The Safety Net, Work Incentives, and the Economy since 2007

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by

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Chairman Ryan, Ranking Member Van Hollen, members of the committee: thank you for the opportunity and honor to discuss with you today how new safety net program rules over the past couple of years have changed the reward to work. A multitude of public policies affect that reward, and thereby affect who is employed. In some cases, the monetary reward to work is zero, or worse.

Overview

A basic economic principle is that the monetary reward to working has important effects on how many people are employed, and how much they work. By definition, the monetary reward to working is the difference between the resources a person has available to use or save if she works and what she has available when she does not work.

The effect of taxes and subsidies on the reward to working can be summarized as a marginal tax rate: that is, the difference between taxes paid net of subsidies received when working and net taxes paid when not working, sometimes expressed as a fraction of the amount produced when working.

People without jobs or otherwise with low incomes sometimes receive benefits from social safety net programs. The benefits are rarely called taxes by laymen, but economists understand the benefits to have many of the characteristics of marginal tax rates because a program beneficiary loses some or all of her benefits as a consequence of working. The more income that a person receives when *not* working, the less is the reward to working.

A multitude of public policies affect the reward to working. To name just a few: federal, state and local income taxes, payroll taxes, unemployment insurance benefits, and nutrition assistance programs.

Thanks to a labyrinth of relevant programs, the marginal tax rate can equal or exceed 100 percent in some cases, which means that the reward to working is zero or negative. In such cases, a person might have *more* resources available to use or save as a consequence of working *less*.

Legislation that "cuts" or "credits" taxes can nonetheless reduce the reward to working, and increase the marginal tax rate appropriate for labor market analysis, if it cuts taxes more for those who work less than it cuts taxes for those who work more.

Even private sector transactions such as the settlement of mortgage, consumer, and child support debts sometimes have many of the characteristics of taxes paid to the public treasury, especially in terms of their propensity to reduce the reward to working.

The reward to working, and therefore the marginal tax rate, affects behavior. High marginal tax rates mean small incentives to seek, create, and retain jobs. The consequences of high marginal tax rates are felt all over the economy, even by persons whose individual marginal tax rates might not be all that high.

America absolutely must have taxes and safety net programs, even though they reduce the reward to working. But if this Congress wants to understand or shape what is happening in the labor market or to the budgets of social programs, it would be counter-productive to approximate marginal tax rates as zero, or to assume them to be eternally constant regardless of what incentives are embodied in new legislation.

In reality, at least a dozen new and important federal and state safety net benefit rules have collectively changed the reward to working, especially for groups whose employment rates are particularly sensitive to safety net benefits.

Of course, unemployment insurance program benefits are now available longer into unemployment spells – up to 99 weeks – than they were five years ago. But also don't forget that new modernization provisions now provide unemployment benefits in a variety of circumstances when benefits were formerly unavailable. While it lasted, the 2009 American Recovery and Reinvestment Act (hereafter, ARRA) also added a bonus to weekly unemployment checks, and helped unemployed people pay for their health insurance. The food stamp program expanded in a variety of dimensions. All of these policy changes, and more, served to increase marginal tax rates over the past couple of years.

By my calculations, the net effect of all of these changes through 2012 was to increase marginal tax rates for the median household head or spouse at least four percentage points above what they were in 2007 (Mulligan 2012), on top of the forty-plus percent marginal tax rate already in place. Marginal tax rates have increased even more for less-skilled people.

It is sometimes claimed, by non-economists at least, that the safety net does not prevent anyone from working because supposedly everyone strives to have more income rather than less, and would gladly take any available job that paid them more than the safety net did. This "income maximization" claim is contradicted by the most basic labor market observations, not to mention decades of labor market research. A presumably unintended consequence of the recent safety net expansions has been to reduce the reward to working and thereby keep employment rates low, keep unemployment rates high, and keep national spending low, longer than they would have been if safety net program rules had remained unchanged.

The remainder of my testimony offers more detail as to marginal tax rate changes in recent years, and how they relate to the government safety net.

A Labyrinth of Public Policies Affect the Reward to Working

The marginal tax rate is the difference between taxes paid net of subsidies received when working and taxes paid net of subsidies received when not working, sometimes expressed as a fraction of the amount produced when working. Among the variety of measures that economists use to study the reward to working, this concept of the marginal tax rate has the advantage that it readily captures important combined incentive effects of a multitude of tax and subsidy programs (Gruber and Wise 1999).

