

**Statement of**

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On

**Marginal Tax Rates, Work, and the Nation's Real Tax System**

**Joint Hearing of the  
*Subcommittee on Human Resources and*  
Subcommittee on Select Revenue Measures  
Committee on Ways and Means**

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**C. Eugene Steuerle is the Richard B. Fischer chair and an Institute Fellow at the Urban Institute. Portions of this testimony are taken from other work by the author, particularly for *Tax Notes Magazine* and *The Future of Children*. I am indebted particularly to Adam Carasso, Linda Giannarelli, Elaine Maag, Caleb Quakenbush, Stephanie Rennane, and Katherine Toran for both past and current work with me on marginal tax rates. All opinions expressed herein are solely the author's and should not be attributed to any of these individuals or organizations with which he is associated.**

**Chairmen Davis and Tiberi and Members of the Subcommittees on Human Resources and Select Revenue Measures:**

Thank you for the opportunity to be here today. In my testimony, I make six basic points.

- (1) The nation's real tax system includes not just the direct statutory rates explicit in such taxes as the income tax and the Social Security tax, but the implicit taxes that derive from phasing out of various benefits in both expenditure and tax programs. What I have labeled "expenditure taxes" are like tax expenditures in the sense that both tend to hide the full impact of government and are seldom dealt with on a consistent basis.
- (2) These taxes derive largely from a liberal-conservative compromise that emphasizes means testing as a way of both increasing progressivity and saving on direct taxes needed to support various programs. Although low- and moderate-income households are especially affected, middle income households face these expenditure taxes, too, as in the phase out of Pell grants and child credits, the gradual removal of "preferences" in the alternative minimum tax and of the exemption of Social Security benefits from taxation.
- (3) At the Urban-Brookings Tax Policy Center and the Urban Institute's Income and Benefits Policy Center we have done quite a bit of work on calculating these rates, particularly for low and moderate-income households. Through such models as the "Net Income Change Calculator," or NICC, we can show their effect for individual states. Adding in health care makes the calculations more difficult, but when added in, these rates can be quite high, especially for households with children, commonly reaching 50 percent when moving toward full-time work or a second job in the household; for those getting housing and other assistance, the rate can easily jump to 80 percent or more.
- (4) Many studies have attempted to show that the effect of these rates on work, and the results are mixed and ambiguous. Work subsidies such as the EITC generally encourage work for those who might otherwise not work or simply reside on welfare, but may tend to discourage work at higher income levels, particularly for second jobs in a family or moving to full time work. Design matters greatly. For instance, Medicaid will discourage work among the disabled more than a subsidy system such as adopted in health reform; on the other hand, health reform will probably encourage more people to retire early. Perhaps one of the most important conclusions is that for the same amount of cost, a program that requires work will indeed lead to more work more than one that does not. EITC and welfare reform have done better on the work front than did AFDC.
- (5) In addressing these issues, other behaviors and consequences must also be considered. Means testing and joint filing has resulted in hundreds of billions of dollars of marriage penalties for low and middle income households. Many of these programs do help those with special needs,

although they vary widely in their efficiency and effectiveness. There is some evidence that well-developed programs can improve behaviors such as school attendance and maternal health. At the same time, long-run consequences are often hard to estimate.

- (6) Just as a classic liberal-conservative compromise got us to this situation, so might it require a liberal-conservative consensus get us out of it. Many potential reforms replace hidden government with explicit government, which may make it look bigger. Some reforms may reduce benefits for some low-income households; others may cost more, hence raising tax rates for others not facing such high rates. Put another way, reform requires looking at hundreds of billions of dollars' worth of programs, since phase outs and means tests are everywhere. Reforming them means recognizing there will be winners and loser along the way. Among the many approaches to reform are (a) seeking broad-based social welfare reform rather than adopting programs one-by-one with multiple phase-outs, (b) starting to emphasize opportunity and education over adequacy and consumption; (c) putting tax rates directly in the tax code to replace implicit tax rates, (d) making work an even stronger requirement for receipt of various benefits, (e) adopting a maximum marginal tax rate for programs combined, and (f) letting child benefits go with the child and wage subsidies go with low-income workers rather than combining the two.

### **The Nation's Real Tax System**

The tax rates faced by taxpayers include both statutory rates and all the various phase-outs of benefits in both expenditure and tax programs, as well as fees that are for the most part unavoidable. I have labeled these latter items expenditure taxes. Phase outs reduce or tax away particular program benefits typically on the basis of income or other personal characteristics of the household. Expenditure taxes should be distinguished from voluntary fees or charges for services received by the government. In the direct tax system, direct taxes are those that are compulsory. In contrast, most fees are voluntary. When those fees rise, it is generally because the cost of benefits voluntarily purchased by the taxpayer has increased, as when one makes greater use of national parks or inland waterways. Obviously, the distinction between taxes and fees is sometimes more difficult to make, but the separation is still useful (e.g., I view the "fee" for Social Security Part B more like a tax since it is hard to avoid, but one can debate the matter). In the case of expenditure taxes, a similar distinction might be drawn between those fees that are given freely in exchange for some public services and those reductions in benefits that are mandatory.

