Designing a Work-Friendly Tax System: Options and Trade-Offs

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Abstract

The current federal tax system often imposes its highest effective marginal tax rates on low- and moderate-income individuals, especially those who are trying to work their way off the welfare system. This paper suggests some simple ways to reduce those high effective marginal tax rates. It joins past work in the field that addressed marginal tax rates and low-income working families by outlining possible reforms to the earned income tax credit and the child tax credit, and breaks some new ground by coupling integration (and simplification) of the income tax and Social Security tax systems with worker incentive credits and universal grants.

One approach would replace the current earned income tax credit with a $2,000 per working parent credit and a refundable $1,000 per child tax credit. A more comprehensive approach would integrate the individual income tax and Social Security tax systems into a single, comprehensive income tax system with refundable $2,000 per working parent earned income tax credits and $1,000 per person refundable personal tax credits or universal grants. In short, this paper considers how to make the federal tax system more work-friendly for low- and moderate-income workers.

The options for tax reform we present here illuminate the very large trade-offs policymakers must confront in the pursuit of tax base broadening and greater efficiency, while maintaining progressivity.

Designing a Work-Friendly Tax System: Options and Trade-Offs

Taxes influence our choice between work and leisure. High effective marginal tax rates may discourage and certainly distort our incentive to work. Marginal rates differ from average tax rates in that they quantify the rate that applies to a worker's last dollar of earnings. A tax filer earning $18,000 in 2004 and in the 10 percent tax bracket would face a marginal tax rate of 10 percent on each additional dollar earned above $18,000.[1] This is true even though most of her income below $18,000 may not be taxable—in other words, her average tax rate would be well below 10 percent.

Suppose further that she has two children and receives the earned income tax credit—a generous tax credit targeted to low-income families that decreases by 21.06 cents for every dollar earned above $14,040. This benefit phaseout rate is *hidden* to her in the sense that it is not associated with any tax bracket on her tax forms. However, her *effective* marginal tax rate includes it, amounting to the sum of the 10 percent income tax plus the 21.06 percent EITC phaseout, for a total rate of 31.06 percent. But this calculation is still not complete. We have not included the child tax credit that would *lower* her effective marginal tax rate (because this credit is still phasing in at her salary level) or her Social Security payroll taxes that would raise it again. We see, though, that effective marginal tax rates may differ from statutory tax rates by a good deal—they may be both lower and higher—and they are confusing to assess because our panoply of tax statutes and programs place differing statutory and hidden rates in effect at nearly every income level.

It is this effective marginal tax rate that economists believe strongly influences a household's decision to engage or not engage in more work[2]—regardless of whether the household is aware of the tax rate. The higher the tax rate, the less the household will gain from additional work and (many believe) the more likely the household will substitute leisure for work or find some way of avoiding the tax. In particular (although, not without debate), the empirical evidence tends to show that high effective marginal tax rates can discourage work by low- and moderate-income individuals, especially those who are trying to work their way off the welfare system.[3] Unfortunately, the current federal tax system often imposes its highest effective marginal tax rates on just those individuals. The purpose of this paper is to suggest some options for reducing those high effective marginal tax rates.

The reform options described in this paper are in line with some past work in the field addressing high tax rates confronted by low-income families.[4] One approach would replace the

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* This paper builds on Forman (2004).

[1] Before tax credits are applied.

[2] See, for example, Rosen (2002), pp. 375–84.

[3] See, for example, Rosen (2002); Eissa (1996); Coe et al. (1998); Richards (1999); Triest (1996); CBO (1996); Danziger et al. (2002); and Shaviro (1997).

[4] See, for example, Carasso, Rohaly, and Steuerle (2003, forthcoming); Sawicky, Cherry, and Denk (2002); Sawhill and Thomas (2001); and Ellwood and Liebman (2000).

current earned income tax credit with a $2,000 per working parent credit and a refundable $1,000 per child tax credit. We go on to suggest a more comprehensive approach that integrates the individual income tax and Social Security tax systems into a single tax system with refundable $2,000 per working parent earned income tax credits and $1,000 or $2,000 per person refundable personal tax credits or universal grants. This paper considers how to make the federal tax system more work-friendly and less distortionary for low- and moderate-income workers.

I. The Individual Income Tax Imposes High Tax Rates on Low- and Moderate-Income Workers

A. Going from Income to Taxable Income to Tax Liability

What follows is a brief summary of how we get from gross income to taxable income and tax liability on a federal income tax form. Workers pay federal taxes based on their taxable income. As a starting point, tax filers first determine how they will file their return, based on their marital status and family situation. Different rate schedules and deduction amounts accompany each filing status. Next, filers determine the amount of their gross income. The term "gross income" broadly includes income from wages and most investments recognized during the tax year. Adjustments may be taken to this gross amount if the taxpayer contributes to an individual retirement or health savings account, pays tuition for a child in college or is paying college loans, or is self-employed, among other reasons.

A tax filer subtracts certain deductions from gross income to get taxable income. Most filers simply claim a standard deduction and a personal exemption for each family member or person represented on the return. Some filers, particularly those with moderate or higher incomes (or those owning a home and paying a mortgage), claim certain itemized deductions when the sum of these deductions exceeds their standard deduction.

Table 1 shows the basic standard deductions, personal exemptions, income tax threshold before credits, and income tax thresholds after applicable credits for some typical taxpayers in 2004.[5] Also, by way of comparison, note that the minimum wage in 2004 was $5.15 an hour, and an individual working full-time year-round at the minimum wage would earn just $10,712.[6]

A taxpayer's standard deduction, personal exemptions, and tax credits together shelter a certain amount of income from tax liability. For all three cases, the income tax threshold before tax credits is the sum of the standard deduction plus personal exemptions: $7,950 for a single filer, $22,100 for a married couple with two children, and $16,450 for a head of household with two children, as shown in table 1. However, because each filer in these case examples would also be eligible for tax credits like the earned income tax credit (EITC) and the child tax credit,

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[5] See also Maag (2004).

[6] $10,712 = $5.15 per hour × 40 hours per week × 52 weeks per year. The minimum wage has not been increased since September 1, 1997. See U.S. Department of Labor, "Minimum Wage," http://www.dol.gov/dol/topic/wages/minimumwage.htm.

the level of wages at which the filer would effectively owe positive tax is substantially higher: $9,490 for a single filer, $40,200 for a married couple with two children, and $33,930 for a head of household with two children.

B. The Earned Income Tax Credit

The EITC subsidizes wages for low-income workers with and without children. For tax year 2004, a family with two or more qualifying children is entitled to a refundable earned income tax credit of up to $4,300.[7] The credit is computed as 40 percent of the first $10,750 of earned income. For married couples filing joint returns, the maximum credit is reduced by 21.06 percent of earned income (or adjusted gross income, if greater) in excess of $15,040 and is entirely phased out at $35,458 of income. For single parents, the maximum credit phases out between $14,040 and $34,458. Families with one child receive a commensurately smaller credit (34 percent of the first $7,660 of income or a $2,604 maximum benefit) that begins phasing out at the same income levels as the credit for two children.

In 2004, childless individuals and couples between the ages of 25 and 65 were entitled to an earned income credit of up to $390. The credit is computed as 7.65 percent of the first $5,100 of earned income, but completely phases out by $11,490 ($12,490 for married couples).

C. The Child Tax Credit

Taxpayers with qualifying children under the age of 17 can claim a tax credit of up to $1,000 per child. The child tax credit first offsets a taxpayer's income tax liability. Then, for taxpayers with earned income in excess of $10,750 in 2004, the remaining available credit is rebated to the taxpayer at 15 cents for each dollar the taxpayer's income exceeds this threshold, up to the $1,000 credit amount. The credit begins phasing out at a 5 percent rate once the taxpayer's adjusted gross income surpasses $110,000 for married couples filing joint returns and $75,000 for single parents.

D. Effective Marginal Tax Rates on Earned Income under the Income Tax

The federal income tax system is generally progressive.[8] That is, taxpayers with higher incomes generally pay tax at higher rates than taxpayers with lower incomes. Because of the many phaseouts and other special rules, however, effective marginal tax rates can bounce all over the place, and the highest effective marginal tax rates are often imposed on low- and moderate-income taxpayers in the phaseout range of the earned income tax credit.[9] In that regard, figure 1a shows the effective marginal income tax rates imposed on typical married couples with two

[7] The term "qualifying child" generally includes a child under the age of 19, a child under the age of 24 who is in college, or a child of any age that is permanently and totally disabled.

[8] See, for example, CBO (2003).

[9] See, for example, Burman and Saleem (2003).

minor children, at varying levels of earned income; figure 1b shows these rates for a typical head of household with two minor children. Note that for each of these (and subsequent) marginal rate charts, we determine effective marginal tax rates by solving the following problem: if the taxpayer were to receive $1,000 in addition to the annual income he or she now receives, at what effective rate would that $1,000 be taxed?

