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Taxes, Welfare and Work

The highest tax rates in the United States today are not imposed on the wealthy. They are imposed on the poor.

When people on welfare earn income, they face two types of penalties. Not only do they have to pay taxes on their earnings, but they have their welfare benefits reduced as well. This reduction in benefits is a de facto tax, because it reduces their net income the same way direct taxes do.

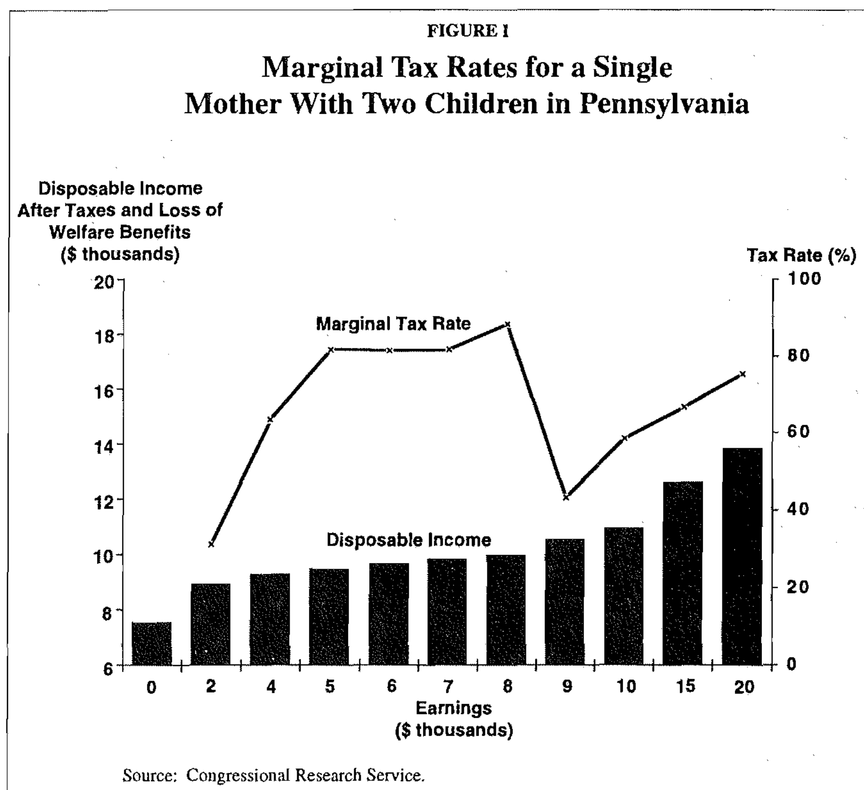
Depending on the precise combination of earnings, taxes and benefits, a welfare mother can easily face marginal tax rates of more than 100 percent. That is, she loses more than a dollar in taxes and benefits for each additional dollar she earns. Obviously, this is a severe disincentive to go to work and get off welfare.

Marginal Tax Rates for Welfare Mothers. Figure I illustrates the problem. A single mother with two children living in Pennsylvania receives $7,548 in benefits if she has no earnings. If she earns $2,000, the combination of taxes and lower benefits raises her disposable income by just $1,375. This is equivalent to a tax rate of 31.25 percent on the earnings.

On the portion of earnings between $5,000 and $8,000 per year, the marginal tax rate rises to well over 80 percent. In other words, out of each additional dollar she earns her disposable income rises by less than 20 cents.

FIGURE I

Marginal Tax Rates for a Single Mother With Two Children in Pennsylvania



Source: Congressional Research Service.

Thus a woman earning $8,000 per year in wages is just $2,408 better off than a woman who does not work at all. This is equivalent to an effective average tax rate of 70 percent on her total earnings.

High marginal tax rates are inherent in means-tested welfare programs. The more quickly benefits are phased out, the higher the tax rate. Reducing benefits gradually makes the tax rate lower but is expensive since it raises the level of earnings one can have and still receive benefits.

Marginal Tax Rates and the EITC. Another cause of high marginal tax rates for the poor is the Earned Income Tax Credit (EITC). This program provides working families with a refundable tax credit — a check from the government equal to 36 percent of earnings, rising to 40 percent next year. In 1995, more than 18 million families are expected to benefit from the EITC, at a cost of $24 billion — $20 billion of which represents a direct budgetary outlay in the form of refunds, with the remaining cost to government coming in reduced revenue. In many states, more than a quarter of all families receive the EITC, according to the Treasury Department.