Identifying expenditure taxes does not make them good or bad. Some believe that expenditure taxes are useful ways of channeling net benefits to the most needy or of restricting participation levels. As a policy matter, each expenditure tax needs to be judged on its own merit. To make an informed judgment, however, requires that policymakers be fully aware of how these tax-like mechanisms work and interact and take into account their combined impact on the economy and on the operation of government programs.

Just like tax expenditures, clarifying the size of both tax expenditures and expenditure taxes helps prevent hidden government. When government actions are more apparent, voters and policymakers can make better, more informed judgments. Many expenditure taxes apply to lower income households through means testing of programs like SNAP (formerly Food Stamps) for which they qualify categorically, but they also apply to many middle-income families, as in Pell grants, child credits, the

phase out of itemized deductions, and phase out of the exemption of Social Security benefits from taxation, the removal of exemptions from the alternative minimum tax. Although I will concentrate here on the programs affecting low-to-moderate income households, it is quite easy for middle-income households to face marginal tax rates of 40 percent or 50 percent or more (15 percent Social Security tax plus 15, 25, or 28 percent in the federal income tax, plus a few percent of state income tax, plus the phase out rates, less interactions).

### **What Causes Expenditure Taxes and Consequent High Tax Rates?**

Congress enacted Social Security, Aid to Families with Dependent Children (AFDC), and various housing programs in 1935; the Food Stamp Act in 1964; Medicare and Medicaid in 1965; the EITC in 1975 (and subsequent expansions of the credit in 1987, 1990, 1993, and 2001, among others); the Child Care Development Block Grant in 1990; welfare reform in 1996 (which replaced AFDC with TANF); the State Children's Health Insurance Program (SCHIP) in 1997; and the child tax credit in 1997 (expanded and made refundable in 2001). The list could go on and on.

Each program, as well as its subsequent reforms, was the product of unique social forces and was designed to address a specific social need. Had they all been enacted as one comprehensive program, lawmakers might have been more inclined to coordinate and focus on the combined tax rates, combined subsidy rate, marriage penalties and subsidies, and combined incentive effects. So many items are now phased out in many of these programs that the nation's true tax system remains largely hidden.

Means testing particularly represents a classic liberal-conservative compromise. Conservatives sometimes favor hidden expenditure taxes because, relative to a direct tax, they make expenditure programs appear smaller and avoid raising the top rate of income tax (the one often of most concern to supply side economists partly because others are less likely to apply at the margin). Liberals often favor expenditure taxes because they allow benefits to be concentrated more on those who are measured as being poorer. Programs with lower expenditure tax rates often extend net benefits to higher levels of income and may be less progressive.

Often both conservatives and liberals support their stances by arguing that high tax rates on benefit recipients have little effect on behavior. While this may or may not be true, as discussed below, one really wonders why as a society we worry about 40 percent tax rates on the rich if 50 or 100 percent tax rates on the poor have little or no effect. Are the poor really that different?

Note that we are quite inconsistent in how we decide when to means test or not. Public education, Social Security, and Medicare are more universal. Social Security and higher educational benefits and farm subsidies tend to be larger for those with higher incomes than those with lower incomes, though Social Security also applies a type of lifetime income test that tends to restore some progressivity. Head Start, TANF, and housing vouchers are concentrated on low income and are means tested at moderate levels. Child credits do not phase out until higher income levels. Medicaid provides a cliff effect: earn one more dollar and consequently lose a health insurance package that one dollar before was free. The new health exchange subsidies avoid that cliff and start phasing out at modest income levels but then stretch fairly high into the income distribution. The earned income tax credit phases in and then out.

### **What Does the Nation's Real Tax System Look Like?**

At the Urban-Brookings Tax Policy Center and the Urban Institute’s Income and Benefits Policy Center we have done perhaps the most extensive work anywhere on the size of these combined tax rates.

Let’s begin by displaying two hypothetical cases for a more-or-less “universal benefit” and then a “maximum benefit” system for households with children. Case 1 (Figure 1a) considers a single parent household with children—the type of household most affected by these high tax rates—and shows federal income taxes, employer and employee portions of the Social Security tax, personal exemptions, child credits and dependent care credits, the earned income tax credit, SNAP, Medicaid, SCHIP, and the new health exchange subsidy (as if it was available in 2011). A focus on this set of programs is important because, in theory every household with children is eligible for these programs if its income is low enough. The benefits are generally not restricted by waiting lists and are universally available as long as recipients meet certain eligibility criteria, mainly income level, which can vary by state. In a sense, then, the tax rates levied by these programs apply to all households, though they may have moved out of the very high tax rate part of this regime when their annual earned incomes start to exceed \$40,000 or higher, and they have moved beyond the income cutoffs for several of the transfer programs. Put in terms of panel 1, these latter households have moved to the right along the horizontal axis beyond, first the high-benefit and low-or negative-tax rate regime (which applies to earnings of roughly \$0 to \$10,000), and then, the high-tax-rate regime (which applies to incomes of roughly \$10,000 to \$40,000).