The married couple in figure 1a initially has income below its $22,100 income tax threshold before credits and receives an earned income tax credit equal to 40 percent of its first $10,750 of earned income. Once the couple's earned income exceeds $10,750, the couple is entitled to the maximum earned income tax credit of $4,300; once the couple's income exceeds $15,040, the couple starts to lose that credit at the rate of 21.06 percent, until the credit is fully phased out at $35,458. Also, once the couple's earned income reaches $10,750, the couple's two $1,000 child tax credits become refundable at the rate of 15 percent of the couple's earned income in excess of $10,750 until the full $2,000 is allowed. Once the couple's income reaches its income tax threshold before credits of $22,100, the couple is subject to positive income tax rates, initially at the 10 percent rate and then eventually at the 15, 25, 28, 33, and 35 percent rates. Also, once the couple's income exceeds $110,000, the couple will begin to lose its two $1,000 child tax credits; those credits will be completely taken away when the couple's income reaches $150,000. At incomes above $142,700, the couple sees its itemized deductions begin to phase out at a 3 percent rate—however, as itemized deductions tend to grow with income (for example, state and local taxes), they never phase all the way out. Finally, once the couple's income exceeds $214,050, the couple will begin to lose its four $3,100 personal exemptions; those exemptions will be completely taken away when the couple's income reaches $336,550.

The effective marginal income tax rates applicable to the head of household with two children and portrayed in figure 1b rise in the same way as for the married couple.

Until now, we have not discussed how capital income for individuals—such as capital gains, dividends, and interest income—is treated under the tax code. A special rule provides that the maximum tax rate on dividends and net capital gains is 15 percent. That special rule also provides for a 5 percent rate on the dividends and net capital gains received by moderate-income taxpayers (those in the 10 and 15 percent income brackets).[10] However, as higher-income taxpayers tend to receive much larger portions of their total income from these sources than lower-income taxpayers, they partially avoid the higher statutory rates (e.g., 25, 28, 33 and 35 percent) they confront on their wages.

Finally, it is also worth noting that the current tax system often imposes significant marriage penalties on low-income workers. Persons pay a marriage "penalty" when they owe more tax (or receive less of a refund) when filing as a married couple than when filing as single individuals or single heads of household.[11] Two examples follow in table 2.

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[10] This rate will fall to 0 percent in 2008.

[11] A marriage "subsidy" is the reverse—the couple's mix of tax and transfer benefits is more if the two spouses marry than if they remain single. For more on marriage penalties in the tax code, see Bull et al. (1999); Carasso and Steuerle (2002); and Rosen (1987).

Example 1 shows the tax penalties or bonuses for a single man earning $10,000 and a single mother with two children earning $10,000 if they remain unmarried (column C) compared with if they marry (column D) and earn $20,000 combined. Column E quantifies the gain or loss from getting married versus remaining single—that is, the marriage bonus or penalty. In example 1, the result is a *bonus* of $734 because the larger standard deduction and extra dependent exemption wipe out the family's pre-credit tax liability and the additional income (i.e., going from $10,000 to $20,000) allows the family to claim $1,388 in child credits. These two factors compensate for the $859 in EITC the family loses.

Example 2 shows what results if the single man earns $20,000 and the single mother earns $15,000. Column E reveals that the additional family income for a married couple versus remaining single all but eliminates the family's EITC—a loss of $4,002. While the family gains $160 due to a lower before-credit tax liability and $1,362 in additional child credits, these gains are not enough to compensate for the loss of nearly all their EITC. Hence, the family would bear a $2,480 marriage *penalty* were these two adults to marry.

At work here are an EITC that declines at a 21.06 percent rate as earned income climbs above $14,040 ($15,040 for married couples) and a child credit that increases against income earned above $10,750 at a 15 percent rate *and* dollar-for-dollar against income tax liability.[12] For fairly low-income families, marriage shelters more income against tax owing to larger deductions and exemptions and the phasing in of the child credit. For couples at somewhat higher incomes, though, the high phaseout rate of the EITC overpowers the phase-in of the child credit, resulting in a tax penalty if they marry.[13]

II. Payroll Tax Rates and Low- and Moderate-Income Workers

A. The Basic Computation

Payroll taxes—also known as FICA (Federal Insurance Contributions Act) taxes—are levied on earnings in employment and self-employment covered under the Social Security program, and split evenly between employers and employees. For 2004, both employers and employees pay Social Security and disability taxes of 6.2 percent of the first $87,900 of wages and Medicare taxes of 1.45 percent on all wages (SSA 2003). Employees are not allowed to deduct their portion of payroll taxes for income tax purposes. The employer's portion of payroll taxes, however, is excluded from the employee's income for income tax purposes.

Similarly, self-employed workers, who must pay taxes for both the employer and employee, pay an equivalent payroll tax of 15.3 percent on the first $87,900 of self-employment

[12] Recall from table 1 that a head of household begins to owe income tax—before any credits are applied—at incomes above $16,450. Since the income tax rate is 10 percent in this bracket, the child credit effectively phases in at a 25 percent rate above $16,450—15 percent against each dollar of earned income plus another 10 percent to offset the income tax rate—until the maximum credit of $1,000 per child is reached.

[13] This explanation assumes both spouses have similar earnings. When earnings are disparate, the family often receives a marriage bonus.

earnings and 2.9 percent of self-employment earnings over that amount. Self-employed individuals may deduct half these taxes for both payroll and income tax purposes. This puts self-employed individuals in a position approximately equivalent to that of employees.

B. Effective Marginal Tax Rates on Earned Income under the Social Security Payroll Tax

Figure 2 shows the effective marginal payroll tax rates imposed on workers with varying levels of earned income. In that regard, most economists believe that the burden of payroll taxes paid by employers actually falls on the employees themselves in the form of reduced wages.[14] In effect, workers bear the brunt of the employment taxes paid by their employers. Overall, the payroll tax is regressive; we assume covered workers pay the full 15.3 percent of their first $87,900 of earned income and 2.9 percent on earnings above $87,900.[15] As is common in this type of analysis, figure 2 ignores the value of any future Social Security and Medicare benefits that might result from these payroll taxes (CBO 2003, p. 5).

In tax year 2003, 83 percent of wage-earning households paid more in payroll taxes than in income taxes. This figure drops to 53 percent if only the employee's share is considered (Gale and Rohaly 2003).[16] Because Social Security taxes are subject to the $87,900 wage cap, average payroll tax rates for households earning less than this amount are higher than for households earning more than $87,900. However, there are three important caveats. First, while lower- and moderate-income workers pay more in payroll taxes than upper-income workers, they pay substantially less in income taxes.[17] Second, a key motivation of the enabling EITC legislation was to improve work incentives for low-income households by counteracting the regressivity of the payroll tax: the current, childless EITC exactly cancels out the employee portion of the payroll tax these households pay,[18] while the substantially more generous EITC for households with children more than offsets the combined employer–employee payroll tax liability. Third, the lifetime value of Social Security and Medicare benefits for most low-income families exceeds the lifetime value of the combined employer and employee taxes they paid. However, since this paper focuses on the contemporaneous work incentive effects of taxes and marginal rates, it ignores the long-term incentive effects of entitlement benefits.

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[14] See, for example, CBO (2003). Also, note that some workers, such as employees of state and local governments, do not participate in the Social Security system and so do not pay these payroll taxes.

[15] This is a simplifying assumption. Because the half of the payroll tax paid by the employer is excluded from the individual's taxable income, the effective marginal tax rates faced by covered workers are generally slightly less than 15.3 and 2.9 percent. For example, for someone in a 25 percent income tax bracket, the effective tax rate increase because of the employer's share of the payroll tax is 5.74 percent, not 7.65 percent ($5.7375 = 7.65 \times [1 - 0.25]$). See, for example, Feldstein (2005).

[16] Note that these figures reflect results for all wage earners. If we look at only those submitting actual tax returns, the figures drop to 74 percent and 48 percent, respectively.

[17] Recall from table 1 that a typical married couple with two children does not owe any income tax on income below $40,200; for a single parent-family, this amount is $33,930.

[18] Provided these low-income families earn below the wage level—$14,040 for families with two children, $15,040 if married—at which the EITC starts to decline.

III. Effective Marginal Tax Rates on Earned Income as a Result of Income and Payroll Taxes Combined

When both income and payroll taxes are considered, the effective marginal tax rates on earned income can be high, especially for low- and moderate-income workers with children. Once again, effective marginal tax rates fluctuate, rather than increase steadily as earned income increases. For example, figure 3a shows the effective marginal tax rates on earned income imposed on married couples with two children. Figure 3a is the result of combining the income tax and payroll tax data underlying figures 1a and 2 and shows that the highest marginal tax rates are imposed on moderate-income couples earning around $30,000 a year with children.

Figure 3b shows very similar results for heads of household with two children. The highest effective marginal tax rates—over 50 percent—are imposed on heads of household earning around $30,000 a year.

