***** THIS TESTIMONY IS EMBARGOED UNTIL *****
*****WEDNESDAY, JUNE 27, 2012 AT 10:00 A.M. *****

The Implicit Tax Rate on Low Income Americans

Clifford F. Thies
Eldon R. Lindsey Chair of Free Enterprise and Professor of Economics and Finance
Shenandoah University

June 27, 2012

A few years ago, when I was a resident scholar at a D.C.-based think tank, I had the occasion to brief visiting delegations of parliamentarians from Europe on social insurance and social services here in the United States. I did this mostly by contrasting our programs to theirs.

Our social insurance and social service programs, I said, appeared to be less expensive. But, their programs were not as perverse as ours in terms of undermining the incentive to work. The main reason their programs were not as perverse as our programs was that, in Europe, social insurance and social services are not means-tested.

That is, in Europe, retirement benefits, health insurance and social services that are provided to some are usually provided to all, regardless of work, income, asset and other "tests" as are used in the United States. In contrast, here, you are generally denied benefits as you work more, have more income, have assets, and so forth.

As a result of the loss of benefits, people in the United States who are at the margin between being dependent on the government and being independent, may have little economic incentive to work. To be sure, there may be an inner motivation to work. And, there may be the idea that, in the long run, working can lead to a better future. But, there is no immediate, tangible feed-back reinforcing the inherent goodness of work; and, over time, as the habit of work wanes, we can suspect so too would appreciation for its inherent goodness.

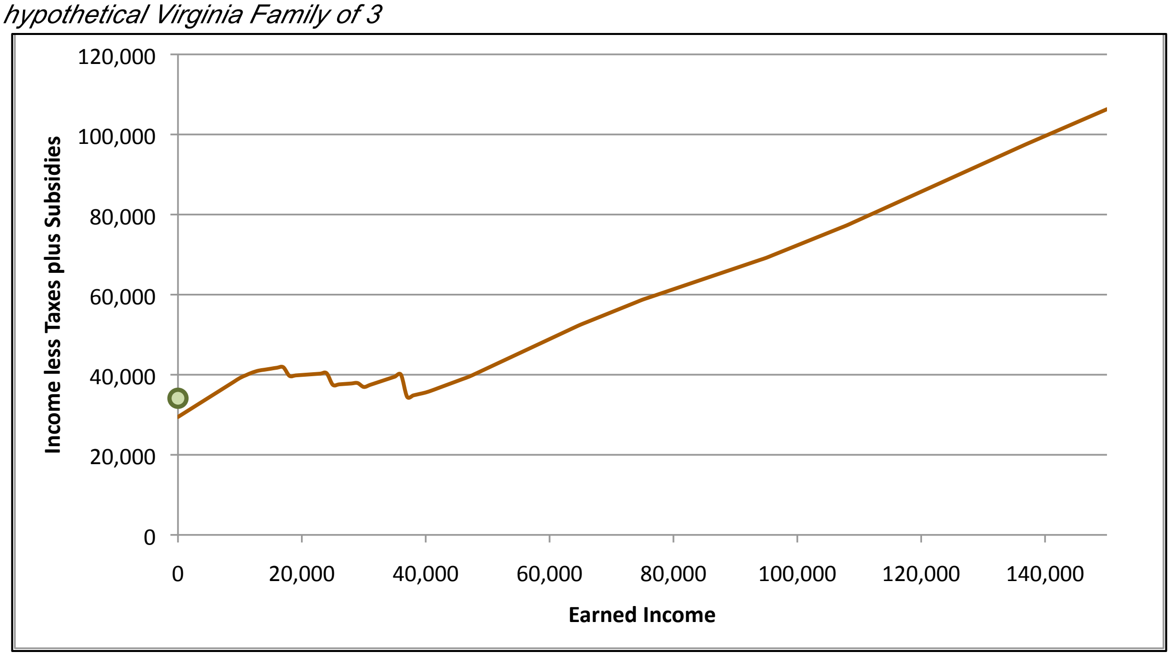
Since I gave those briefings, there have been some changes to the social insurance and social service programs of the United States that impact the incentive to work. Until recently, these changes represented a mixed bag, some improving the incentive to work, and some not. On the plus side, the complete end of the Social Security disallowance for earned income improved the incentive to work for people over their Social Security retirement age. On the other hand, the taxation of Social Security benefits for persons having other income weakens the incentive to work.