Case 2 (Figure 1b) includes the same programs as Case 1 but also assumes the single parent with two children is receiving welfare cash assistance (TANF), housing assistance, and child care benefits (direct expenditures for child care). In many ways, it is an extreme case, since only a small minority of low-income families receive all these benefits. As a general rule, these additional programs are not universal, in contrast to those in Case 1. Rather, they are parceled out either through time limits for years of eligibility or through queues as to who may participate. Households are much less likely to benefit from the programs in Case 2 than those in Case 1. In Case 1, the family receives the most benefits at about \$10,000 to \$15,000 of earnings—mostly because the EITC is fully phased in by that earnings level, while most other benefits are either still phasing in or have not yet phased out. In Case 2, where the household is on TANF and receives housing, maximum benefits are still available when there are no earnings. Benefits drop off steeply as earnings start to exceed those amounts.

The health benefit graph (Figure 1c) displays what the health system at the top of Case 1 and 2 looks like in isolation from the other programs. There are legitimate debates over how to deal with these calculations and their incentive effects, but it is such a large portion of the social welfare system that I felt it would be misleading to leave it out.

Figure 2 then shows the effective marginal tax rate that derives from the combination of income, Social Security, and state taxes, combined with the phase out of the various benefits shown in Figure 1a and 1b. As can be seen, tax rates begin to spike somewhere above \$10,000 or \$15,000. This is summarized in Figure 3.

There we calculate the effective average marginal tax rate if this household increases its income from \$10,000 to \$40,000. That is, how much of the additional \$30,000 of earnings is lost to government through direct taxes or loss of benefits? The average marginal tax rate in the first bar of Table 3, 29 percent, is based simply on federal and state direct taxes, including Social Security and the EITC. The rate rises appreciably as the family enrolls in additional transfer programs in bars 2 and 3. For a family

enrolled in all the more universal non-wait-listed programs like SNAP, Medicaid, and SCHIP, the average effective marginal tax rate could be 55 percent. Enrolling the family in additional waitlisted programs, like housing assistance and TANF, ratchets the rate up above 80 percent.

Put another way, while we might think of the income tax rate schedule as showing rates of 0, 10, 15, and 25 percent respectively, the true rate schedule faced by these families includes rates like -40 percent (from the initial phase-in of the EITC) and 50 and 80 percent.

The high tax rates especially affect the choice of a household with children to work full-time a bit above the minimum wage or to marry or stay married. I will return to these issues below. However, for those in the universal system, the structure does encourage labor force participation, and those in TANF also face a variety of incentives to keep or take a job.

Some caveats are in order. A number of eligible households do not apply for benefits, such as the food subsidies for which they are eligible. We have performed some analyses of the population as a whole at the Urban Institute and find that the average rates across households will be lower than what you see in the table because of less than full participation in the programs. By the same token, we have not included the child care grants in these calculations. Add those in, and the rate can exceed 100 percent (though keep in mind that those receiving those particular grants must work to receive them).