IV. High Effective Marginal Tax Rates Distort Individual Choices and Devalue Work

Taxes distort individual choices between work and leisure, and the higher the effective tax rate, the greater the distortion.[19] Taxes on earned income reduce the rewards from work and so tend to make leisure relatively more attractive than work. This is the substitution effect: high tax rates will cause individuals to substitute leisure for work. On the other hand, the lower relative wages after taxes mean that workers will receive less after-tax income from the same amount of work effort and so will have less ability to consume all goods, including leisure. This is the income effect: high tax rates or benefit-reduction rates will cause individuals to work harder to restore that lost income. As the substitution and income effects work in opposite directions, the net effect on work can be ambiguous: theory alone cannot answer the question of how labor force behavior is affected by changes to the tax system. However, the empirical evidence suggests that taxes and benefit reductions tend to discourage work by low-skilled workers and secondary earners, but do not have as much of an impact on other workers.

How workers respond to higher taxes is not always clear, but the higher the tax, the less value workers will derive from their wages. In general, if the government wants to minimize work disincentives, it should keep the effective marginal tax rates on earned income as low as possible.[20] In that regard, figures 3a and 3b reveals a fundamental problem with the current federal tax system—some of the highest effective marginal tax rates are imposed on low- and moderate-income taxpayers. Thus, high effective marginal tax rates may have significant ramifications on the work effort, skill development, and household structure and relationships of the working families they impact. The impact of high effective tax rates on women workers has been found to be much larger and more significant than the effect on men, with the result that

[19] See, for example, Shaviro (1999, p. 1198); Rosen (2002, p. 377); and Eissa (1996).

[20] We know that the distortions that result from taxes increase as effective marginal tax rates increase. Indeed, economists suggest that the distortions increase exponentially with increases in the effective marginal tax rate. For example, a 60 percent payroll tax rate is likely to induce nine times (not three times) as much distortion as a 20 percent payroll tax rate.

high rates tend to reduce women's work effort. One reason is that women are more likely than men to be the secondary earner and have lower wages.[21]

Worse still, these high effective marginal tax rates in the federal tax system often combine with similarly high benefit-reduction rates in the welfare system to result in virtually confiscatory effective marginal tax rates on the earned income of many low- and moderate-income taxpayers trying to work their way off the welfare system.[22] Consequently, reducing the applicable federal tax rates would help reduce the work disincentives in the combined tax and transfer system.

V. A Modest Reform: Restructure the Earned Income and Child Tax Credits

The several reform options we describe here illustrate the considerations and trade-offs that reforms aimed at low-income families and high tax rates entail. All reform options we present are revenue-neutral by design.[23]

The previous sections illuminated the high effective tax rates that fall on low-income families and discussed the economic literature on the distortion of worker choices that such high rates create. Designing a more work-friendly tax system that is also revenue-neutral requires leveling out tax rates across the income distribution. This "leveling out" can be accomplished by shifting the higher tax rates that fall on lower-income families to workers at higher incomes, or leveling out rates across low-income groups,[24] or repealing other tax expenditures or deductions. While we are concerned with reducing marginal tax rates for some groups and with their subsequent behavioral responses, the latter is difficult to discern even with a macroeconomic model and general equilibrium equations, while the former *will* affect behavior by changing the amount of after-tax income workers have and therefore how much they can consume.

However, we still note that such burden-shifting reforms may induce some middle- and higher-income workers to scale back their work effort even while prompting some lower-income workers to ratchet up theirs. Also, we find that reforms that achieve large marginal rate decreases (incentive gains) in the key $20,000–$35,000 range often raise rates at the very bottom and at high incomes to compensate (incentive losses).

The real trade-offs, we believe, are not the overall behavioral responses to work but the specific responses to work and investment among higher-income, higher-productivity groups.

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[21] See Eissa (1996).

[22] See, for example, Carasso and Steuerle (forthcoming); Salehezadeh and Kickham (2004); Coe et al. (1998); and Giannarelli and Steuerle (1995).

[23] We consider a reform revenue-neutral if the change in tax revenue is less than $2 billion. Our estimates are *static* and do not account for behavioral adjustments, which, particularly among higher-income workers, may reduce the actual revenue these reform options generate.

[24] For example, lowering the high effective marginal tax rates that fall on heads of households earning between $20,000 and $35,000 by raising (really, making less negative or making slightly positive) the effective marginal tax rates on heads of households earning between $0 and $10,000.

First, while it is a bit of an exaggeration, if a reform winds up adding 10 short-order cooks to the workforce due to markedly lower marginal rates but dropping one Bill Gates due to slightly higher rates, then national output will decline even while national employment rises. Second, if a reform induces higher-income groups to alter their mix of income to avoid the higher taxes, then that reform will have to raise tax rates even higher (creating greater distortion) to capture the same amount of tax revenue as before from these groups, to remain revenue-neutral.

A. A $6,800 Payroll Tax Exemption and a $1,000 Tax Credit

One way to reduce effective marginal tax rates on low- and moderate-income workers would be to restructure the earned income tax credit and the partially refundable child tax credit. One approach would separate out the work incentives from the child benefits and replace these credits with (1) an exemption from paying payroll taxes (i.e., Social Security, Disability, and Medicare taxes) on the first $6,800 of income and (2) a $1,000 per child, fully refundable tax credit—that is, a work benefit and a child benefit.[25] Granting a $6,800 payroll exemption to every worker could be costly. However, these revenue losses could be offset by broadening the base of the income and/or payroll taxes. For example, it could make sense to pay for a $6,800 per worker exemption by raising rates applicable to wages and earnings in excess of the $6,800 exemption. Alternatively, lawmakers could eliminate the cap on Social Security wages and earnings ($87,900 in 2004).

Consider a single parent with two children. Under current law, she can claim an earned income credit of up to $4,300, but that credit phases out at the rate of 21.06 percent of her income in excess of $14,040. Replacing the current credit with a $6,800 per worker payroll tax exemption and a $1,000 per child tax credit, our hypothetical parent would receive $2,520 worth of tax benefits, but those benefits would never phase out as her income increased. A $6,800 exemption from payroll taxes would be worth $520 per worker (or $1,040 if the credit applied to the employer portion as well), and the two child tax credits would be worth $2,000. As there would be no reason to phase out either of these tax benefits, millions of low-income workers would no longer face the moderate marginal tax rates that accompany the current phaseout of the earned income tax credit.[26]

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[25] See, for example, Yin and Forman (1993).

[26] Since the child tax credit by design begins phasing in just as the EITC is phasing out, the high effective marginal rates of the latter are mitigated somewhat for the taxpayer.

Alternatively, it could make sense to allow taxpayers to claim standard deductions and personal exemptions under the Social Security tax system as well as under the income tax system. In 2004, for example, a single parent with two children can claim a $7,150 standard deduction and three $3,100 personal exemptions under the income tax, for a income tax threshold before credits of $16,450. If she were allowed to claim a $16,450 tax threshold for the Social Security payroll tax as well, she would save $1,258 in payroll taxes and the earned income credit could be reduced accordingly ($1,258 = .0765 × $16,450). The benefit would be twice as large if the tax threshold also applied to the employer portion of the Social Security tax. Refundable child tax credits could also be used to give her another $1,000 per child. Again, under this approach, taxpayers would no longer face extraordinarily high effective marginal tax rates like those that result from the phaseout of the current earned income tax credit. However, such a tax proposal would be costly.

Figure 4 shows that the payroll exemption plus the fully refundable child credit flatten the marginal rates confronting low- to moderate-income heads of household with children. Gone are the steep work incentives and disincentives of the EITC and in their place are smaller work incentives at the bottom followed by an expected stepladder increase in marginal rates as incomes rise. While the reform raises marginal rates on those earning below about $14,000 (really, makes them less negative, from –40.0 to –15.3 percent), it lowers rates by 20 percentage points in the $21,000 to $36,000 range. The repeal of the Social Security wage cap meanwhile raises tax rates by 12.4 percentage points at incomes above $87,900, although instituting a child credit that no longer phases out at a 5 percent rate partially offsets this burden at incomes between $75,000 and $115,000.

Using the Urban–Brookings Tax Policy Center's Microsimulation model,[27] we estimate this option provides low- to middle-income workers with tax cuts ranging from 5.3 percent of after-tax income for those earning between $0 and $10,000 to 1.0 percent for those earning $75,000 to $100,000. With this reform, it is mainly persons earning above $200,000 who bear a tax increase (between 3.5 and 4.6 percent of after-tax income)—the partial payroll tax exemption cancels out most of the cap elimination's adverse distributional impact for those earning below $200,000. Appendix tables 1a and 1b show the distributional impact of this proposal by both dollar income range and quintile of *cash income,*[28] respectively.