The marginal tax rate appropriate for labor market analysis includes not only the combined sum of the extra taxes owed when working, but also adds the combined sum of all safety net benefits foregone, because taxes generally take away from the resources available to people who work while safety net benefits generally add to the resources available to people who do not work.

Many of us worked on our federal individual income tax Form 1040 over the weekend and may be familiar with our tax rate on that form. But the marginal tax rate as defined above is significantly different from the Form 1040 rate because, among other things, the federal individual income tax is only one of many taxes. As a consequence of working, and the additional spending and saving that wage income permits, American workers (and employers on behalf of employees) pay income, payroll, sales, excise, property, and other taxes to federal, state and local governments.

Federal, state, and local governments deal in massive amounts of resources, and affect the reward to working both in the process of obtaining revenue and in the process of distributing revenue to beneficiaries. The Bureau of Economic Analysis estimates that income, payroll, sales, and excise taxes amounted to about 23 percent of national income and over 30 percent of the nation's labor income, on average between 2000 and 2010. Even if none of that revenue had been spent on safety net programs, the tax collections by themselves would have reduced the reward to working.

Safety net program spending is also significant, especially during the last several years. I estimate that federal, state, and local spending on non-elderly beneficiaries of unemployment insurance, nutrition assistance, Medicaid, and other means-tested subsidies occurred at a combined rate of more than $400 billion per year in 2009 and 2010, measured in fiscal year 2010 dollars (Mulligan 2011). Even if governments had somehow been able to fund these programs without any taxes, the process of distributing the program benefits would have reduced the reward to working.

Legislation that "cuts taxes" can nonetheless reduce the reward to working, and increase the marginal tax rate appropriate for labor market analysis, if it cuts taxes more for those who work less than it cuts taxes for those who work more because the reward to working is the difference between taxes (net of subsidies) paid when working and taxes (net of subsidies) paid when not working.

Thanks to the labyrinth of relevant programs moving large amounts of resources, the marginal tax rate can equal or exceed 100 percent in some cases (Romich, Simmelink and Holt 2007), which means that the reward to working is zero or negative. In such cases, a person might have *more* resources available to use or save as a consequence of working *less*.

The reward to working, and therefore the marginal tax rate, affects behavior. High marginal tax rates mean small incentives to seek, create, and retain jobs, and to make the sacrifices of time, hassle, etc., naturally required by employers, customers, and clients in exchange for a paycheck. The consequences of high marginal tax rates are felt all over the economy, even by persons whose individual marginal tax rates might not be all that high.

The economic distortions created by marginal tax rates are not linear: an increase from 90 percent to 100 percent has a greater effect on incentives than an increase from 40 percent to 50 percent, which itself has a greater effect on incentives than an increase from 0 percent to 10 percent. A rate increase from 0 to 10, for example, still leaves a worker with 90 percent of her reward from working, whereas a rate increase from 90 to 100 leaves her with no reward.

Marginal Tax Rate and Government Safety Net Changes in and around the Great Recession

At least a dozen new and important federal and state safety net benefit rules have collectively changed the reward to working, especially for groups whose employment rates are particularly sensitive to safety net benefits.

The unemployment insurance (hereafter, UI) program offers weekly cash benefits to people who have lost their jobs and have as yet been unable to find and start a new one. On average they receive about $300 a week until they start working again, until they stop looking for work, or until their benefits are exhausted. Before the recession, an unemployed person in a typical state without high unemployment would often have his benefits limited to a maximum of twenty-six weeks (United States Department of Labor 2007). The federal law in place before the recession included some local labor market "Extended Benefit" triggers that, based on the statewide unemployment rate, would automatically lengthen the maximum benefit period. These automatic triggers began to extend the duration of benefits around the nation in the middle of 2008 (United States Department of Labor 2011a). At about the same time, the Supplemental Appropriations Act of 2008 included new "Emergency Unemployment Compensation" (EUC) legislation that extended maximum benefit periods for the entire nation. The Worker, Homeownership, and Business Assistance Act of 2009 further extended the EUC periods, so that unemployment insurance benefits could be paid up to 99 weeks (United States Department of Labor 2011b).