More recently, changes in health insurance may significantly change the effective tax rate facing low income Americans. Also, our long period of depressed economic conditions may have acclimated a large number of Americans to such thing as extended periods of unemployment, part-time work supplemented by food stamps and the like, and early retirement via disability. In addition to overall economic conditions, many individuals find themselves burdened by underwater mortgages, unproductive student loan debt, and back taxes and support payments that cannot be discharged through bankruptcy. An overall plan to spur economic growth may need to have a component that deals with those who are today counted as discouraged and as marginally attached to the labor force.

An article I wrote in 2009 concerning the way means-tested benefits and ordinary taxes affect the incentive to work of low-income Americans has received a lot of attention.[1] I showed, for a hypothetical Virginia family consisting of one adult and two children, that there was little change in the total of cash and benefits received from working more, until a level of income of about $40,000 was achieved. Only at that point was the virtue of work rewarded with an actual gain in standard of living. Prior to that point, additional earnings were mostly negated by reduced benefits.

Figure 1. The Dead Zone

Earned income less social security, federal and state income tax plus EITC, food stamps, Medicaid/SCHIP, Section 8 housing (line) versus Welfare cash grant and subsidies (dot) for a hypothetical Virginia Family of 3



---

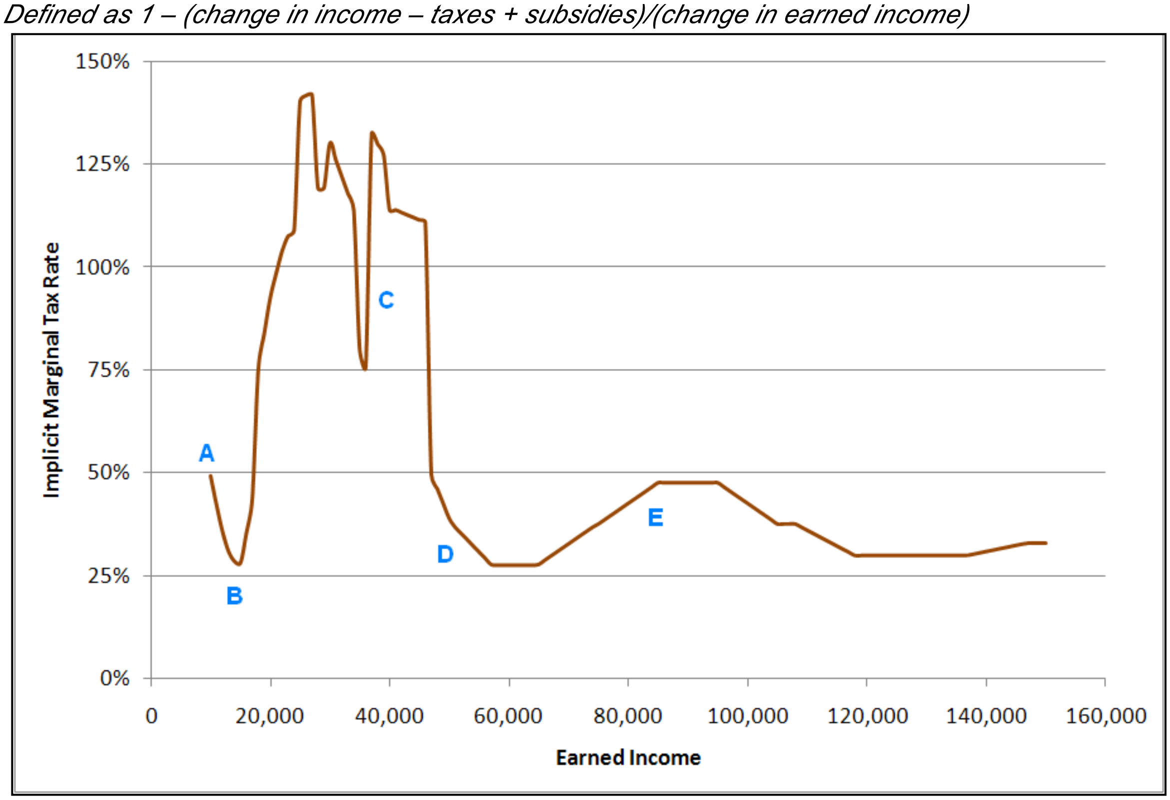
[1] http://mises.org/daily/3822

To see exactly what is happening, the chart below shows the implicit tax rate on the last $10,000 of earned income (initially by comparison to the welfare grant and then by comparison to income less taxes plus subsidies).