B. A $2,000 Per Working Parent Earned Income Credit and a $1,000 Child Credit

Another approach for keeping marginal effective tax rates low would be to install a universal $2,000 per working parent earned income tax credit and a $1,000 per child refundable tax credit, both of which are refundable from the first dollar of earnings.[29] The $2,000 per working parent earned income tax credit could be computed as 20 percent of the first $10,000 of earned income, and it might not phase out at all, or phase out very slowly at the rate of 5 percent of income from $35,000 to $75,000. Figure 5 shows how such a $2,000 per working parent earned income tax credit could work, with or without a phaseout.

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[27] Please see www.taxpolicycenter.org for details on the tax model and its data sources. Also, please note that the revenue and distributional estimates produced for this paper are *static*, meaning they do not factor in the behavioral responses of tax filers to the changes in the tax law that are considered.

[28] Cash income includes wages and salaries, employee contribution to tax-deferred retirement savings plans, business income or loss, farm income or loss, Schedule E income, interest income, taxable dividends, realized net capital gains, Social Security benefits received, unemployment compensation, energy assistance, Temporary Assistance for Needy Families (TANF), workers' compensation, veterans benefits, Supplemental Security Income, child support, disability benefits, taxable IRA distributions, total pension income, alimony received, and other income including foreign earned income. Cash income also includes imputed corporate income tax liability and the employer's share of payroll taxes. This puts the income measure on a pretax basis.

[29] Along the same lines, some have suggested replacing the earned income tax credit with a $1,530 payroll tax credit, to offset the payroll taxes incurred on the first $10,000 of earnings, and with a $2,000 per child "simplified family credit." See, for example, H.R. 3655, 108th Congress, introduced by Dennis J. Kucinich, Barbara Lee, and Bernie Sanders (Dec. 8, 2003); Catts (2003); and Sawicky (2003).

Under this approach, a single parent with two children would be entitled to up to $4,000 in refundable tax credits. She could claim two $1,000 refundable child tax credits, and if she worked full-time year-round, even at the minimum wage, she could pick up another $2,000 from the working parent earned income credit, for a total of $4,000. The downside to the working parent credit is it would impinge on incentives. A jointly filed return of $20,000, where each spouse earned $10,000, would receive $4,000 in working parent credits, while a head of household return of $20,000, all earned by one person, would receive only $2,000 in working parent credits. But this is one of the trade-offs.

Compared with current law, the two fully refundable credits drop marginal rates, notably for heads of household earning under $35,000, as seen in figure 6. The biggest difference is having a worker earned income credit (EIC) that does not have a 21.06 percent phaseout. The worker EIC would phase out at only 5 percent, phasing down between $35,000 and $75,000 of income. The result is similar from a marginal rate standpoint to the payroll tax exemption option. Marriage penalties would also be a lot smaller and occur at higher incomes under a system of $2,000 per working parent earned income tax credits. Married couples would receive $2,000 per working parent with the 5 percent phaseout beginning at $60,000 of joint income and phasing down to zero by $140,000 of income.

We estimate that a $2,000 per working parent tax credit plus a $1,000 per child refundable credit with phaseouts as described would be revenue-neutral and very modestly raise the after-tax incomes of households earning between $20,000 and $75,000 by 0.2 to 1.3 percent. Adversely affected are roughly a quarter of households earning between $0 and $20,000 who are mostly single-headed and lose more from the repeal of the EITC than they gain from this proposal—they lose between 1.3 and 2.1 percent of their after-tax income. (Also affected are those taxpayers in the proposal's lowered phaseout range for the child tax credit.) Average tax rates are 1–2 percentage points higher for earners between $0 and $20,000 of income, but are about 1 percentage point lower for earners at higher income ranges. The distributional effects are shown in detail in appendix tables 2a and 2b.

C. A $1,680 Universal Grant

Instead of refundable child tax credits, it could make sense to have a system of refundable personal tax credits or universal grants. A universal grant is a cash transfer paid to every person without regard to income level. For example, consider a simple universal grant that guaranteed every person $1,680 a year. Under such a system, an unmarried individual would receive $1,680, a parent with two children would receive $5,040, and a married couple with two children would receive $6,720. All personal exemptions, the standard deduction and itemized deductions, and individual tax credits would be repealed under such a system.

Universal grants could be paid out in the form of refundable personal tax credits, and these personal tax credits could replace personal exemptions, standard deductions, child tax credits, and the child-related component of the earned income credit. For example, every person

in a household could receive a $1,680 refundable personal tax credit and tax filers could be taxed at relatively low rates on all their income.[30]

Like other transfer programs, universal grants may have a negative effect on the overall work effort of beneficiaries. Figure 7 shows that, while a universal grant would flatten the overall marginal rate structure, it may remove tax rewards at the bottom of the income distribution for single parents who work. We speculate that any reduction in work effort would be less than under welfare-type transfer programs, which pit high benefit-reduction rates against income earned from employment. Universal grants, by definition, do not phase out as income rises. Consequently, recipients of universal grants would face *only* normal tax rates and no phaseouts and so should have virtually every incentive to work and earn more money to support themselves and their families.

We estimate that a $1,680 universal grant option provides substantial gains to everyone earning below $50,000—particularly to those in the $0 to $20,000 range that see average tax cuts on the order of $1,000. Those earning above $75,000, however, lose 2 to 4 percent of after-tax income and bear average tax rates 1 to 3 percentage points higher because the value of their standard or itemized deductions in terms of reducing their tax liability under current law tends to exceed the value of the universal grants under our reform. The distributional results are shown in more detail in appendix tables 3a and 3b.

VI. A More Comprehensive Solution

Beyond simply restructuring the earned income tax credit, it could make sense to fundamentally restructure the current tax system. For example, Congress might want to integrate the current individual income and Social Security taxes into a single, comprehensive income tax system. That integrated tax system could have just a few progressive tax rates and could easily accommodate a few refundable tax credits. It would also apply to all sources of income, whether from earnings or capital. Repealed would be the regular income tax, the alternative minimum tax, and all payroll taxes. (The estate tax and corporate income taxes were neither altered nor repealed for this simulation.)

For example, imagine an integrated tax system with $2,000 per working parent refundable earned income tax credits (computed as 20 percent of the first $10,000 of earned income), $1,000 per person universal grants, and two tax rates: 24.5 percent of the first $100,000 of income if married ($50,000 if single) and 36 percent on income in excess of $100,000 if married ($50,000 if single). The reform would allow only two filing statuses: single and joint. Assume there are no exemptions or deductions.[31] Assume further that there is no phaseout of

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[30] Refundable tax credits have an equal value for all individuals, whereas deductions are more valuable to individuals facing higher tax brackets. For example, the current personal exemption ($3,100 in 2004) is worth $868 to taxpayers in the 28 percent tax bracket but just $310 to taxpayers in the 10 percent bracket ($868 = .28 × $3,100; $310 = .10 × $3,100). On the other hand, a $1,680 refundable personal tax credit would have the same value for all individuals.

[31] This suggestion is made for the sake of simplicity. Some deductions are legitimate—such as some legal and business expenses—and are not just loopholes. Ironically, a tax reform that truly got rid of all exemptions and

either the universal grants or the working parent tax credits. Table 3 shows how this integrated, comprehensive income tax system would work for single parents with two children making from $0 to $200,000, and figure 8 graphs the effective marginal tax rates imposed by this tax system at various income levels.

The combined picture shows how this simple tax and universal grant system could help meet the income needs of low-income families without undermining the incentive to work. In sharp contrast to the current tax system, figure 8 shows that marginal tax rates would increase only in a predictable, step-like manner; nor would the reform impose the highest effective marginal tax rates on low- and moderate-income taxpayers. Over an income range of about $20,000 to $50,000, the comprehensive reform would impose marginal rates 8 to 26 percentage points lower on families than current law. However, at income levels of $50,000 and above, the reform would levy marginal rates 3 to 9 percentage points higher on families.

To lessen marriage penalties and bonuses, the brackets for joint filers are set at twice that for single filers.[32] Then, each working parent could claim his or her own worker credit, his or her own universal grant, and universal grants for each child and face the 24.5 percent rate on remaining taxable income before hitting the 36.0 percent maximum tax rate. Additionally, since the $2,000 per working parent refundable credits and the $1,000 universal grants do not phase out, they do not produce any penalties—only potential bonuses, in the case of the refundable working parent credit, which phases in at a 20 percent rate.

The comprehensive option produces sizeable gains for those earning below $200,000—they receive tax cuts averaging $300 to $1,000 per filing unit. Those earning above this range, however, experience single- to double-digit percentage losses in after-tax income. See appendix tables 4a and 4b for details. Again, these cost and distribution estimates are *static*—while workers at lower incomes may or may not increase their work effort on net in response to reduced tax burdens, those earning $500,000 and above may restructure their compensation and investments to mitigate the impact of their higher tax burdens, reducing tax collections and raising the costs of this option.