It is widely recognized that the UI benefit duration rules changed over the past couple of years (see Elsby, Hobijn and Sahin (2010), Shimer (2010), Daly, et al. (2012) and the studies cited in Council of Economic Advisers (December 2010)). Nor is it a surprise that a person unemployed more than 26 weeks saw her marginal tax rates increase as a result of the rule changes, because they provided benefits that would terminate if and when she went back to work before the benefits were exhausted. More surprising is that other safety net expansions collectively served to increase marginal tax rates significantly more than the new UI benefit duration rules did, not to mention reinforce the labor market impacts of the latter (Mulligan 2012).

The February 2009 American Recovery and Reinvestment Act (hereafter, ARRA) expanded eligibility by encouraging states to "modernize" (and relax) their UI eligibility requirements by processing earnings histories through an "alternative base period," including persons who quit their job for compelling family reasons, adding 26 weeks of eligibility for persons enrolled in training programs, and/or paying benefits to persons who search only for part-time work (United States Department of Labor 2009). The modernization provisions raised marginal tax rates for people who would have found it difficult or impossible to qualify for UI under the previous rules.

The ARRA also raised marginal tax rates by exempting the first $2,400 of unemployment benefits received by an unemployed person from 2009 federal income tax (United States Department of Labor 2011b). This provision is an example of a "tax cut" that nevertheless reduced the reward to working because it reduced taxes for people who experienced unemployment sometime during 2009 and did not reduce taxes for people who worked throughout the year.

The ARRA's Federal Additional Compensation (FAC) provision also raised marginal tax rates by adding $25 per week to unemployment compensation checks. This $25 per week was not available to people who were working, because unemployment compensation checks are reserved for people who are unemployed.

For laid off workers who wanted to remain on their former employer's health plan, the ARRA's COBRA subsidy offered to pay 65 percent of the cost. For a $13,027 annual family health insurance premium (Crimmel 2010), that subsidy was worth more than $700 per month. Many of the unemployed did not receive the COBRA subsidy, but the subsidy increased marginal tax rates for people who did receive it, or would have received it had they not been working.

The Department of Agriculture's food stamp program, now known as Supplemental Nutrition Assistance (SNAP), provides funds to low income households for the purpose of buying food (Social Security Administration 2008), often in conjunction with cash assistance programs. The rules for SNAP eligibility were relaxed in and around the 2008-9 recession as states were eliminating the "asset test," as the 2002 Farm Bill permitted them to do. The asset test elimination increased marginal tax rates appropriate for labor market analysis because households could receive SNAP benefits based solely on their net income, and not based on the value of their assets. For persons in the few states that retained asset tests, new federal asset eligibility rules were relaxed by the 2008 Farm Bill (Eslami, Filion and Strayer 2011, 6).

Both the 2008 Farm Bill and the 2009 ARRA increased the amount of the SNAP benefits paid to eligible households, and thereby increased marginal tax rates.

The Housing and Economic Recovery Act of 2008 created a first-time home buyers' tax credit of up to $8000, but it phased out as annual family income varied beyond the income limitation. This provision is another example of a "tax cut" that nevertheless reduced the reward to working because it reduced taxes for people below the annual income limit more than it reduced taxes for people earning above it (people who work fewer weeks during the year are more likely to earn below the annual income limit required to obtain the full credit).

The 2009 ARRA created a refundable personal income tax credit for calendar years 2009 and 2010 called the "Making Work Pay Tax Credit" (hereafter, MWPTC). For most people, the MWPTC had no effect on the reward to working because they or their household would have received the same amount of the credit regardless of an individual's work decision. A few persons saw their reward to working increase, a few others saw it reduced.

In contrast to the many provisions cited above, the employer portion of the federal payroll tax has been reduced since January 2011 and thereby reduced marginal tax rates appropriate for labor market analysis since that date. By my calculations, the net effect of all of these changes through 2012 is still to leave marginal tax rates for the median household head or spouse at least four percentage points higher now than they were in 2007 (Mulligan 2012), on top of the forty-plus percent marginal tax rate already in place. Marginal tax rates have increased even more for less-skilled people.

Of the several safety net expansions cited above, three of them from the ARRA have expired and thereby no longer elevate marginal tax rates as they did when the expansions were active: the COBRA subsidy, the FAC, and the federal income tax exemption for UI. MWPTC has also expired. The other marginal-tax-rate-elevating provisions remain in place today.

The Patient Protection and Affordable Care Act was passed in March 2010. As a result of this legislation, Medicaid enrollment and spending are expected to increase significantly in 2014, when the program is made "available to able-bodied adults with incomes up to 133 percent of the federal poverty level" (Sack 2010). By increasing the resources that part of the population can have when their incomes are low, this provision of the Act will increase their marginal tax rates. Other provisions of the Act, such as means-tested health insurance premium assistance, will also increase marginal tax rates when they go into effect.