At "A", the marginal tax rate is quite high, essentially because of the generosity of the package of cash and noncash benefits provided to those on welfare. At "B", the marginal tax rate is relatively low (!) because of the Earned Income Tax Credit (EITC). From "B" to "D", we are in the Dead Zone, with implicit marginal tax rates mostly exceeding 100 percent.

Figure 2. Implicit Marginal Tax Rates

Defined as 1 – (change in income – taxes + subsidies)/(change in earned income)



At “C”, the implicit marginal tax rate is momentarily "only" 75 percent. This is because, in the face of losing other means-tested benefits while the federal income tax kicks in, the children of the household still qualify for the State Children's Health Insurance Program (SCHIP). The lull in the onslaught is momentary, however, ending as soon as that prop is removed from the household.

At “D”, the family is finally done with jumping through the hoops to qualify for the give-away programs. Now all it has to concern itself with is paying taxes. But there is no rest for the weary because, at “E”, the child tax credit phases out.

Gregory Mankiw of Harvard University liked the basic point I made, which he and many other economists make themselves in their textbooks.[2] What I did was give concreteness to the argument. Mankiw said that the Congress should have CBO perform the calculations I attempted, so as to make the calculations more authoritative. While that would indeed make the calculations more authoritative, we should avoid thinking that the problem is one of making calculations. Ultimately, what we should want is to see is real progress in the standard of living of people at the low end of the income distribution, something we have not seen since the 1960s.

The basic point I made in that article is well established in economic theory. Assuming a goal of the tax structure is to redistribute wealth from some who have a high ability to produce to others who have less ability, and that high taxes rates

[2] http://gregmankiw.blogspot.com/2009/11/poverty-trap.html

diminish the incentive to produce, then the optimal tax structure involves zero or even a negative tax rate on those who have low earnings and a higher tax rate or progressively higher tax rates on those who have high earnings.[3] Such a profile of tax rates looks very different from what we effectively have, given our means-tested programs.

In our system, the loss of benefits as a person earns more, in conjunction with ordinary taxes, implies that the effective tax rate is very high for people with low earnings, when economic theory says that tax rate should be zero or even negative. My calculations indicate that the effective tax rate on low-income Americans is approximately 100 percent. "Supply side economics" should apply to all of us, including those of us who have low income.

Moving from theory to application, things get complicated very quickly. In 1962, to provide income security through an optimal tax structure, Milton Friedman proposed what he called the Negative Income Tax. Friedman's proposal involved a combination of a cash grant and a flat income tax.[4] He had intended the Negative Income Tax to replace much of the welfare system, not simply be an addition to it. Therefore, when the Nixon Administration transformed the proposal into an add-on to the welfare system called the Family Assistance Plan, Friedman opposed it. So too

[3] The classic reference of this is James A. Mirrlees, "An Exploration in the Theory of Optimal Income Taxation," *Review of Economic Studies* 38 (1971): 175-208. A useful survey of the literature is Robert Moffitt, "The Negative Income Tax and the Evolution of U.S. Welfare Policy." *Journal of Economic Perspectives* 17 (2003): 119-140.
[4] Ch. 12, "Alleviation of Poverty," in Milton Friedman, *Capitalism and Freedom*. University of Chicago Press, 1962.

did many of the big city mayors and governors of the country, who saw it as diverting welfare dollars from their control.[5]

Subsequent manifestations of Friedman's proposal as an add-on to the welfare system included the so-called McGovern Grant of George McGovern when he was the nominee of the Democratic Party for president in 1972; and, the initially modest Earned Income Tax Credit enacted in 1975. The EITC has grown so that it is, today, the largest cash disbursing part of the welfare system. The EITC, unique among income security programs and in keeping with the idea of the Negative Income Tax, reinforces the incentive to work over a certain income range. Unfortunately, because of the EITC's give-back region and the interplay of ordinary taxes and the means-testing of other income security programs, this reinforcement of the incentive to work is very limited.