**Figure 1a**

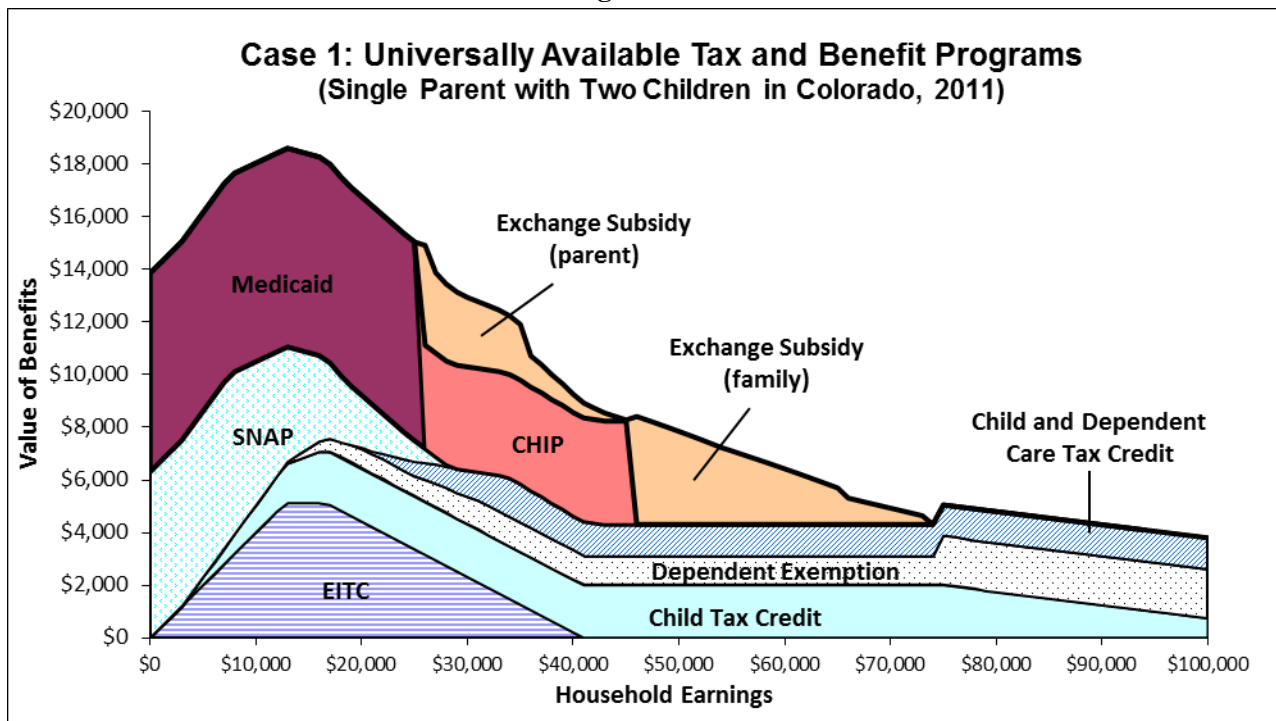


Figure 1b

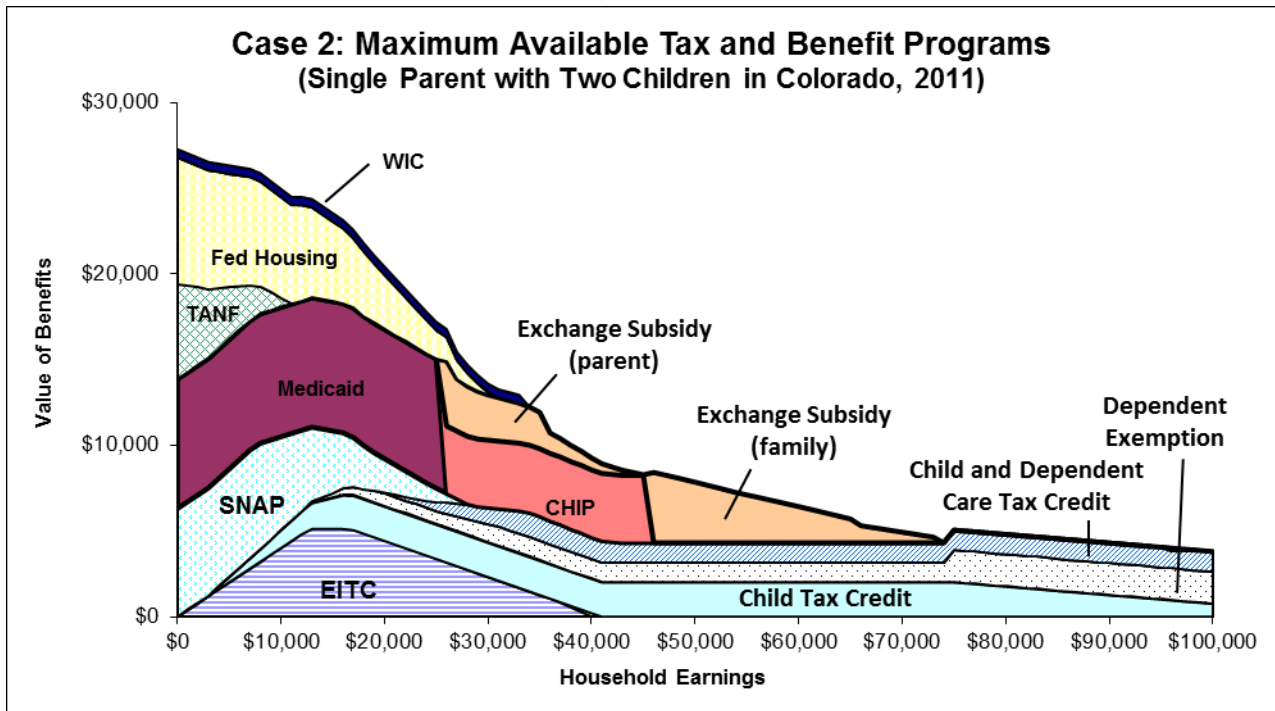
