, reflect the fact that (1) many families don't fully understand how benefits (particularly tax credits) adjust as earnings rise; (2) low-wage workers often have limited ability to control the number of hours they work or find higher-paying jobs; and (3) many families that face high marginal tax rates do so for only relatively short periods of time.

Research Suggests Marginal Tax Rates Have Only Modest Effects on People's Work Decisions

Many policymakers focus on marginal tax rates out of concern that higher rates will negatively affect an individual's decisions about whether and how much to work. As economists have long noted, however, the effects of taxes and tax rates on work are not as clear-cut as many people assume, in part due to at least two competing forces:

- **Substitution effect:** On the one hand, by lowering the net benefit from working an additional hour, a higher marginal tax rate could convince someone to work less than he or she otherwise would. That's known as the "substitution" effect, based on the idea that reducing the monetary benefits of work will lead people to substitute leisure for work.

- **Income effect:** On the other hand, someone facing a high marginal tax rate may work *more* hours in order to reach a particular after-tax income level, such as the level needed to afford rent and other basics. (Many low-wage workers work multiple jobs and long hours, despite low pay, to secure a more adequate income.) That's known as the "income effect."

A recent review of research on how various income-tested programs affect people's choices about work, co-authored by Robert Moffitt, concluded that most low-income benefit programs have at most a modest impact in reducing work. Overall, the study found, programs' work disincentives are small enough to have "almost no effect" in diminishing the safety net's success in reducing poverty.[9] After accounting for these modest overall behavioral effects, the authors found, the safety net lowers poverty by about 14 percentage points. In other words, *one of every seven non-poor Americans* would be poor without the safety net — that is, more than 40 million people.

Reducing Marginal Tax Rates Creates Difficult Policy Trade-Offs

All else being equal, policymakers and analysts of all political stripes appropriately prefer lower marginal tax rates. But, in public policy, all else is rarely equal.

Policymakers can reduce the marginal tax rate associated with a program (such as SNAP or the EITC) in only three ways. All three involve difficult trade-offs:

- **Phase down benefits more gradually and extend them higher up the income scale.** That raises program costs significantly. Policymakers could offset those added costs through spending cuts or tax increases elsewhere in the budget but, if so, they must consider the pros and cons of both the expansion and the offsets.
- **Phase down benefits more gradually and extend them to families higher up the income scale *without* raising costs by cutting the level of assistance to poorer families.** That reduces the support for the families and children who most need help and can push them deeper into poverty.
- **Eliminate all assistance to needy individuals and families.** That would eliminate the phase-down but leave needy families destitute.

Similarly, policymakers could offset some or all of the marginal tax rates created by one program or tax policy by changing other programs or parts of the tax code, but the basic calculus remains the same. Reducing marginal rates in a program or the tax code costs money; unless policymakers are willing to let budget deficits rise, they must offset that cost through tax increases or program cuts that necessarily involve policy trade-offs.[10]

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[9] Yonatan Ben-Shalom, Robert A. Moffitt, and John Karl Scholz, "An Assessment of the Effectiveness of Anti-Poverty Programs in the United States," prepared for the *2012 Oxford Handbook of the Economics of Poverty,* Chapter 22. A version of this study is available at http://www.irp.wisc.edu/publications/dps/pdfs/dp139211.pdf.

[10] For example, Melissa Kearney and Lesley Turner have proposed a "second earner tax deduction" to reduce marginal rates on second earners in married-couple families. (The proposal would not affect single-parent families.) A married couple filing a joint return would be eligible for a deduction equal to 20 percent of the lower-earning spouse's first $60,000 in earnings; the deduction would begin phasing down once family income reached $110,000. The proposal is structured so that the deduction can be applied when determining a family's EITC and, thus, it would increase the EITC for families in the credit's phase-down range (and have no effect for families on the upslope or plateau). The proposal, which would reduce taxes for moderate- and middle-income families, would cost $8.2 billion per year, the authors

Conclusion

There is no painless way to reduce marginal tax rates. The structure of major means-tested programs reflects a balance among competing priorities: assisting families that need help, limiting program costs, and avoiding high marginal tax rates. Lowering marginal tax rates would be a positive change *if* it did not harm poor families, but it could deepen poverty and harm children if its costs were offset through cuts in assistance to those already on the edge. In light of the growing evidence[11] that raising the incomes of poor children has important long-term education and health benefits, the substantial risk of causing long-term harm by making poor children still poorer would almost certainly outweigh what the evidence suggests would likely be only modest benefits from reducing marginal tax rates.

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estimate. They put forward one possible offset: cutting the personal exemption for a spouse by 75 percent, which means that middle- and high-income married couples in which only one spouse worked (or the second spouse had only very modest earnings) would pay *higher* taxes in order to offset the tax cut for married couples in which both spouses work. This may well be a reasonable trade-off. Many policymakers, however, likely wouldn't be willing to raise taxes on married couples with a stay-at-home spouse. Whatever one's views on the proposal, it shows the importance of considering the impact of both a proposed cut in marginal tax rates *and* the proposed offset. For information on this proposal, see "Giving Secondary Earners a Tax Break: A Proposal to Help Low- and Middle-Income Families," Brookings Institution, December 2013, http://www.hamiltonproject.org/files/downloads_and_links/THP_Kearney_DiscPaper_Final.pdf.

[11] See Arloc Sherman, Sharon Parrott, and Danilo Trisi, "Chart Book: The War on Poverty at 50, Section 3," Center on Budget and Policy Priorities, January 7, 2014, http://www.cbpp.org/cms/index.cfm?fa=view&id=4073#Part5, and Arloc Sherman, Danilo Trisi, and Sharon Parrott, "Various Supports for Low-Income Families Reduce Poverty and Have Long-Term Positive Effects On Families and Children," Center on Budget and Policy Priorities, July 30, 2013, http://www.cbpp.org/cms/index.cfm?fa=view&id=3997.