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MAKING WORK PAY WITH TAX REFORM

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Welfare reform's stated aim is to move recipients off the rolls and into jobs, but its effectiveness hinges on how tax systems and labor market regulations reward work. In addition to policies to raise the minimum wage and lower unemployment, Congress should also give attention to how tax systems can be reformed to help workers and their families. To this end, the reauthorization of the Temporary Assistance for Needy Families (TANF) program in 2002 should include an examination of the tax incentives and burdens faced by low-wage workers.

To provide tax relief to families with children, *refundable* income tax credits tied to earnings and family size are the indispensable remedy. Many families who work and pay payroll taxes see little gain from income tax cuts, and the changes in the tax code passed in 2001 do little to remedy the problem. The tax code would better serve working families if it integrated existing tax benefits into a Simplified Family Credit (described in detail in Cherry and Sawicky (2000) and in the forthcoming Sawicky, Cherry, and Denk).

Taxes and low-wage workers: then and now

Consider a single woman with one child who leaves the TANF program and lands a job paying $16,000 a year. How would this family fare in terms of taxes?

Under the law prior to 2001, this family had an income tax liability of $533 minus a Child Tax Credit (CTC) of $500, dropping the family's tax burden to $33. This family also received a cash refund of $1,963 under the Earned Income Tax Credit (EITC), for a net benefit of $1,930. But this worker paid $2,448 in payroll taxes (employer and employee combined), so in this sense she actually paid more in federal taxes than she received in credits.

Suppose this working mother's employer is willing to spend $100 to give her a pay raise. First, the employer must use part of that $100 for its share of payroll taxes, so the employer can raise the worker's gross income only by $92.89. The worker pays another $7.11 in payroll tax, leaving $85.78. Being in the 15% income-

tax bracket, another $13.93 goes to the federal government, leaving $71.85. Finally, the worker's EITC benefit decreases at a rate of 16%, or $14.86. Ultimately, the worker ends up with $56.99 of the original $100—not much more than half. Under this system, the marginal tax rate is 43%, and these calculations don't even take into consideration state and local taxes.

New tax legislation went into effect in 2001, but the difference for this low-wage worker is negligible. Given the same $100 raise, the payroll tax remains the same, but the income-tax rate drops by five percentage points, leaving an after-tax income of $76.49. The EITC take-away is the same, leaving this family with $61.63, an improvement of $4.64 over the old system.

What about the new Child Tax Credit? Under new law, the credit rises to $1,000 per child in 10 years. After adjusting for inflation, in 2001 that $1,000 is worth $787. If it was available in 2001, this worker would get the full credit. But the problem with the new CTC is that, while providing a tax cut to the worker, it phases in more quickly than the old credit. Families with one child and incomes over $14,128 receive the maximum credit. The new CTC has no impact on the marginal tax rate faced by this worker, nor by most other workers. The key problem remains the overlap of the EITC phase-out and the income tax rate.

The new CTC is a double-edged sword. It provides welcome tax relief to very low-income families, but it fails to significantly improve incentives they face "on the margin" (i.e., its effect on marginal tax rates is limited). The marginal tax rate (MTR) has been reduced from 43% to 38% for incomes roughly between $16,000 and $21,000, but then the rate goes back up to 43% because the taxpayer enters the 15% income-tax bracket. Household heads need to earn $29,000 to get clear of the EITC phase-out range before they can look at lower marginal rates of about 30%.

Another important concern for this family's tax situation is the effect of marriage. If a single parent finds an employed marriage partner, the couple must file a joint return to claim its EITC benefits. In many instances the partners' tax liability will be much higher than their separate, combined taxes as single persons. In the example above, if the single mother marries a worker earning $20,000 a year, their combined tax liabilities increase by $2,273. The cause of this so-called marriage tax is the high MTR discussed above. Since marriage is widely recognized as an important escape route from poverty for female-headed families with children, it would make sense to reduce MTRs and thus reduce marriage penalties.

How integrating tax credits can help

To eliminate some of the problems with the current tax code, a Simplified Family Credit (SFC) could replace the dependent exemption, the Child Tax Credit, and the Earned Income Tax Credit. (See the Appendix for a sample SFC form.)

To provide tax relief to the very poorest workers, any refundable income tax credit must *phase in* more rapidly. In other words, for the first $100 in earnings, the subsidy must be higher than the present rates of either 34% or 40% for families with one or two children, respectively. For simplicity's sake, a uniform phase-in rate of 50% would work best. Raising maximum credit levels would also increase after-tax benefits for these workers.