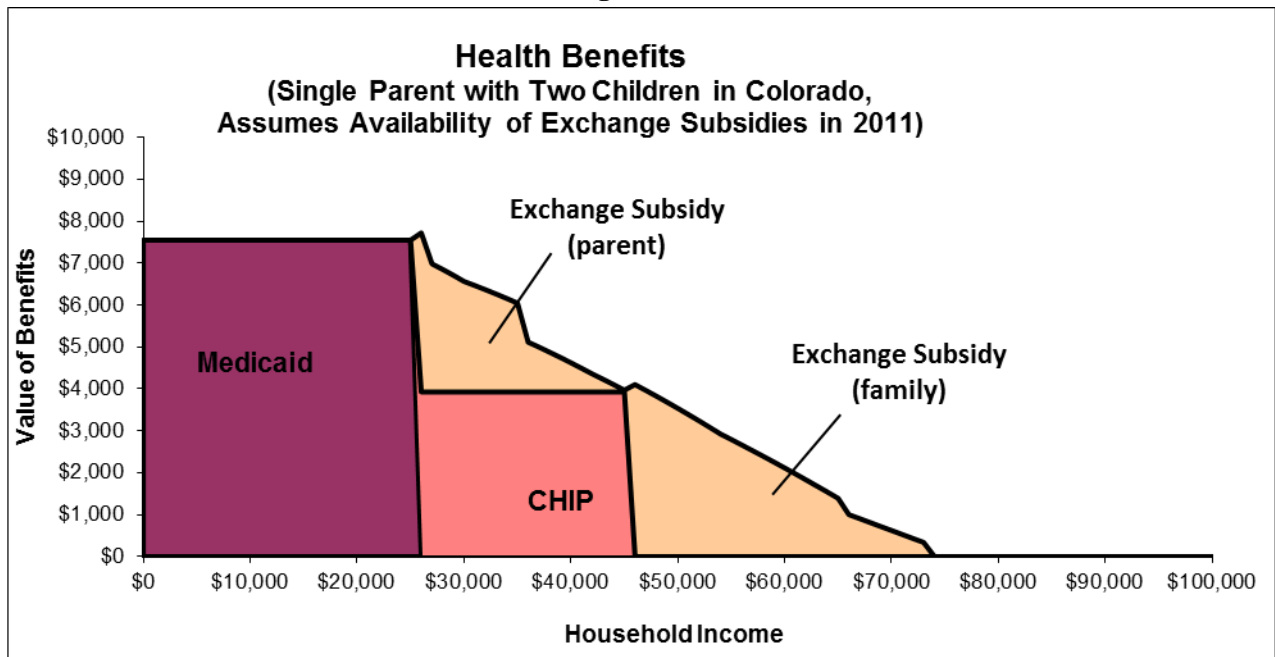
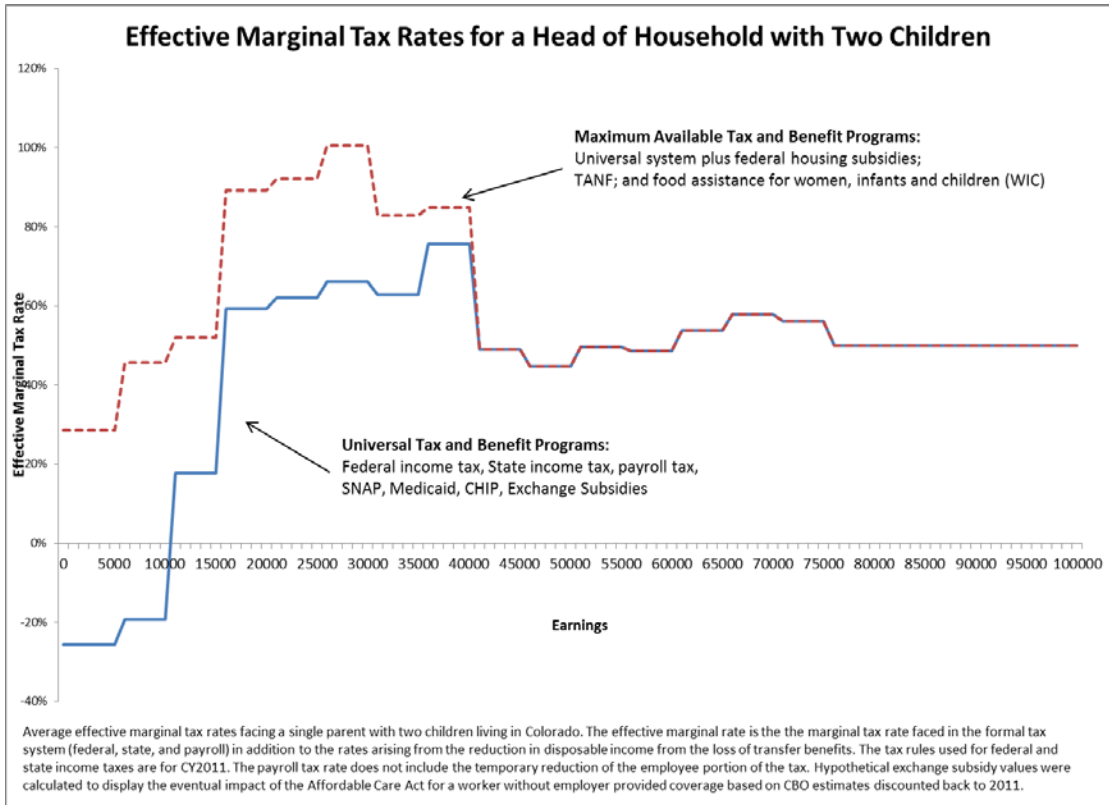