Wage Garnishment and Related Private Sector Activities Affecting the Reward to Work

The Internal Revenue Service, Department of Agriculture, and state unemployment agencies are not the only institutions looking at a person's employment status and federal individual income tax return to determine how much she should pay or receive. My own employer, the University of Chicago, and thousands of other universities, colleges, and schools look at federal income tax returns through their financial aid programs to determine how much a parent should pay for her child's education. While we welcome the opportunity to help students from disadvantaged families, economists have long recognized that financial aid practices affect incentives for students' parents to work and save (Dick and Edlin 1997).

Workers sometimes have their wages garnished by creditors and/or child support agencies. Garnishments may be a necessary part of a well-functioning credit market and necessary to properly support children, but they also serve to reduce the reward to working by the person whose wages would be garnished (Holzer, Offner and Sorensen 2005).

Even if these private sector actions affecting the reward to work had been constant over time, they still interact with the safety net expansions cited above because the economic distortions resulting from marginal tax rates depend on the sum total of all taxes, subsidies and garnishments that derive from a person's wages. Moreover, it does not appear that the private sector's influence on marginal tax rates has been constant over time. A new federal bankruptcy law went into effect in late 2005. The 2009 ARRA stepped up enforcement of child support debts (National Conference of State Legislatures 2009).

Perhaps the most dramatic single increase in marginal tax rates has been associated with the federal guidelines for the settlement of "under-water" home mortgages. Mortgage modification initiatives have been the one of the main ways the federal government has sought to reduce home mortgage foreclosures, especially when those foreclosures are motivated by negative home equity (Congressional Oversight Panel 2009, 4). In 2008, the Federal Deposit Insurance Corporation (FDIC), Federal National Mortgage Association (Fannie), and the Federal Home Loan Mortgage Corporation (Freddie) all announced debt forgiveness or "loan modification" formulas. The Treasury Department continued this work under President Obama's administration with its "Home Affordable Modification Program" (HAMP) as part of its "Making Home Affordable Initiative," which replaced the Fannie and Freddie programs.

These programs often recommend a new mortgage payment amount that is lower than the payment specified in the original mortgage contract. More important in terms of marginal tax rates, the new payment is set in proportion to the borrower's income at the time of the modification. The more the borrower is earning at the time of the modification, the more she will be required to pay her lender over the next five to seven years, or more. The marginal tax rate on income earned at the time of modification can easily exceed one hundred percent and sometimes exceed two hundred percent as a result of the federal modification guidelines, not to mention the many other taxes and subsidies that also reduce the reward to working (Mulligan 2009; Herkenhoff and Ohanian 2011).

The Income Maximization Fallacy

It is sometimes claimed, by non-economists at least, that the safety net does not prevent anyone from working because everyone strives to have more income rather than less, and would gladly take any available job that paid them more than the safety net did. This "income maximization" hypothesis is contradicted by the most basic labor market observations, not to mention decades of labor market research.

Before the recession began, well over 100 million Americans were not working. To be sure, some of them could find no reward in the labor market and would be stuck without gainful employment no matter how lean the safety net got. But many others were not working by choice. You probably know skilled stay-at-home mothers or fathers who could readily find a job but believe that the net pay from that job would not justify the personal sacrifices required. They are examples of people who deliberately do not maximize their income. Other examples are people who turn down an out-of-town promotion in order to avoid relocating their families, and workers who eschew higher paying but less safe occupations. Earning income requires sacrifices, and people evaluate whether the net income earned is enough to justify the sacrifices.

When the food stamp or unemployment programs pay more, the sacrifices that jobs require do not disappear. The commuting hassle is still there, the possibility for injury on the job is still there, and jobs still take time away from family, hobbies, and sleep. But the reward to working declines, because some of the money earned on the job is now available even when not working.