Lowering the universal grant from $1,000 to $500 lowers both marginal rates somewhat: the 24.5 percent rate falls to 22.0 and the 36 percent rate falls to 34.6. This option is shown in appendix tables 4c and 4d. The distribution is less favorable for those at lower and moderate incomes, as the decrease in marginal tax rates is not enough to make up for the lost $500 in grants. Particularly, those earning between roughly $10,000 and $30,000 see tax increases on the order of $100 or more whereas they enjoyed tax cuts of several hundred dollars on average with the higher universal grants and marginal rates. But the tax rate incentives are somewhat improved—particularly by lowering the top rate to below 35 percent—and economic theory holds that workers respond to incentive effects (tax rates) rather than levels (tax benefits).

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deductions would actually take the tax system *further* away from correctly measuring and counting taxable income than under current law.

[32] Marriage bonuses would still occur, however, as higher-income couples would alter their mix of income to avoid the tax.

Also, this comprehensive income tax system could theoretically be designed as a return-free, final withholding system. Consequently, few taxpayers would ever need to file tax returns. Such a return-free system—which would be far from easy to implement[33]—could significantly reduce burdens on both taxpayers and the IRS.[34]

All in all, an integrated, comprehensive income tax system with refundable credits would be simpler to administer than the current tax system and it would minimize work disincentives on low- and moderate-income workers with children. However, depending on how high the upper tax rate or rates is set, the option could induce tax-avoiding behavior among the very high income. In short, this approach would make the tax system work-friendly, but perhaps at significant cost.

VII. Conclusion

The current federal tax system imposes some of its highest effective marginal tax rates on low- and moderate-income workers. These high effective marginal tax rates result primarily from the combination of income taxes, Social Security taxes, and the phaseout of the earned income tax credit. The problem is that these high effective marginal tax rates tend to discourage work effort and skill development by many of the very individuals who are trying to work their way off the welfare system.

We described several revenue-neutral reforms to our tax system that would alleviate high tax rates on these workers. One way to reduce these high effective marginal tax rates on low- and moderate-income workers would be to restructure the earned income tax credit. For example, one approach would replace the current credit with a $6,800 per worker exemption from Social Security taxes and a $1,000 per child refundable tax credit. A similar approach would replace the current earned income tax credit with a $2,000 per working parent earned income tax credit and a $1,000 per child refundable tax credit that phased out at moderate income levels.

A more comprehensive approach would be to fundamentally restructure the current system by integrating the current income and Social Security tax systems into a single, comprehensive income tax system. That system could have just a few progressive tax rates, and could easily accommodate a few refundable tax credits. For example, an integrated, comprehensive income tax system might have $2,000 per working parent refundable earned income tax credits, $1,000 per person universal grants, and just two tax rates: 24.5 percent of the first $100,000 of income ($50,000, if single) and 36 percent on income in excess of $100,000

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[33] See Burman (2003).

[34] See, for example, Treasury (2003). The Treasury report estimates that up to 52 million taxpayers (41 percent) could be freed from having to file income tax returns with an exact withholding system. Most of these people would no longer have to gather information, become familiar with tax laws, or prepare and file returns. The burden on the IRS also would be greatly reduced. Moreover, even more taxpayers could be freed from having to file returns if Congress were to restructure the tax system. In that regard, the Treasury report notes that exact withholding would work best if we had fewer tax rates; fewer deductions, allowances, and credits; and if interest and dividend income were taxed at a flat rate and withheld at the source. It could also make sense to get rid of joint tax returns and instead make the unit of taxation the individual, not the family (Ibid., 2).

($50,000 if single). Such a system would be easier to administer than the current system and would rationalize work incentives on low- and moderate-income workers with children. In short, this approach would make the tax system work-friendly.

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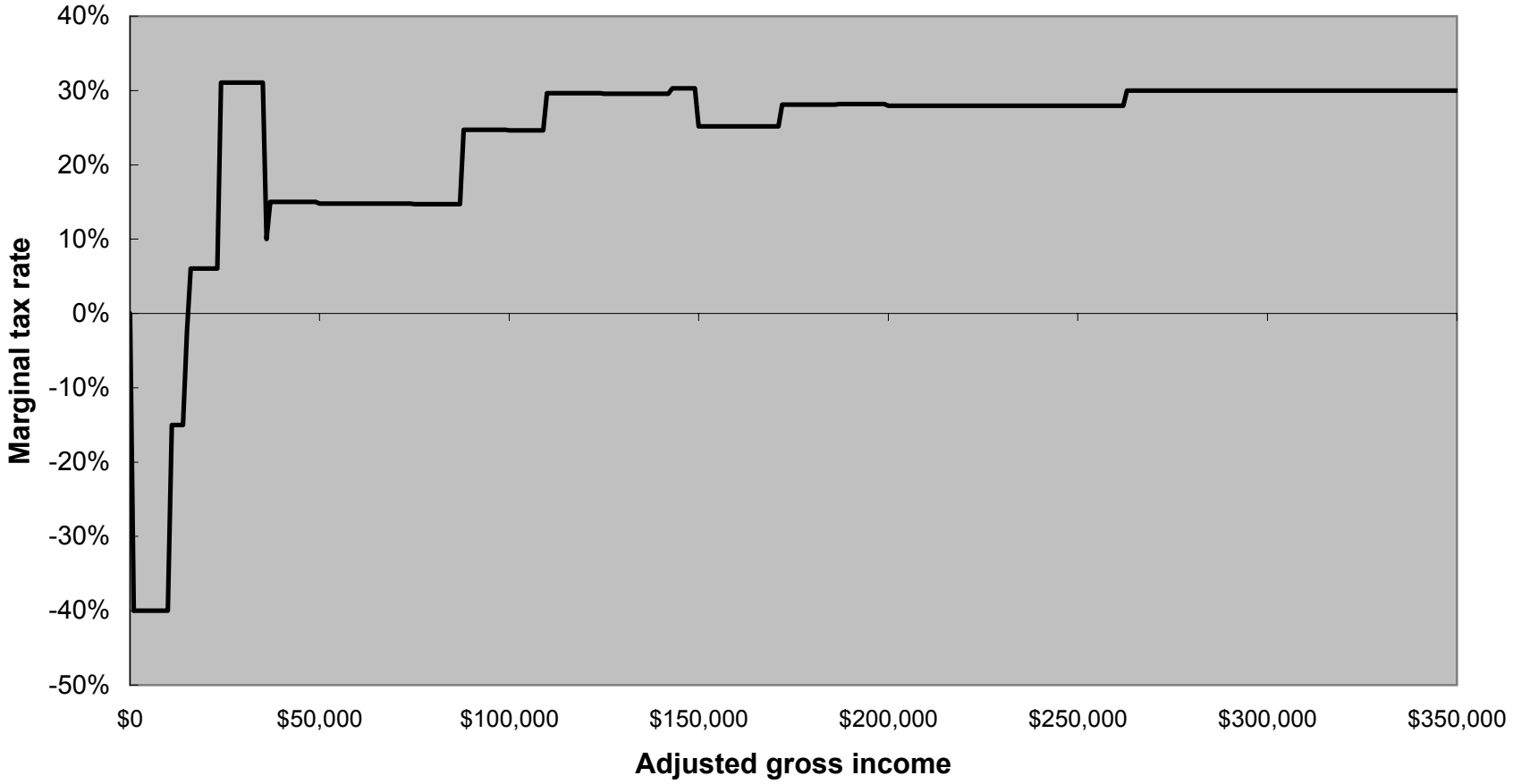
TABLE 1. Standard Deductions, Personal Exemptions, and Income Tax Thresholds for Various Taxpayers, 2004

	Unmarried individuals	*Heads of household with two children*	*Married couples with two children*
Standard deduction	$4,850	$7,150	$9,700
Personal exemptions	$3,100	$9,300	$12,400
Income tax threshold before credits	$7,950	$16,450	$22,100
Income tax threshold after credits (EITC and CTC)	$9,490	$33,930	$40,200