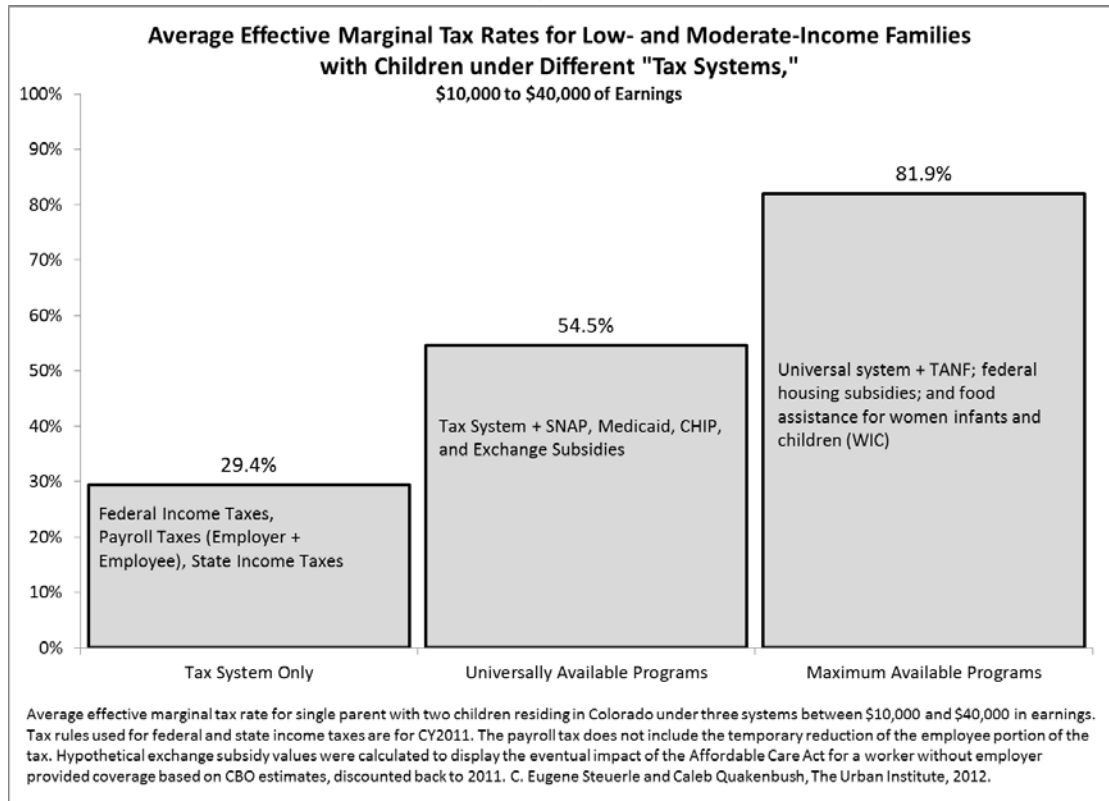
Figure 1c



**Figure 2**



**Figure 3**



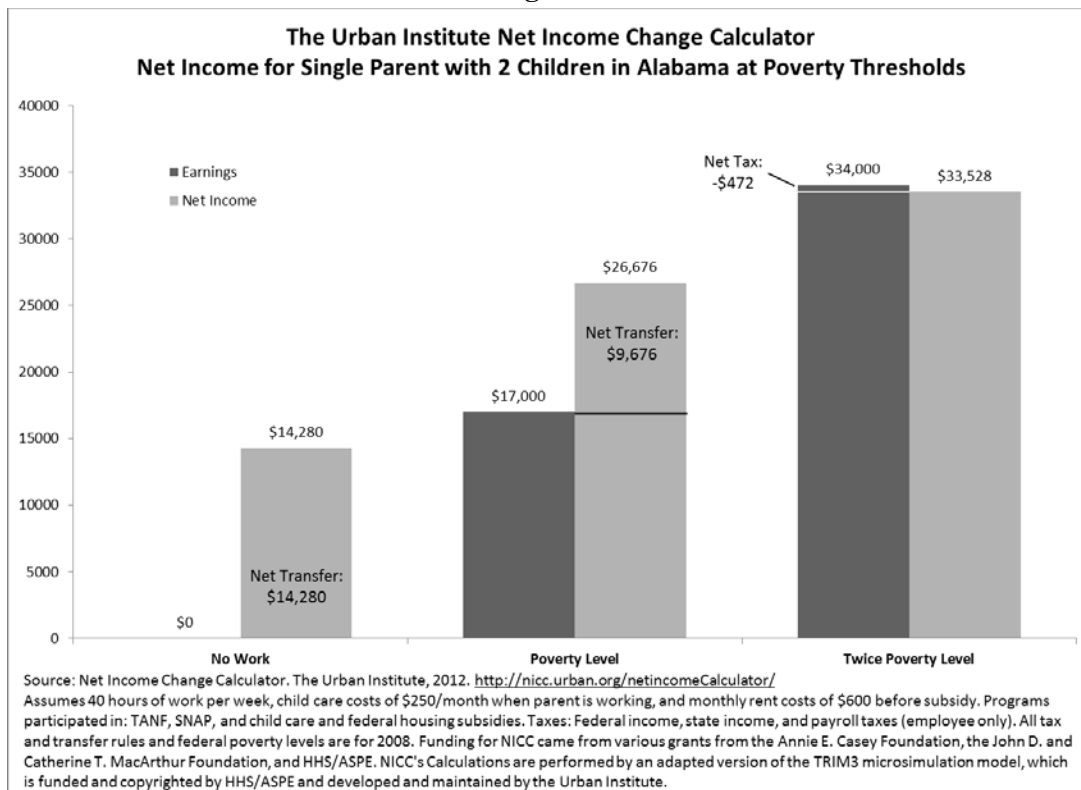


**The Net Income Change Calculator.** The Urban-Brookings Tax Policy Center and the Income and Benefits Policy Center have also collaborated with government and foundations to produce a Net Income Calculator (NICC), which can be found at <http://nicc.urban.org/netincomeCalculator/>.<sup>1</sup> It allows individuals to generate a state by state analysis of tax and transfer benefits available to individuals and families as income, weekly hours, wage levels, and program participation varies. The calculator does not currently include a calculation for various health care programs, in part because of the complex issues related to their valuation. Nonetheless it is especially useful in developing specific state data for those who are interested.

