

## *Making Work Continue to Pay Working Group*

### *The Federal Tax Cut And Low & Middle-Income Working Families: An Opportunity For Meaningful Tax Relief*

As the federal government is poised to enact a tax cut, policymakers have a unique opportunity to help working families by adjusting or eliminating the phase-out rates of the Earned Income Tax Credit (EITC). Currently, low-wage workers face extremely high marginal tax rates, which average over 60% and often exceed 100%. Changing the phase-out rates of the federal EITC could support low-income working families' efforts to improve their economic situation. There are a number of proposals that could accomplish this goal while also providing tax relief to a broader group of working poor and middle-income taxpayers.

Over the last fifteen years, the treatment of lower-income families by the Internal Revenue Code has improved significantly. There have been increases in personal exemptions and standard deductions, dramatic expansion of the Earned Income Tax Credit (EITC), and creation of the Child Tax Credit. These actions have raised the income level at which working families begin to incur income tax liability, and millions of families now receive meaningful earnings supplementation through the tax system. Changes in taxes and benefit programs have made it possible for millions of parents to support themselves and their families through work.

Unfortunately, these gains have a hidden cost. The interaction of tax and benefits programs (at both the federal and state levels) means there is often little benefit from working harder and earning more. The sum of earnings plus benefits minus taxes (what could be called *true* "take-home" pay) changes little whether earnings rise or fall. Consider the following example:

*Single parent in Wisconsin with two children; working full-time, 50 wks/year*

<b>Hourly Wage</b>	<b>Yearly Wage</b>	<b>Take-Home Pay</b>	<b>Marginal Tax Rate</b>
\$6.00	\$12,000	\$19,260	Na
\$8.50	\$17,000	\$20,736	70%
\$9.25	\$18,500	\$20,302	129%
\$12.00	\$24,000	\$23,271	54%
\$15.00	\$30,000	\$26,173	48%

*"Take-home pay" includes wages, state and federal taxes and the cash value of food stamps*

The family is losing much of each additional dollar it earns. Between \$6 and \$15 an hour, the family's "marginal effective tax rate" -- the rate at which those additional earnings are reclaimed -- is 62%. Over \$11,000 out of the additional \$18,000 in earnings is lost because tax credits phase out and benefits are reduced. At certain points, the rate is even higher. For example, because of the loss of all Food Stamp benefits, the effective tax on a raise from \$8.50 to \$9.25 an hour is 129%. In other words, the family would actually *lose* \$434 in true take-home pay because of a 75 cent an hour raise.

The points at which workers lose money by earning more differ from family to family, depending on marital status, number of children, housing costs, and other factors. Nonetheless, the overall inability to get ahead by earning more is a problem for almost all working parents with incomes between 75% and 200% of the federal poverty level.

High marginal effective tax rates are also a drag on the overall economy. Employers already face challenges in recruiting and maintaining an adequate supply of labor. Shortages of skilled laborers will only increase as baby boomers age and retire. When the structure of taxes and benefit discourages workers from moving into better-paying jobs (however unintentionally), the result is increased recruitment burdens for employers. Making work continue to pay, by lowering the marginal tax rates affecting low and moderate income workers, is essential to maintaining a high-quality workforce, meeting the needs of businesses, keeping America competitive, and sustaining economic growth.

No single tax or benefit program is itself the culprit; the problem comes from the cumulative impact of a variety of programs. When the problem is at its worst (between \$13,000 and \$18,500 for the family in the example), the three largest components of the marginal effective tax rate are:

- Food Stamps 28.75%
- Federal EITC 21.08%
- Social Security/Medicare 7.65%

At higher incomes, Food Stamps is not an issue, but the 15% federal income tax rate is.

### Proposals to Support Working Families With A Federal Tax Cut

The federal government is poised to enact a very large tax cut. As we look at the most equitable ways to utilize budget surpluses, the nation needs to devote resources to resolving the work disincentives faced by lower-income working families.

Simply cutting tax rates might seem like a good solution. However, lowering the lowest federal rate from 15% to 12% would not affect many of these families (because the federal taxes they pay are payroll and excise taxes, not *income* taxes), and it would offer only three percentage points of relief to those who would benefit. Other alternatives include:

- Reducing the high phase-out rate of the EITC

Reducing the phase-out rate from 21% to 10.5% would substantially improve the economic situation of low- and moderate-income families. Reducing the phase-out rate in this way would not only assist low-income families, by increasing their refund, but would provide tax relief to families with incomes between \$31,000 and \$50,000. An even larger reduction of the EITC phaseout rate, to 6%, would provide tax relief to families with incomes up to \$75,000.

- Eliminating phase-out of the EITC

Eliminating the phase-out of the EITC could be used to provide a more universal tax cut, available to all families making more than \$13,000. No matter how it would be structured for higher-income taxpayers, it would entirely remove the EITC as a marginal tax rate factor.

A beneficial byproduct of either of these changes would be the reduction or elimination of the penalty faced by single low-income parents who choose to marry. Under current law, the combination of the couple's income can lead to a significant reduction in the amount of EITC received.

- Offsetting the EITC phase-out rate by phasing-in another credit or benefit

One proposal would take President Bush's proposed doubling of the child tax credit and make it partially refundable. Because the proposed credit would increase by 15% for each dollar earned above \$8,000 (until fully phased-in), it would reduce the marginal effective tax rate by 15 percentage points through a sizeable portion of the income range over which the EITC is phased-out.

Including one or more of these proposals in the final federal tax cut package would provide significant tax relief, restore sense to a system that currently acts as a disincentive for the working poor to get ahead, and put more disposable income in the pockets of those who need it the most.