AMERICAN ACTION FORUM

Testimony before the Ways and Means Committee
How Welfare and Tax Benefits can Discourage Work

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I would like to thank Chairmen Davis and Tiberi, Ranking Members Doggett and Neal, as well as the other members of the subcommittees for the invitation to address the committee on this topic.

During my 20 years as a professional economist I have come to the conclusion that marginal tax rates matter a *lot*: the proportion of each dollar of income that a person keeps to spend or save has a tremendous effect on how much (and whether) we work, how much we save, and when we retire.

What's more, this is true across all income classes. While the bulk of the academic research and political debate tends to focus on the marginal tax rates on small businesses and upper income households, the truth is that even middle and lower-income households can face high effective marginal tax rates exceeding 40 percent, thanks to the phase-outs of poorly-designed welfare and entitlement programs. Regardless of a person's income, high marginal tax rates deter work, effort, and reported income.

In the 1970s and 1980s the labor market literature described men between 30 and 55 as the "hard core" employed. Regardless of what happened to tax rates, the economy, or the broader economic landscape men in this cohort worked—they had to, since most of this cohort was married and supported a family.

However, this is no longer the case. The labor force participation rates for thirty-something and forty-something men has been trending down for almost two decades, for a variety of reasons. First, fewer people are choosing to get married at all: only 51 percent of all adults 18 or older are married today, the lowest this has ever been[1]. Men who aren't married and are without a family have fewer obligations keeping them in the work force.

Men who do marry are doing so later: today, the average age of a first marriage is now 29 for men and 27 for women[2], which is two years higher than it was just a decade ago. What's more, men who do get married are much more likely to have a spouse who is working than twenty or thirty years ago, as we have seen a dramatic rise in women's labor force participation rates—especially among married women—over the last three decades. In short, we are in an economy where more and more people

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[1] Morello, Carol: "Married Adults at Record Low." *Washington Post*, December 14 2011.
[2] U.S. Census Bureau, 2010 Community Survey.

have options to toiling at a job for forty hours a week—and if it isn't worth their while they will work part-time and/or live off the financial support of their spouse, their parents, their savings, or welfare.

None of these options are necessarily problematic: we can all conjure the image of a graduate student bunking with his family, or a husband who remains at home to raise their children, or empty nesters scaling down their lifestyle and retiring early to take care of their parents. However, I submit that these scenarios do not describe the vast majority of people dropping out of the labor force.

To be sure, the main reason that we have seen greater numbers of people unemployed the last four years than at any time since 1982 has been our moribund economy, but not a few of the 12.7 million people currently unemployed are not working because they have decided it is not worth their while, and recent policy changes have led many more to reach that conclusion.

High Implicit Marginal Tax Rates Deter Labor Force Participation

There has been a lot of work—and contentious debate—over how high marginal tax rates on upper income earners and small businesses deter work and reported income; indeed, it is the primary point of contention between the two parties with regards to tax policy today, it is safe to say. In the spirit of comity and quest for brevity I will steer clear of this topic and focus on people in the lower portions of the income distribution.

Most people imagine that our tax code is uniformly progressive, with effective marginal tax rates gradually rising with income. However, the combined effects of our tax code and the myriad welfare programs result in a very jagged marginal tax rate profile for lower-income individuals. For instance, the earned income-tax credit program phases out benefits for low-income earners at a rate of $1 for every $6 earned, with benefits ceasing for households earning above roughly $50,000. 27 million families received the benefit in 2009.[3] SNAP benefits (i.e. food stamps) are another benefit for those at or near poverty that quickly phases out as incomes increase, and nearly 47 million people receive them.

The reason for the relatively rapid phase-outs is that some in Congress wanted to make sure that these benefits disproportionately helped lower-income families that pay no taxes, and the right was willing to accept these limitations to keep benefit costs down. As a result, people at the bottom of the distribution see their benefits quickly diminish as their obtain jobs and start to work. A working parent in a family of four may see an effective marginal tax rate above twenty percent at an income between $40,000 and $50,000 a year—a result that makes no economic sense at all to anyone on either side of the aisle.

There are also situations where the cost of earning more money can exceed 100 percent. For instance, the Obama administration has encouraged states to implement "broad-based categorical eligibility" for SNAP benefits, meaning that they are to deem an applicant eligible if he is receiving another low-income assistance program or merely received a brochure inviting him to apply. Making enough money to be ineligible for TANF will thus trigger the loss of all SNAP benefits as well. Restricting eligibility of SNAP benefits to actual TANF beneficiaries would save $11.7 billion over the next decade, incidentally.

[3] "Policy Basics: The Earned Income Tax Credit." The Center for Budget and Policy Priorities, February 2012.

Recent Changes to Welfare Programs have Depressed Work Incentives

In the wake of the Great Recession, Congress substantially altered eligibility rules for various welfare benefits. For instance, it extended the length of unemployment insurance benefits to 99 weeks, exempted a portion of UI benefits from taxation, awarded a weekly $25 bonus to recipients, eliminated extended benefit experience rating, and for a time covered 65 percent of COBRA expenses after a layoff.