Figure 3 below shows the type of calculation that can be done. The example chosen was a family participating or potentially participating in a variety of programs (in this case, TANF, SNAP, housing and child care assistance) in Alabama. As can be seen, with no work at all this family generates \$14,000 in benefits. If it earns poverty level income of about \$17,000, its total income would rise to about \$26,700 or close to \$13,000. Once again, we see that rates are moderate for getting into the workforce, in part because of the EITC. However, if the family earns about twice the poverty level, or an additional \$17,000, income would rise by only about \$6,900—an effective average marginal tax rate of about 60 percent, to which must be added any loss of health insurance benefits.

Many years ago, the high taxation of welfare recipients who went to work was labeled a “poverty trap.” In doing these calculations a number of years ago, Linda Giannarelli and I decided that the poverty trap had been largely removed but had been replaced by what we called the “twice poverty trap.” These numbers reconfirm that analysis.

**Figure 4**



## **The Effect on Work**

Economic theory tells us that distortions in behavior increase disproportionately with the marginal tax rate. However, these distortions can take different forms: less work, more work, and other behavioral shifts such as avoidance of marriage. Many empirical studies have attempted to isolate the net effect of these rates on work, and the results are mixed. Generally speaking, programs like the EITC and various work-related experiments show that those programs tend to encourage labor force participation. But they tend to discourage work at higher income levels, such as taking a second job in the family. This, of course, is what we might expect, since in a phase-in range the EITC increases rewards from work while providing no income to those who don't (in economic terms, the substitution effect is positive and there is no income effect). By the time one reaches the phase-out rate, income is higher as well as marginal tax rates, and other programs are also phasing out. Therefore, disincentives are fairly high at this level.

Welfare reform also attempted to cut the Gordian knot by making benefits conditional upon work. Generally speaking, work did increase after reform, although there is some dispute on how much was due to the EITC, welfare reform, or the better economy. My own view is that one major reason for the increased work effort was that governors started telling their welfare administrators that they were going to be judged by how many people they got off welfare, rather than how many clients they served. Perhaps one of the most important conclusions is that for the same amount of cost, a program that requires work will indeed encourage work more than one that does not. EITC and welfare reform have done better on the work front than did AFDC.

Design matters greatly. For instance, Medicaid will discourage work among the disabled more than a subsidy system such as adopted in recent health reform; on the other hand, health reform will probably encourage more people not now on Medicaid to retire early. I believe those numbers are reflected, though indirectly, in CBO's estimates of the effect of health reform on the budget and economy. Many workers face discrete choices to work or not work or try to take another job; it is often not easy to vary hours on any one job.

In my view, few of these empirical studies do a good job at telling us the long-term effect on behavior. Looking at the data over time, I conclude that the "income" effect—the consequence of having higher income—often is more important than the tax effect. Don't forget also that the tax effect by itself at times has a reverse income effect, in that some people will work more to generate the same net income that they might need. Some evidence comes from other programs. For instance, the availability of Social Security for almost a decade more than when it was first created seems clearly to have induced earlier retirement, independently of whether there was any tax effect. There are also psychological factors we are only beginning to assess. For instance, once on disability and sometimes unemployment, people develop different life patterns that become more habitual; for some, being out of work for a long time can also add to depression, which then rebounds on ability later to work. As already noted, the disabled are especially reluctant to give up Medicaid. The signals that government shares with its people can be powerful, such as whether work is of intrinsic value to society; at the same time, government choices may reflect rather than develop such societal values.

Finally, asking whether government benefit programs provide disincentives to work may be the wrong question. Yes, they often do. Any such effects must be contrasted with the good they may do so as to form a judgment of their merit. Here, I think the more important question may be how we can create a social welfare structure that does the maximum good by minimizing distortions and other unintended or undesired consequences. When relative comparisons are made, I think we have considerable prospect at improving upon a structure that has done a moderately good job at reducing hunger and poverty, but a mediocre job at providing opportunity and investment, rather than just adequacy and higher levels of consumption, to a significant portion of our population.

### **Other Consequences.**

**Marriage Penalties.** Means testing and joint filing has resulted in hundreds of billions of marriage penalties for low and middle income households.

Essentially, when moderate-income couples marry, their marginal tax rate moves up from, say, 25 percent, to the 50 and 80 percent ranges shown above. For instance, a moderate income male marrying a working mother with children can easily cause her to lose EITC, SNAP, Medicaid, and other benefits as well.

Marriage penalties arise because of the combination of variable U.S. tax rates and joint, rather than individual, filing by married couples for benefits and taxes. If graduated taxes were accompanied by individual filing or if all income and transfers were taxed at a flat rate, there would be no marriage penalties. The EITC, by the way, can provide both subsidies and penalties, and Social Security generally provides very large marriage bonuses.