Decades of empirical economic research show that the reward to working, as determined by the safety net and other factors, affects how many people work and how many hours they work. To name a small fraction of the many studies: Hoynes and Schanzenbach (2012) show

how potential participants stopped working or reduced their work hours when the food stamp program was introduced. Studies of unemployment insurance find that program rules have a statistically significant effect on how many people are employed, and how long unemployment lasts. Yelowitz' (2000) research shows how a number of single mothers found employment exactly when, and where, state-level Medicaid reforms increased their reward from working. Gruber and Wise (1999) and collaborators show how the safety net for the elderly results in less employment among elderly people. Autor and Duggan (2006) and the Congressional Budget Office (2010) explain how the number of disabled people who switch from work to employment-tested disability subsidies depends on the amount of the subsidy relative to the earnings from work. Murphy and Topel (1997) show how poor wage growth among less-skilled men helps explain their declining employment rates during the 1970s and 1980s.

Because economists have identified many other cases in which means-tested and employment-tested subsidies caused people to work less (Krueger and Meyer 2002), it should be no surprise that the same kinds of behavioral responses occurred since 2007: a larger safety net reduced aggregate employment and hours worked.

Other Misconceptions about Marginal Tax Rates

I previously cited at least a dozen changes in subsidy rules that served to raise marginal tax rates. Any one of them may appear insignificant by itself, especially for the purpose of aggregate labor market analysis. But that doesn't mean that the combination of a dozen or more potentially small marginal tax rate increases is itself small.

Focusing on just one of any of the safety net expansions is also misleading as to the magnitude of the overall increase in marginal tax rates and therefore potentially misleading as to the sources of the major changes in the labor market since 2007. It is even possible that attention to one program in isolation of the wider safety net could motivate backwards public policy responses.

To see this, imagine that UI rules became more generous, and that added to the number of households who were unemployed and with less income than they have when working. A number of the added unemployed people apply for food stamps, which from the food stamp program's point of view makes it look like "the economy is getting worse," so food stamp officials recommend enhancing food stamp benefits, which further increases the marginal tax rate. But, in this example, the added food stamp applications come from higher marginal tax rates created by UI, and the right food stamp policy response may be to reduce benefits in order to stabilize the overall marginal tax rate. My point here is not that the actual safety net expansions were excessive but rather that the economics of the safety net can be different when the safety net is viewed as a whole rather than on a program-by-program basis. The distinction is more than academic: recent events involved expansions of the safety net in many dimensions, and all of that occurred on top of a labyrinth of other safety net programs.

Another misconception is that most of the growth of federal income security program spending came from the recession, and not from more generous program rules (Krugman 2011). My estimates suggest the 2007 to 2010 rate of increase of inflation-adjusted per capita government spending on Unemployment Insurance and SNAP was at least triple of what it would have been if the real benefit and eligibility rules had remained what they were in 2007 (Mulligan 2012).

It is sometimes thought that safety net transactions only impact the people who participate in the programs. To the contrary, the safety net is funded by taxpayers, lenders, owners of government debt, beneficiaries of government programs other than the safety net, or some combination thereof. As a portion of the beneficiaries opt to earn less, they also opt to spend and save less, as their household budget constraint requires. They lawfully pay less taxes. Businesses anticipate having fewer employees and invest less. These behavioral changes are bad news for employers in general, for people who produce the consumer and investment goods that beneficiaries would be buying if they were back at work (and goods the program funders would be buying if they were not funding the expansions), and for people who live in places like Michigan whose economies are especially intensive in the production of such goods (Galí, Gertler and Lopez-Salido 2007).

Conclusions

The bottom line is that helping the poor and economically vulnerable has a price in terms of labor market inefficiency. Since 2007, we have been paying more of that price: American public policies moved significantly in the direction of less labor market efficiency, and perhaps more than was necessary for providing assistance to those who need it.

First of all, 100 percent marginal tax rates are difficult to justify as a reasonable balance between equity and efficiency, yet even in 2005 some demographic groups were subject to 100 percent marginal tax rates (Romich, Simmelink and Holt 2007), and the recent safety net expansions documented here added to the number of people facing such rates.

Second, rather than making people feel safer, a number of the safety net expansions may themselves be a source of uncertainty via the political process because, among other things, they must be repeatedly renewed by Congress, and taxpayers are still unsure of exactly who will pay for them (Baker, Bloom and Davis 2011).

Third, my testimony explains how multiple parties – governments, lenders, and courts – have claims on the income that appears on a person’s tax return. Multiple tax collectors can lead to excessive marginal tax rates, as each individual collector might not value the effect of his extraction on the revenues received by the other collectors (Olson 2000). For these reasons, it is likely possible to reduce marginal tax rates and enhance labor market efficiency without giving up much or any of the benefits that come from safety net programs.

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