The government also relaxed asset and net income tests for SNAP benefits, increased the maximum benefit *twice* (October 2008 and then in April 2009), excluded more income from the benefit formula, and took other steps to expand the ranks of eligible food stamp recipients.

The result of this munificence is that the statutory safety net generosity for non-elderly heads or spouses markedly increased since 2008. University of Chicago economist Casey Mulligan estimated that it increased by nearly six percentage points from 2008 to 2009, reaching nearly fifty percent of the average laid-off person's income, including foregone taxes[4].

One thing that economists know—and the data show—is that when the net benefits to working are lower, people are less likely to find work. For instance, increasing the number of weeks that a worker receives unemployment insurance is commonly done whenever there is a recession, although 99 weeks is well beyond what was done in previous recessions. What we observe when benefits last 26 weeks, as is normally the case, is that a fair proportion of people find jobs the first month or two, a trickle of others find jobs in months three through six, and then most of the rest become employed in month seven, when benefits expire. When we extend benefits to nine months we see the same pattern, except that the magical month when the bulk of the unemployed rejoin the work force becomes month ten. Or if we extend it to 52 weeks then it becomes month thirteen. Most people would rather not work if they can afford not to, it turns out, and I include myself among that number.

In essence, these changes have increased the effective marginal tax rate on lower and middle income workers. Mulligan estimates that the effective marginal tax rate for workers receiving the standard mix of benefits for unemployed workers has gone up by over four percentage points since 2008.[5] People with relatively modest incomes are losing as much as forty percent of each dollar earned, and this has definitely had an impact on labor market behavior. This includes the effect of the "temporary" two percentage point reduction in the employee portion of the payroll tax.

Incidentally, Mulligan estimates that the brunt of the increase in the cost of federal income security programs resulted *not* merely as a consequence of the severe recession, but primarily due to the increased generosity of the benefits. Government spending on unemployment insurance and SNAP is at least triple of what it would have been if the real benefit and eligibility rules had remained as they were in 2009.[6]

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[4] Mulligan, Casey B. "The Expanding Social Safety Net." NBER working paper no. 17654, December 2011.
[5] Mulligan, Casey B. "*The Labor Market and the Great Recession: How Redistribution Distorted the Economy.* Oxford Press, 2012.
[6] Mulligan, "*The Labor Market and the Great Recession."*

PPACA will Exacerbate the Cost of working for Lower-income Earners

The Affordable Care Act will make health insurance available to individuals whose employers do not provide health insurance through the creation of various state-run health exchanges. Low-income workers will receive a subsidy to purchase health insurance, which the law begins to phase out when a family's income rises above 133 percent of the poverty level. As a result of the claw back, the effective marginal tax rate facing low-income earners will go up even higher: Economists Alex Brill and my boss, Doug Holtz-Eakin, estimate that this subsidy phase-out can add as much as ten percentage points to the effective marginal tax rates of the subsidy recipients.[7] On top of the slough of already generous benefits it is sheer folly to add yet another that serves to further increase the effective cost of employment for the lower and middle class.

No one is accusing people receiving these benefits and eschewing work to be lazy: People generally behave rationally, respond to incentives, and are well aware of the opportunity costs of their choices. For example, a couple with a young child at home may sensibly conclude that it does not make sense for the husband to take additional hours of work or for the wife to take a part-time job because of the subsequent reduction in benefits this would trigger.

The longer-term problem with the lower labor market participation rates among this cohort is that it can be self-reinforcing: the longer people go without a job the more their skills atrophy or become outdated and their contacts become stale and it becomes more difficult for them to obtain a job, not to mention the stigma that being out of work for an extended period of time has in the eyes of many employers, unfairly or not. This is especially damaging for younger workers, who need not only to acquire experience and skill but also a familiarity with the ways of the workaday world. Five years of intermittent work at the beginning of one's ostensible career can nip it in the bud.

A former Treasury Secretary (William Simon) once remarked that we should have a tax code that looks like it was done on purpose. The same can be said for our array of welfare benefits and entitlement programs. The creation (and more importantly, the recent expansion) of each one was done with good intentions, but the cumulative effect has been to create a system that discourages people from working, while costing our government tens of billions of dollars it cannot afford. And it is important to note that the enormous ballooning in cost is *not* due to the recession, and that it is the very design and recent munificence of the benefits that are exacerbating the unemployment we are currently experiencing.

Nearly twenty years ago the Congress and Administration worked together to craft substantive bipartisan reforms of our welfare system to great success. Millions of Americans that had given up looking for a job returned to the labor market and managed to transition surprisingly well, thanks in no small part to a well-designed system. In a mirror image of our current situation many people attributed the unemployment rate reaching below four percent to the booming economy, but the truth of the matter is that the reformed system that encouraged everyone to look for (and stick with) a job had a lot to do with the booming economy in the first place. It is time we looked at these programs again, holistically, with an eye towards fixing a system that no one can rightfully deny is irredeemably broken.

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[7] Holtz-Eakin, Douglas and Alex Brill, "Another Obama Tax Hike." *Wall Street Journal*, February 4th 2010.