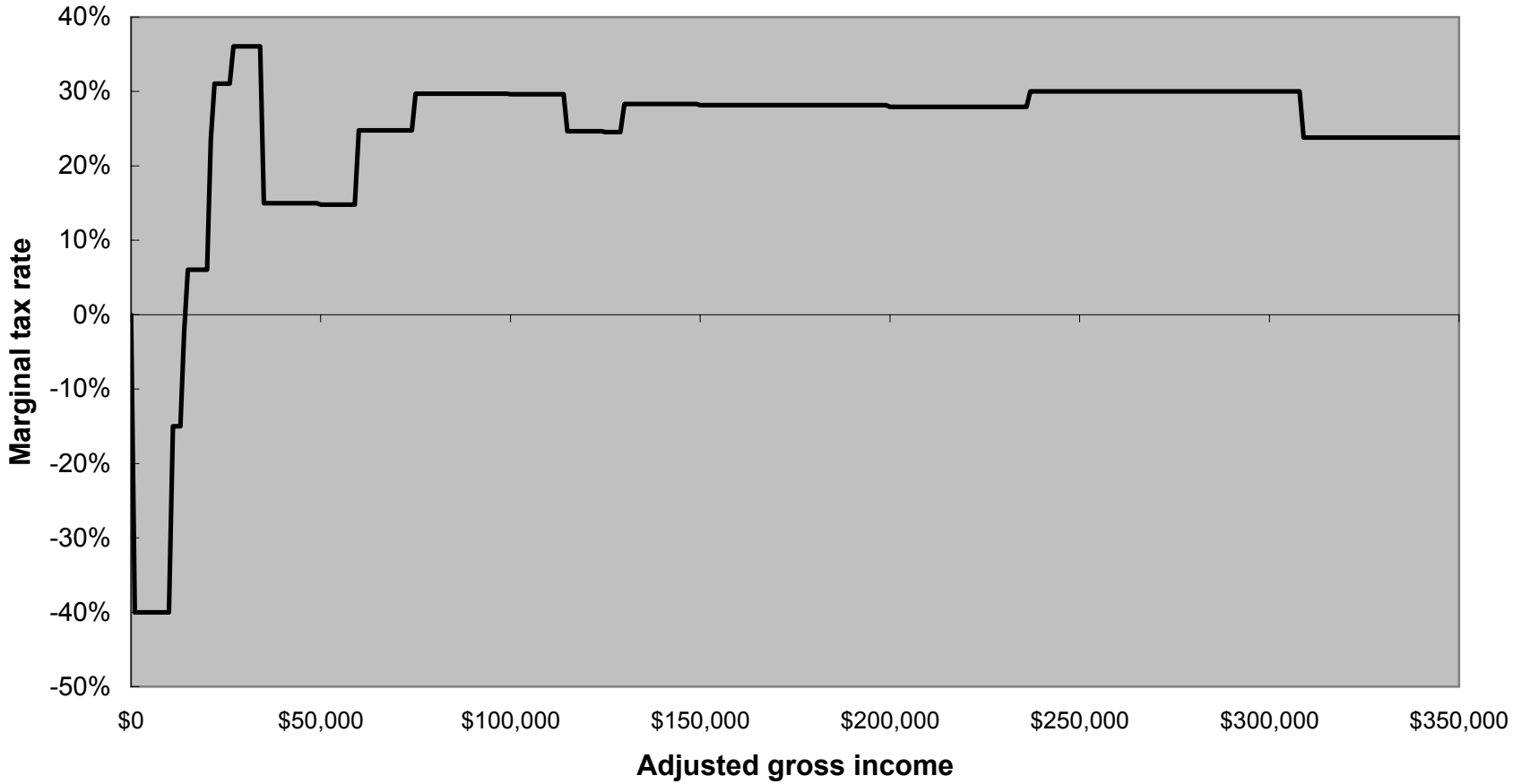
Sources: Internal Revenue Service 2004 and Urban-Brookings Tax Policy Center.

FIGURE 1a. Effective Marginal Income Tax Rates for Married Couples with Two Children in 2004



Source: The Urban-Brookings Tax Policy Center.
Notes: Authors' calculations include the AMT and assumptions about itemized deductions and capital gains/dividend income (see appendix). Children are assumed to be under age 18 and qualify for the dependency exemption, the EITC, and the child tax credit. Marginal tax rates include statutory income tax rates in the regular income tax system or the AMT, where applicable, plus phaseout rates from the EITC, the child tax credit, the personal exemption, and itemized deductions.

FIGURE 1b. Effective Marginal Income Tax Rates for Heads of Household with Two Children in 2004



Source: The Urban-Brookings Tax Policy Center.
Notes: Authors' calculations include the AMT and assumptions about itemized deductions and capital gains/dividend income (see appendix). Children are assumed to be under age 18 and qualify for the dependency exemption, the EITC, and the child tax credit. Marginal tax rates include statutory income tax rates in the regular income tax system or the AMT, where applicable, plus phaseout rates from the EITC, the child tax credit, the personal exemption, and itemized deductions.

TABLE 2. Marriage Bonus and Penalty Examples in the Income Tax for Tax Year 2004

Example 1. Single Man Earns $10,000, Single Mother Earns $10,000, Married Couple Earns $20,000

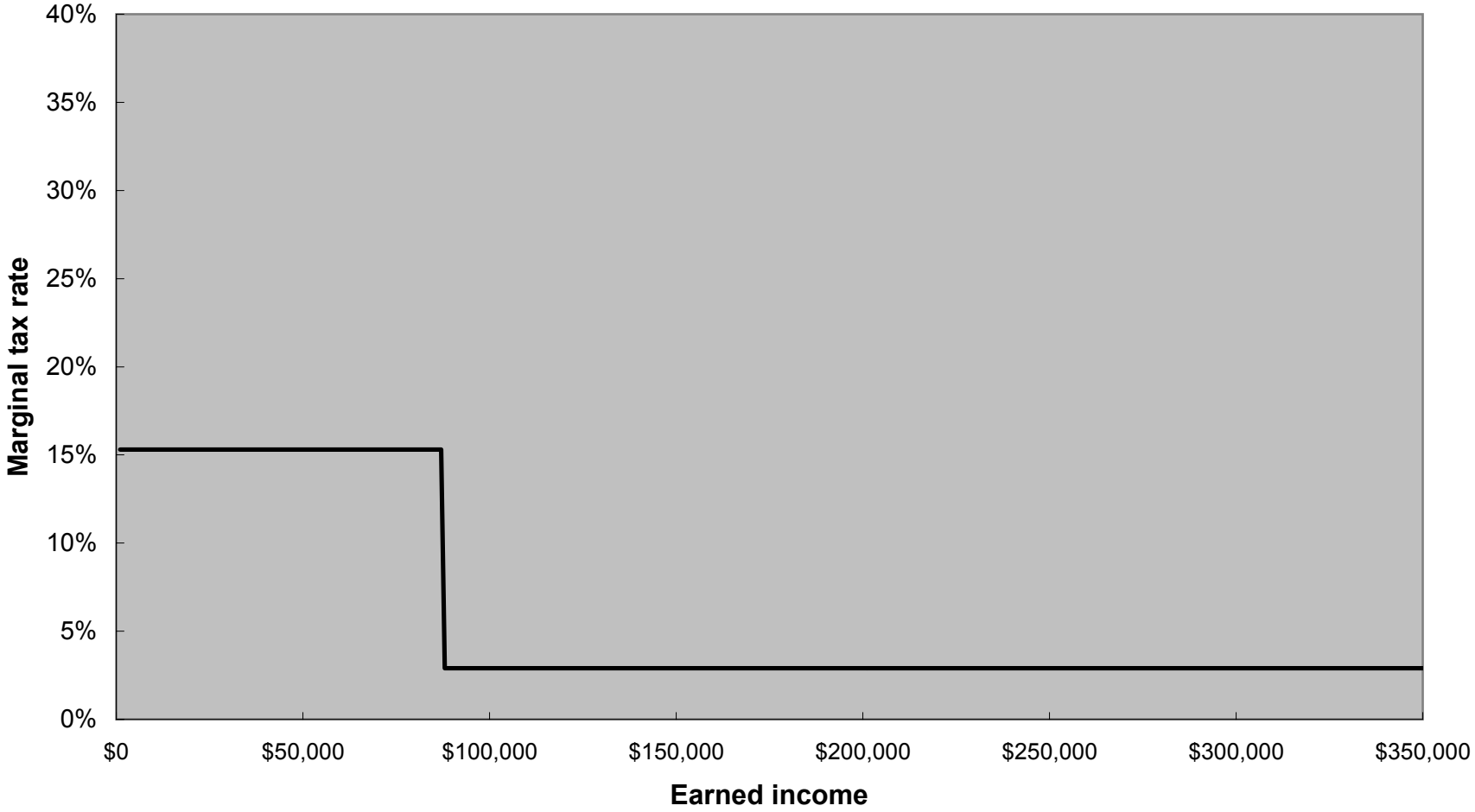
Tax Item	A Single man	B Single mother w/ 2 children	C Single man and mother A + B	D Married couple w/ 2 children	E Difference marriage makes D - C
Before-credit tax liability (-)	($205)	$0	($205)	$0	$205
EITC (+)	$114	$4,000	$4,114	$3,255	($859)
Child credit (+)	$0	$0	$0	$1,388	$1,388
Penalty (-)/ Bonus (+)	($91)	$4,000	$3,909	$4,643	**$734**

Example 2. Single Man Earns $20,000, Single Mother Earns $15,000, Married Couple Earns $35,000

Tax Item	A Single man	B Single mother w/ 2 children	C Single man and mother A + B	D Married couple w/ 2 children	E Difference marriage makes D - C
Before-credit tax liability (-)	($1,450)	$0	($1,450)	($1,290)	$160
EITC (+)	$0	$4,098	$4,098	$96	($4,002)
Child credit (+)	$0	$638	$638	$2,000	$1,362
Penalty (-)/ Bonus (+)	($1,450)	$4,736	$3,286	$806	**($2,480)**

