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RSC Policy Brief: How the Welfare State Creates Implicit Marginal Tax Rates in Excess of 100% on Working Families

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> *"Continued dependence upon relief induces a spiritual and moral disintegration fundamentally destructive to the national fibre. To dole out relief in this way is to administer a narcotic, a subtle destroyer of the human spirit… We must preserve not only the bodies of the unemployed from destitution but also their self-respect, their self-reliance and courage and determination."*

-President Franklin D. Roosevelt, 1935 State of the Union Address.

Background: In 1996, a Republican Congress passed, and Bill Clinton signed, the Personal Responsibility and Work Opportunity Reconciliation Act. This law turned the Aid to Families with Dependent Children (AFDC) program into a reformed Temporary Assistance for Needy Families (TANF) program. However, sixteen years later, there are still approximately 70 means-tested welfare spending programs. Since President Lyndon Johnson declared a "War on Poverty" in 1964, Americans have spent $16 trillion on means-tested welfare. All levels of government may spend another $10 trillion over the next decade based on recent projections.

A means-tested welfare program provides benefits to individuals based on income. This is in contrast to Social Security, Medicare, and other such entitlement programs that provide benefits linked to contributions made by the individual. In order to confine benefits to intended beneficiaries, means-tested programs phase-out as income increases. These phase-outs, along with the tax code, result in extremely high implicit marginal tax rates for many individuals. These rates can exceed 100%. In other words, someone is made financially worse off for earning more money.

However, it is actually very difficult for an individual to determine whether working more, or getting a job that pays more, will result in a smaller personal budget. This is for two reasons:

- *First*, there are about 70 different means-tested welfare programs, each with its own eligibility criteria.

- *Second*, no federal agency is responsible for figuring out how all of these programs (and the tax code) interact with each other in terms of the incentive to work. There is not a federal report that provides a comprehensive analysis of this issue. Here is former Chairman of the Council of Economic Advisors, Greg Mankiw, calling for such an analysis to be conducted by CBO.

What Is the Implicit Marginal Tax Rate?: The *marginal tax rate* illustrates how much money someone can keep, after accounting for taxes, from an extra dollar earned. Counting the income tax, the payroll tax, and state and local taxes, the top marginal tax rate comes close to 50% in many states (see here for an analysis from the Tax Foundation on this point).

But the welfare state adds another dimension to this. Many individuals, especially lower-income and working-class families, face not just higher taxes but also less government benefits for each dollar earned.

When both: **1)** higher taxes and **2)** foregone government benefits are accounted for from an extra dollar earned, you get the *implicit marginal tax rate*.

Selected Examples of the Problem:

- Jeff Liebman, an economic advisor to President Obama, tells the story of a lady who went from earning $25,000 a year to $35,000 a year, and could not make ends meet anymore as a result. See here for the details. He estimated that the government imposed a 130% implicit marginal tax rate on her.

- Spend 'Til the End, authored by Laurence Kotlikoff and Scott Burns, was a notable financial planning book released in 2008. Chapter 11 is entitled "Fire Your Job." The book argues that some people are better off quitting their job and living off the government than being self-reliant and earning a low-wage. The book states:

  > "There are, in fact, hundreds of thousands of Americans for whom working is a financial mistake; for whom earning more money means less, not more, spending power. For these Americans, earning more not only means paying more taxes, it means losing tax credits and various government benefits such that, on balance, their overall spending power declines." (p. 118)

  According to the book, a married couple, each earning $17,500, will have more spending power if one quits their job. The book goes on to offer this advice:

  > "Whoever said the U.S. was a low tax country? It's not. We should all understand this before we choose to work ourselves to death. If you don't know your effective tax bracket, you may end up working a lot more than you would were the financial rewards really clear." (p. 121)

- Economist Clifford Thies shows that the return on work is basically flat from $0 earned all the way to $40,000. In some cases an extra dollar earned reduces someone's spending power.

- Greg Mankiw: "Notice that as earned income rises from about $15,000 to $30,000, income after taxes and transfers is roughly flat. Indeed, it could even fall. The bottom line: If you are poor, the government is inadvertently ensuring that you have little incentive to try to improve your condition."

- University of Chicago economist Casey Mulligan notes that the federal government's Homeowner Affordability and Stability Plan (HASP) caused implicit marginal tax rates of

131% for participants (on top of any other disincentives to work on that household from various phase-outs and higher taxes). See here for the report by Casey Mulligan. And see here for more analysis on this issue from economist David Henderson.

How Obamacare Makes the Problem Worse: Obamacare created new subsidies in excess of $100 billion a year to buy insurance under the law's insurance exchanges. Families between 134% and 400% of the poverty line are eligible for these subsidies. Daniel Kessler, a senior fellow at the Hoover Institution, points out in a recent Wall Street Journal article that Obamacare creates some startling disincentives to work. A family of four earning $96,699 a year would be eligible for a subsidy of $14,799. A family earning $96,700 would receive subsidies of $0. By earning one extra dollar, the family could be made worse off by $14,798, in addition to the increased tax burdens under Obamacare.

Daniel Kessler sums up the issue as follows:

> "The only fix is to drastically reduce or eliminate [these Obamacare] premium subsidies. As the 2012 elections approach, voters will have to decide: For middle-income families, should economic success be determined by work and savings, or by participation in a government program?"

On this same point, in 2009, economist Greg Mankiw noted:

> "President Obama has said he wants to raise marginal tax rates on high-income taxpayers. Yet under his policies, the largest increases in marginal tax rates may well apply not to the rich but to millions of middle-class families. These increases would not show up explicitly in the tax code but, rather, implicitly as part of health care reform."

Conservative Solutions to the Problem:

- **Replace the Earned Income Tax Credit (EITC), and Other Refundable Tax Credits, With a Reformed Tax System.** The RSC's Jobs Through Growth Act (H.R. 3400) creates a new, voluntary tax system that contains none of the work disincentives that come with the EITC and other refundable tax credits. The EITC lowers implicit marginal tax rates for some workers, but then substantially increases rates for other workers seeking to reach the middle-class as the benefit phases out.

- **End Income Phase-outs on Tax Credits/Deductions.** The RSC's Jobs Through Growth Act (H.R. 3400) creates a new, voluntary tax system that does not include any deductions or credits that phase-out as someone earns more money.

- **Repeal Obamacare.** As noted above, the exchange subsidies in Obamacare significantly increase implicit marginal tax rates. House Republicans passed H.R. 2, to repeal Obamacare, in the first month of the new Congress.

- **Block Grant Medicaid.** The current Medicaid program punishes work by cutting off benefits if someone earns too much money. Block granting the program would allow states to experiment with creating Medicaid programs without the anti-work disincentives.

- **Cap Federal Means-Tested Welfare Spending.** The RSC's Welfare Reform Act of 2011 would limit overall federal spending on means-tested welfare programs to the level of 2007 plus inflation growth. This is an overall cap, which means it does not require cuts to any specific program. Instead choices would be made through the budget process.

- **Enforce Work Requirements on the Food Stamp Program and Other Means-Tested Programs.** The RSC's Welfare Reform Act of 2011 would establish work requirements for food stamps, modeled on the success of the 1996 welfare reform law.

As noted in the earlier FDR quote, the welfare state was not originally intended to provide "continued dependence upon relief…" It was intended to help impoverished Americans gain self-sufficiency and access to the American Dream. High implicit marginal tax rates, by contrast, promote continued dependence on government over economic success through an individual's initiative.

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