As for MTRs, the phase-out rate of the credit must be reduced. The SFC could use a "phase-down" rate of 5% or 10%, rather than 16% or 21% under the current EITC. The phase-down would stop at a minimum SFC amount reflecting the value of the CTC and dependent exemptions that it would replace.

So how exactly would this affect the income of low-wage workers? Take again, for example, the mother

earning $16,000 with one child. With an SFC, her income tax would increase to $645, but her SFC could be $3,480, for a net cash refund of $2,835, or $440 better than under current law. Her marginal tax rate would be 38% instead of 43%. Perhaps more important, the range of income over which she faces a combined rate of 41% or more is much reduced.

Another benefit for taxpayers with children is the inherent simplification of the SFC. The sample postcard-sized SFC form (see Appendix) could replace approximately 150 pages of instructions, worksheets, tables, and forms under existing law. Taxpayers could alternatively be given a short booklet of tables in which to look up the credit. Either way, no more than a postcard-sized form would be required. Gone would be the complexity of the EITC that has given rise to unnecessary filing errors, administration costs, and harsh penalties. By contrast, the SFC would enhance the transparency of the tax code; taxpayers would see more clearly the consequences for their taxes of different decisions, at least as far as the credit goes.

Conclusion

A majority of taxpayers have received income tax relief, but little help has been forthcoming to workers who pay no income taxes but still pay substantial payroll taxes. Extending *permanent* tax relief to those left behind or given short shrift by the tax legislation of 2001 should be part of a "make work pay" policy and belongs in the welfare debate.

Primarily because of the Bush Administration's tax cuts, payroll tax revenues are no longer set aside for Social Security. Over the next decade, $400 billion in trust fund surpluses will finance income tax cuts and non-Social Security spending (Kogan 2001). Arguably, remaining Trust Fund surpluses are also fair game for tax cuts. Alternatively, fiscal considerations could dictate that new tax cuts be paid for by "claw-backs" of the more egregious tax cuts recently enacted, many of which will not phase in for some time.

Reductions in the payroll tax rate are costly and poorly targeted, and they would have no appreciable effect on work incentives. A half-percentage point reduction in the payroll tax rate costs the federal government roughly $20 billion. For a full-time minimum wage worker, such a reduction would be worth $1.03 a week. Who would change their work habits for a gain or loss of a dollar a week?

In the example of the single mom discussed above, the SFC has a minimum credit amount of $1,500 and a phase-down rate of 10%. Its annual cost could be as low a $7 billion (see Sawicky, Cherry and Denk, forthcoming, for other options).

Payroll tax exemptions or deductions of one type or another put a clerical burden on employers, particularly the many who do not rely on computers to administer their payroll. Because many workers have more than one employer over the course of a year, changes in the current structure of the payroll tax are not very practical.

By contrast, the integration, simplification, and expansion of tax-based benefits for workers with children solve a multiplicity of problems. Neglect of this issue is one of the more conspicuous failures of this Congress.

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Appendix: Sample Simplified Family Credit form

Shown below are the two sides of a proposed SFC "postcard." The postcard easily contains the instructions, worksheet, and table required to calculate the SFC. The SFC table shows the maximum and minimum credit amounts for families of different sizes and the phase-in and phase-down ranges.

NOT an official or valid form of the Department of the Treasury — Internal Revenue Service			
	Form SFC Simplified Family Credit		**2001**
1	Enter the lesser of line 42, Form 1040, and your Minimum Credit Amount.	**1**	
2	Add up lines 7, 12, 18, and 19, Form 1040, and enter **one-half** of the total.	**2**	
3	Enter the lesser of line 2 & your *maximum credit amount* from SFC Table.	**3**	
4	If line 22, Form 1040, exceeds your *phase-out point* from SFC Table,	**4**	
	enter the difference. If not, enter zero.		
5	Enter your *maximum credit amount* from SFC Table minus 5% of line 4.	**5**	
6	Enter the greater of line 5 or your *minimum credit amount.*	**6**	
7	Enter the lesser of line 2 and line 6.	**7**	
8	Enter the greater of line 1 and line 7. This is your SFC.	**8**	
			Proposed form/worksheet for Form 1040

SFC Table

Number of children	Maximum credit amount	Minimum credit amount	Phase-out point
1	3,500	1,500	15,800
2	5,200	3,000	19,200
3	7,000	4,500	22,800
4	8,000	6,000	24,800
5	8,500	7,500	25,800
6	9,000	9,000	none

More than six children: maximum and minimum credits are calculated by multiplying the number of children by $1,500, with no phase-out point.

References

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