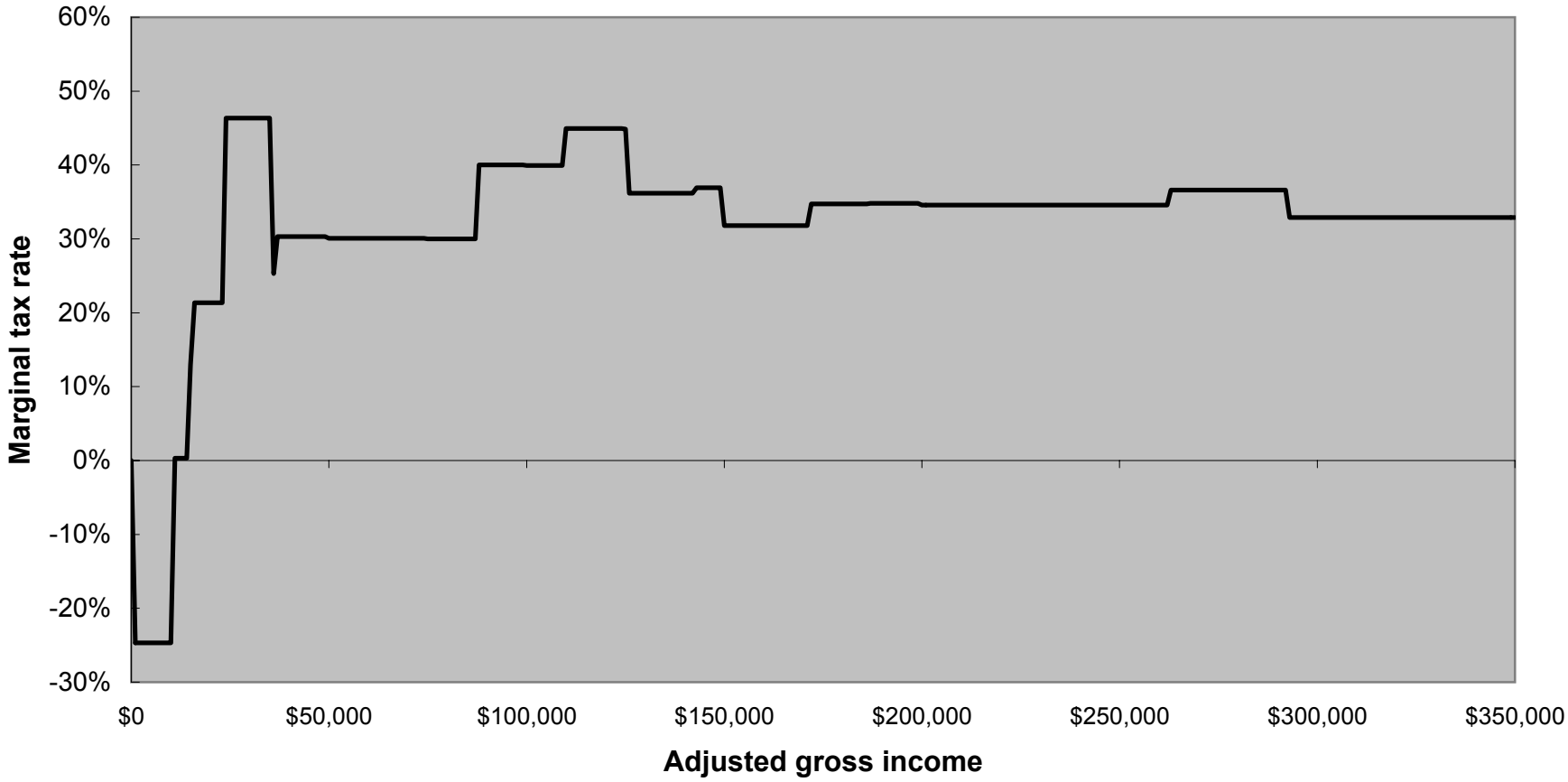
Source: The Urban-Brookings Tax Policy Center.
Notes: Negative values reflect tax *penalties* while positive values reflect tax *bonuses*. These simple examples concern only the income tax and assume tax filers take the standard deduction and do not claim any additional tax credits beyond those shown.

FIGURE 2. FICA Taxes: Effective Marginal Tax Rates on Earned Income



Source: The Urban-Brookings Tax Policy Center.
Notes: Shows employer and employee combined tax rates. Social Security and Disability taxes are assessed up to the taxable maximum ($87,900 in 2004). Medicare taxes are assessed on all earned income.

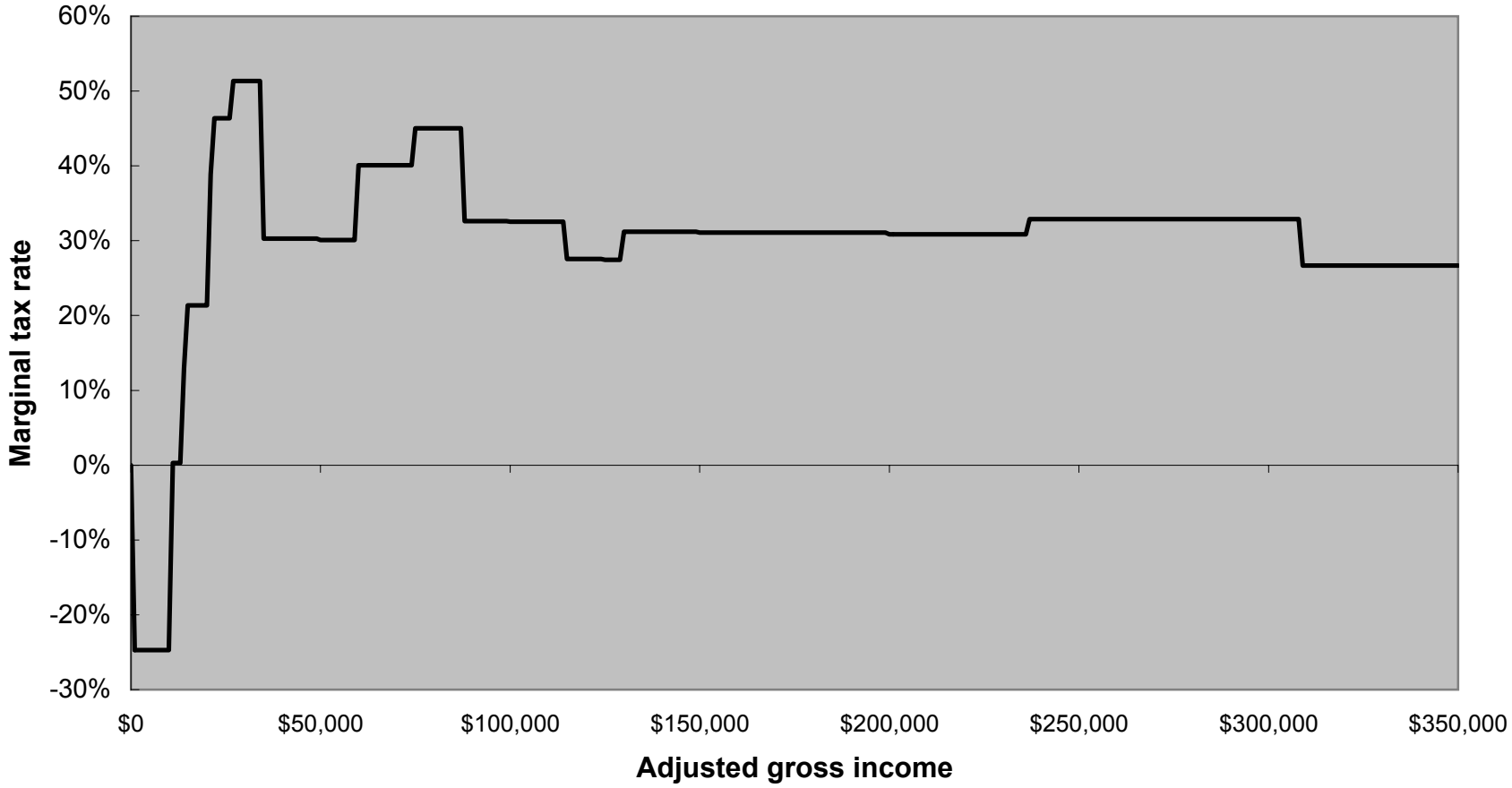
FIGURE 3a. Combined Effective Marginal Tax Rates (Income and Payroll) for a Married Couple with Two Children in 2004



Source: The Urban-Brookings Tax Policy Center.

Notes: Authors' calculations include the AMT and assumptions about itemized deductions and capital gains/dividend income (see appendix). One spouse does not work. Children are assumed to be under age 18 and qualify for the dependency exemption, the EITC, and the child tax credit. Marginal tax rates include statutory income tax rates in the regular income tax system or the AMT, where applicable, plus phaseout rates from the EITC, the child tax credit, the personal exemption, and itemized deductions. For payroll tax purposes, the second earner is assumed to earn 30 percent of total AGI.

