

## Tax System Gets Rough Around the Margins

By Richard Rubin, CQ Staff

The U.S. income tax system is progressive in theory: If you earn more, you pay a higher tax rate. But it doesn't always operate that way, particularly for low-income workers. Families at the bottom of the income scale are sometimes effectively subject to the highest tax rates, because every dollar they earn reduces their eligibility for tax credits and income-based benefit programs.

This is hardly intentional, and it is mostly the consequence of two factors. Frequently, assistance programs are linked to income levels, and lawmakers rarely think comprehensively about how to meet the twin policy goals of helping low-income families meet basic needs while at the same time encouraging them to climb out of poverty through work.

The result is a collision — among multiple assistance programs and their separate income level cutoffs — that can result in often-hidden penalties for those families who earn just a little more money than they did before, potentially creating a disincentive to work.

One of the biggest effects, say experts who have looked closely at this phenomenon, is seen in so-called marginal tax rates. That's the amount owed on the next dollar a person earns. In the case of lower-income workers, the calculation includes the amount of assistance lost when incomes rise.

Marginal rates paid by low-income and middle-income families are gaining particular attention during the debate over expanding health insurance coverage. Both the House and Senate versions of the legislation would use income-based credits to provide subsidies to low-income workers who need help purchasing insurance and making co-payments. Both bills thus would put many families in the position of facing shrinking subsidies if their incomes increased.

Well-intentioned social programs have combined in a way that undermines some of their own goals, said Jim Capretta, a fellow at the Ethics and Public Policy Center in Washington who worked in the Office of Management and Budget under President George W. Bush. "When you pile them all on top of each other," Capretta said, "they create this tremendously powerful incentive trapping people in these programs, and it doesn't pay to work themselves out of it."

Others concede that there are adverse economic consequences from the interplay of higher incomes and phased-out assistance programs, but they downplay worries that people choose not to work as a result.

“In purely economic theory — rational terms that imply that people absolutely understand how all these things intersect on paper — there would look like there ought to be an effect,” said Robert Greenstein, executive director of the liberal-leaning Center on Budget and Policy Priorities. “But there really isn’t a lot of evidence of significant impact there.”

### Complicated Math

Economists and politicians have long understood the power of marginal tax rates to drive behavior. When workers internalize the idea that the government will take a significant chunk of any additional earnings, they learn to be cautious about taking on additional work.

Opposition to high marginal rates animated the tax policies of President Ronald Reagan, for instance. The former actor, who once faced marginal rates as high as 91 percent, helped push the top rate on individual income down to 28 percent in 1988, from 70 percent when he ran for office in 1980.

That was important, Republicans argue, because the people who earn the most and create jobs can know their marginal tax rate by making a simple calculation.

Under current law, a single person who lives and works in the District of Columbia and has more than \$372,950 in taxable income pays a marginal federal income tax rate of 35 percent and a marginal rate of 8.5 percent for the District’s income tax. It’s easy math, and, on top of that, wealthier people tend to have advisers and accountants who can help them navigate the tax system.

On the other end of the income scale, the effects can be just as pronounced, but deciphering them is much harder, because the marginal rate depends on the income-based phaseouts of various benefit programs, each of which has its own eligibility criteria. At low incomes, it’s not just the tax system but the layering of taxes and benefits that causes marginal rates to rise.

In particular, several benefit programs that are critical to low-income workers are directly tied to the tax code. The earned-income tax credit and the child tax credit are both “refundable,” meaning eligible beneficiaries can get checks from the government even if they owe no tax.

For very poor people, Greenstein said, the child credit and earned-income credit rise with wages, creating a strong incentive to work more, because the government effectively matches the additional earnings. But as incomes increase further, those benefits plateau or shrink, and marginal tax rates rise.

The problem comes from liberal pressure to create generous subsidies and conservative pressure to hold down costs by covering as few people as possible, said Eugene Steuerle, co-director of the Tax Policy Center, run jointly by the Urban Institute and the Brookings

Institution. These competing ideals yield significant distortions, or what Steuerle calls a tax system disguised within spending programs.

And the costs add up. For example, a family of one adult and two children with an income of \$22,000 would live at about 120 percent of the federal poverty line. But that level of income would put the family in the phaseout range for the earned-income credit, and every additional dollar of income would reduce the credit by 21 cents (until it disappeared at an income of \$40,295).

If the family's income were to rise above \$23,808, or 130 percent of the poverty line, it would lose eligibility for food stamps. And depending on the state where the family resides, it might also lose child care assistance, housing vouchers, a state earned-income credit or health benefits if its income were to increase.

In North Carolina, families earning more than 150 percent of the poverty line (\$27,465 for a family of three) must pay enrollment fees and co-payments to remain in the state's version of the Children's Health Insurance Program.

Federal housing vouchers are based on an area's median income, which means that eligibility criteria vary by region.

Even that rough set of examples is misleading, because the earned-income credit is based on annual income, while food stamps and other programs are based on monthly income. Each program also has different definitions of income and different allowable deductions.