Congressional Republicans have proposed modest cuts in the EITC of between $10 billion and $19 billion over seven years. Their efforts are being strongly resisted by the Clinton administration, which sharply increased the EITC in 1993 in order to help the working poor.

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In fact, the benefit to working poor families is far less than it appears. The EITC is phased out at a 20.22 percent rate when a family's earned income reaches $11,000, with the credit completely eliminated when its income reaches $26,000. Thus families in the phase-out range face an extra marginal tax rate of more than 20 percent.

Coming on top of direct taxes and the loss of other benefits, this means that families with incomes between $11,000 and $26,000 are being taxed at the rate of about 60 percent on each additional dollar earned, on the average. This total tax rate includes federal, state and local taxes plus the reduction in EITC.

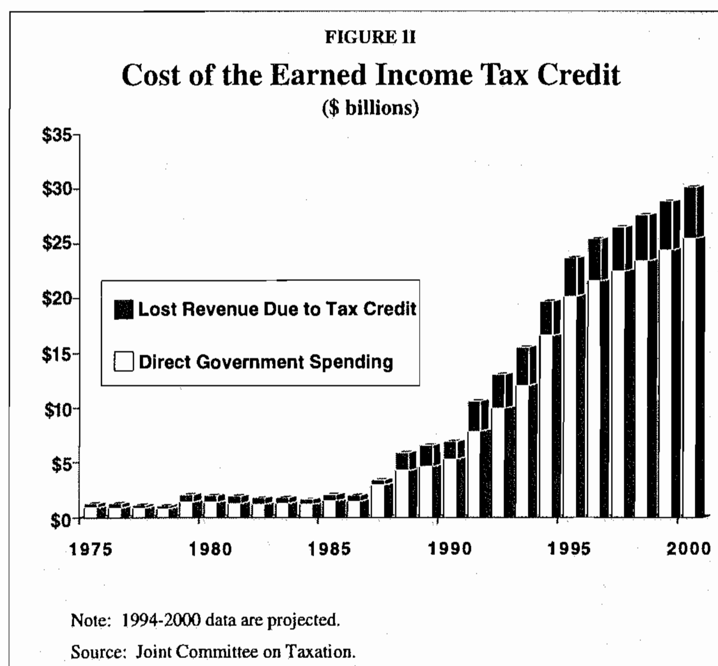
Since about two-thirds of EITC recipients and 84 percent of the income earned by all EITC recipients are in the phase-out range, for most who receive it the credit is a disincentive to work. Due to the EITC, many families reduce rather than increase their work effort.

The EITC does lift some families out of poverty. But it does not help all those who receive it. Many would be better off without it. Professor Edgar Browning of Texas A&M University, in an article in the March issue of the *National Tax Journal*, calculated the effects on family income of the EITC, taking account of the reduced work effort of those in the phase-out range. He discovered that *nearly half of all families receiving the EITC actually had less total money income than they would have had without the credit because they worked less.* Overall, Browning estimated that each $1 of EITC the federal government spends increases the net income of the working poor by just 46 cents.

FIGURE II

Cost of the Earned Income Tax Credit

($ billions)



Note: 1994-2000 data are projected.

Source: Joint Committee on Taxation.

Browning also found that a significant percentage of EITC benefits go to families well above the poverty level. Indeed, according to the House Ways and Means Committee, by 1996, almost one-third of EITC benefits will go to families with incomes over $20,000 per year.

Other studies have also found that the EITC's disincentive effects outweigh its benefits to the working poor. For example, Professors Stacy Dickert, Scott Houser and John Karl Scholz of the University of Wisconsin, writing in the 1995 edition of *Tax Policy and the Economy*, also found that on balance the EITC reduces total hours worked.

And Marvin Kosters of the American Enterprise Institute points out that the EITC imposes a severe "marriage penalty" because it applies to a maximum of two children per qualified worker. Therefore, if both husband and wife work and they have more than two children, they have a powerful financial incentive to get divorced. The reward can be as much as 25 percent of the couple's combined income, according to Kosters.

Solving the Problem. There are just three ways to remove the tax rate effects of means testing. The first is to remove the means test and pay benefits to everyone, regardless of income. The second is to abolish welfare altogether. Neither of these seems feasible at this time; the first is too costly and the second too harsh.

The third approach is the one now being pursued in Congress: require work of those who receive welfare. If welfare recipients are forced to work, then the loss of benefits no longer poses a disincentive.

This Brief Analysis was prepared by NCPA Senior Fellow Bruce Bartlett.

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