Someone looking at our system from Mars would conclude that we don't want moderate income families with children to marry, since we penalize them, but we do want older households (at ages when children are likely to be gone) to marry, since we subsidize them.

**Games Encouraged by Means Testing.** One thing we have learned in public finance is that taxes have significant effects on portfolio behavior even if there is less certain effect on work and saving. Not getting married is the major tax shelter for low- and moderate-income households with children. In many low-income communities around the nation, marriage is now the exception rather than the rule.

Marriage penalties or subsidies are assessed primarily for taking wedding vows, not for living together with another adult. Those who do not feel morally compelled to swear fidelity in religious or public ceremonies for the most part do not suffer the penalties. Our tax and welfare system thus favors those who consider marriage an option—to be avoided when there are penalties and engaged when there are bonuses. The losers tend to be those who consider marriage vows to be sacred.

These effects of marginal tax rates extend well beyond the marriage patterns of low-income families. Divorced couples allocate child support so as to maximize future college aid. Some couples avoid remarriage to avoid losing Social Security or pension benefits. As noted, the disabled sometimes avoid work so as to keep Medicaid, while some of the unemployed delay going back to work.

## Options for Reform

It is impossible in a single testimony to deal with the many ways our social welfare system might be reformed to provide better results. Today that system strongly emphasizes growth in health and retirement benefits, while middle income families and children are facing a situation where their share of the budget is scheduled for rapid decline even while they are being left with ever more debts to pay off.

I believe we are at a major fiscal turning point in our history. At one level, it is forced on us by an unsustainable budget, but at another level it gives us the opportunity to reconsider broader changes to our tax and social welfare structure. In that regard, I believe all of the following deserve strong consideration:

1. **Adopting a broader social welfare reform.** An integrated approach to reform would stop adopting all these tax systems one at a time, with little consideration of how they fit together.
2. **Emphasizing opportunity and education more and adequacy and consumption less.** Long-term reform could also put more emphasis on opportunity, education and work and less on adequacy and increasing consumption levels.
3. **Putting more tax rates directly into the tax code.** A transparent system would replace some implicit taxes with explicit ones, thus facing the same political obstacles as eliminating tax expenditures. Government would have to admit what it is doing. Just as eliminating tax expenditures appears to be increasing size of government when it is not, so also does substituting direct for expenditure taxes appears to be raising taxes when it may not actually raise them.
4. **Making work an even stronger requirement for receipt of other types of benefits.** This type of approach need not reduce benefits overall, since some or all of any additional saving could be applied to those who do work.
5. **Adopting a maximum marginal tax rate.** A partial approach at integration would attempt to create some maximum tax rate for several or many programs.
6. **Letting child benefits go with child, work subsidies go with low-wage workers.** The EITC provides wage subsidies to low-income workers raising children, but then leaves out other low-wage workers and usually creates high tax rates when two earners marry. Reform could separate out the subsidy for children from that from low-income workers.

Innovative approaches need to be tried. Catholic Charities, for instance, supports a National Opportunity and Community Renewal Act for a pilot project that is people-focused and case managed, based on local community opportunities. In the suggested programs under this experiment, a person might qualify for help, but the exact nature would depend on agreement between the case manager and client, allowing them together to tie together and reallocate resources for which the client is eligible. That reallocation would likely increase labor force participation, as it would be largely aimed at improving opportunity and addressing issues that cause the poverty in the first place.

## Conclusion

For several decades now, policymakers have created public tax and transfer programs with little if any attention to the very high tax rates that they inadvertently imposed. Combined effective marginal tax rates from dozens or hundreds of phase-outs can be very high and certainly lead to hidden and confusing government. The rates are especially high for low-to-moderate income households with children and include hundreds of billions of dollars of marriage penalties as well. These high tax rates also extend into many middle-income programs as well.

These developments are in no small part the consequence of a half-century of social policy enactments of roughly similar design. Liberals wishing to keep programs progressive and conservatives wishing to keep budget costs low have together put a substantial portion of household subsidies and assistance onto this platform, yet with no consistency with other programs such as public education or Social Security and Medicare. These penalties can be reduced in various ways but, given their size and magnitude, not without major reconsideration of this multi-decade set of developments and a principled approach to creating a social welfare system for the 21<sup>st</sup> century.

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<sup>i</sup> Initial development of the NICC was funded by the Annie E. Casey Foundation as part of the Low Income Working Families Project. Funding for the update of the 2008 rules was provided, in part, by HHS/ASPE. Additional funding came from the John D. and Catherine T. MacArthur Foundation. NICC's development built on an earlier tool, the Marriage Calculator, developed at the Urban Institute under contract with HHS/ACF. NICC's calculations are performed by an adapted version of the TRIM3 microsimulation model. The standard version of TRIM3 is funded and copyrighted by HHS/ASPE and developed and maintained by the Urban Institute. We are further working with the TRIM3 model to try to determine just how many households are subject to these high rates, which depend upon both family structure and participation levels.