According to Martin Anderson, little priority was given to comprehensive welfare reform during the Reagan Administration.[6] The problem, Anderson said, is that the cash grant needed to replace the welfare system would be too low relative to the package of cash and benefits given to those who qualified for AFDC. In addition, there were indications that liberalizing cash benefits resulted in less work, not more, as well as resulted in more welfare dependency and more family break-up; and, that cash benefits were easily diverted from the well-being of families to

[5] Daniel P. Moynihan, *Politics of a Guaranteed Income*. Vintage Books: 1973.
[6] Martin Anderson. *Welfare: The Political Economy of Welfare Reform in the United States*. Hoover Institution, 1978.

undesirable purposes. During the Reagan Administration, the EITC was expanded. But, perhaps more importantly in terms of the tax rates facing low-income Americans, Social Security taxes – which kick in at dollar one of earned income – were increased as part of the Social Security bailout.

The next major step in the evolution of our current income security system was the welfare reform movement of the 1990s. Many people were involved in the reform of welfare, including Governor Tommy Thompson of Wisconsin, President Bill Clinton and the Congressional Republicans elected in 1994. Welfare reform replaced the former AFDC program with Temporary Aid for Needy Families. Among other provisions, TANF involves time limits on eligibility.

Following the reform of welfare, there was a tremendous fall in welfare rolls, as well as very substantial declines in participation in the food stamp program and other income security programs. To what extent these trends were due to welfare reform as distinct from the vibrant economy of the 1990s is a tough question. Perhaps each – welfare reform and the vibrant economy – reinforced the other.

During the 2000s, the generosity of income security programs was significantly increased, including the food stamp program in 2002 and the EITC in 2006. In addition, Congress made extraordinary extensions of unemployment benefits in response to the recession of 2007-09. The combination of depressed economic conditions and the more generous welfare system was followed by an unprecedented increase in participation in the nation's income security programs. Conversely, labor force attachment has been dropping and many of those who are employed are employed part-time.

These developments are roughly consistent with the social experiments conducted during the 1970s to determine the probable results of a Negative Income Tax; namely, a reduction in work, not an increase. Many people are learning to subsist on part-time wages supplemented by cash and non-cash benefits from the government.

The possibility of revisiting welfare reform in conjunction with reforming the tax code is exciting. Friedman's Negative Income Tax idea was, after all, to be an income security program administered through the income tax system. Unfortunately, the way things have evolved is that the means-testing of our income security programs work almost exactly the opposite of his Negative Income Tax proposal. The combined effect of our income security programs, along with ordinary taxes, is to create a dead zone in which the effective tax rate on working is approximately 100 percent for people with low income.

I will offer, as one possibility of how welfare reform might be combined with tax reform, that part or all of the funds currently going into the EITC be used instead to pay the Social Security taxes of low-income Americans who would qualify for the EITC. This should include both the employee and the employer contribution. This proposal would create a zero bracket in the payroll tax for qualifying workers.

When Friedman proposed the Negative Income Tax, the combined employee and employer payroll tax rate was 6.5 percent. Today, ignoring its temporary reduction, the combined payroll tax rate is 15.3 percent. For most Americans, Social Security taxes are more significant than the income tax. My proposal would not only eliminate the give-back region of the EITC and so remove that perverse aspect of the EITC, it would help to simplify the tax code.

Milton Friedman once said that nobody should pay a tax rate of more than 50 percent. Certainly, nobody would say that low-income people should have a tax rate of more than 50 percent. Perhaps it would be sufficient, then, to merely develop an authoritative calculation of what is the effective tax rate on low-income Americans. But, while my calculations might not be as authoritative as CBO's, I'm not badly mistaken. When you look at the combined effect of the means-testing of our major income security programs, low income Americans are subject to an effective tax rate of about 100 percent.

# # #