Steve Holt, a public policy consultant, conducted a study in Wisconsin earlier this decade and found that many low-income families faced marginal tax rates exceeding the rates on top earners. For 2000, he found that almost a quarter of Wisconsin single-parent families with at least two children had marginal rates above 50 percent, with the affected families concentrated between 100 percent and 250 percent of the federal poverty line.

### Disincentives to Work

Analyses such as Holt's suggest that low-income families pay big penalties for boosting their earnings. But given the complexity involved in determining eligibility, the question is whether workers actually react to these disincentives.

The answer would seem to be "yes — sometimes." The 1996 welfare overhaul law, which removed no-strings-attached cash grants to poor families, is widely viewed as a success in creating incentives for people to work.

Other critics of current policy say that while gradual phaseouts of assistance eligibility based on income don't necessarily influence behavior, "cliffs" such as the end of food stamp eligibility at 130 percent of the federal poverty line or state limits on other subsidies can have dramatic effects.

At least anecdotally, “people are conscious of those,” Holt said. “People will say, ‘I didn’t take that job or I didn’t get that raise because I would have lost my child care or lost my benefits.’ ”

Marginal rates can also influence other kinds of behavior. A recent study by economist Emmanuel Saez at the University of California-Berkeley demonstrated a significant “bunching” of reported income near the point in the earned-income credit schedule that would generate the maximum refund.

That isn’t the result of people working just enough to maximize their tax credit, Saez contended. Instead, because the bunching occurs among taxpayers with large amounts of self-employment income that the IRS cannot easily verify, the data suggests that fraud, not work disincentives, led to the trend.

Others experts emphasize that multiple decisions are affected by marginal tax rates. And the absence of calculated behavior to maximize benefits doesn’t necessarily mean that people’s actions aren’t unconsciously affected by marginal rates. The decisions people make are often not about whether to go to work, but rather about whether to take a second job, retire, work extra hours or move a second earner into the workforce.

“I’m a huge believer in financial incentives, so it may not be conscious, but it certainly permeates behavior,” Capretta said.

The instances in which people don’t react to disincentives would seem to mitigate any worry that high marginal tax rates have much effect among the working class. But even if workers don’t act consciously, they can still feel like they’re switching from government supports to standing on their own legs without improving their personal finances.

Steuerle says these kinds of disincentives to additional work can help shape a cultural norm about the value of employment.

“They don’t know explicitly what’s going on, but they watch what their peers are doing,” he said.

### The Health Care Factor

On top of the existing system of subsidies and tax credits, the health care bills would introduce a new set of marginal rates for people who don’t qualify for Medicaid and aren’t provided insurance by their employers.

The bills would impose higher marginal tax rates on low-income and middle-income families because of how they help families afford the purchase of health insurance on their own. Both the House and Senate bills would grant subsidies for people who make up to 400 percent of the poverty line. Those credits, along with other provisions to cover out-of-pocket costs, are designed to limit the share of income that some families spend on health care. And they are calculated on a sliding scale that decreases as income increases.

An analysis by the congressional Joint Committee on Taxation said that, combined with income and payroll taxes, people making 150 percent of the poverty line would face a marginal tax rate of 59 percent, based solely on tax and health provisions. That analysis focused on the version approved by the Senate Finance Committee, and the subsidy levels haven't changed substantially since then.

At income levels where subsidies disappear, some families might pay higher costs. But that would depend on a variety of factors, including how much health care they used.

Greenstein looks at the health care bills another way, noting that the incorporated tax credits would take effect for people earning more than 133 percent of the poverty line in the Senate bill — a point at which they already could not receive food stamps or some other benefits. Also, he says, current law, which can vary by state, already includes strict eligibility limits for Medicaid and children's health insurance, providing a disincentive for workers to take a higher-paying job unless it also comes with health insurance.

Considering all of those factors, the proposed new health care safety net envisioned in the legislation will encourage people to seek jobs because they won't put their insurance at risk by going to work, Greenstein said. In other words, the legislation would make a trade-off by raising marginal tax rates on millions of people at the same time that it would create a smoother transition out of government support for people who otherwise couldn't afford health insurance.

The debate on health care illustrates the broader issue for lawmakers trying to address the consequences of high marginal rates. The two basic ways to address the problem are to make subsidies less generous or to lengthen the eligibility phaseout period.

A more comprehensive system of tax credits and other benefits might remove eligibility cliffs and better align phaseouts so they don't overlap. That strategy, Holt and others say, would address the broader issue that the multiple programs are not coordinated.

But so far, if the health care debate is any indication, lawmakers aren't interested in such an approach.

**FOR FURTHER READING:** *Senate health care overhaul debate (HR 3590), p. 2822; using the tax code for social goals, 2007 CQ Weekly, p. 385; welfare overhaul (PL 104-193), 1996 Almanac, p. 6-3.*

Source: **CQ Weekly**

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