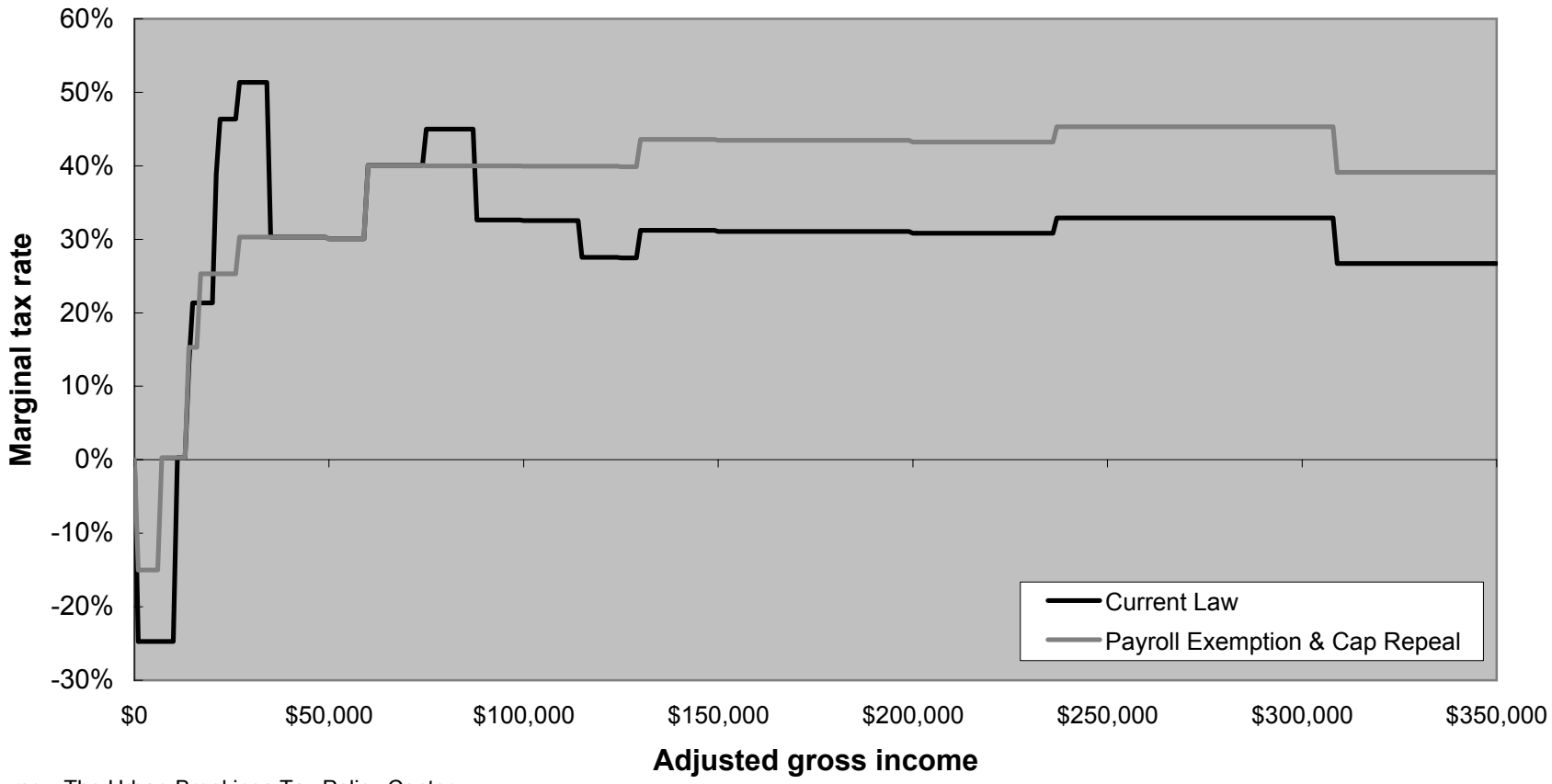
FIGURE 3b. Combined Effective Marginal Tax Rates (Income and Payroll) for a Head of Household with Two Children in 2004



Source: The Urban-Brookings Tax Policy Center.
Notes: Authors' calculations include the AMT and assumptions about itemized deductions and capital gains/dividend income (see appendix). Children are assumed to be under age 18 and qualify for the dependency exemption, the EITC, and the child tax credit. Marginal tax rates include statutory income tax rates in the regular income tax system or the AMT, where applicable, plus phaseout rates from the EITC, the child tax credit, the personal exemption, and itemized deductions.

FIGURE 4. Combined Effective Marginal Tax Rates (Income and Payroll) for a Head of Household with Two Children in 2004

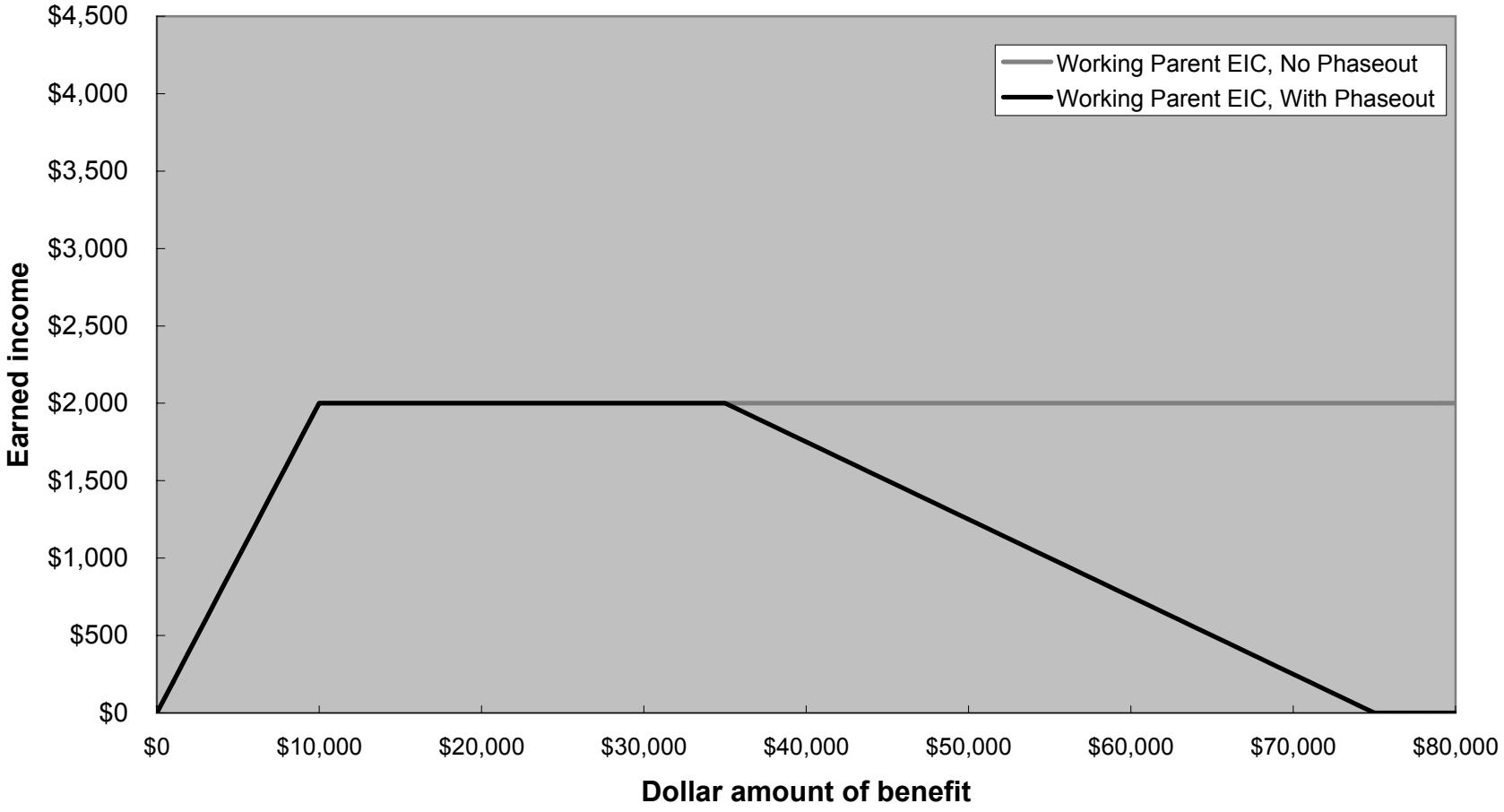
$6,800 Payroll Tax Exemption with Repealed Wage Cap and Fully Refundable $1,000 Child Credit



Source: The Urban-Brookings Tax Policy Center.

Notes: Authors' calculations include the AMT and assumptions about itemized deductions and capital gains/dividend income (see appendix). Children are assumed to be under age 18 and qualify for the dependency exemption, the EITC, and the child tax credit. Child credit does not phase out under reform. Marginal tax rates include statutory income tax rates in the regular income tax system or the AMT, where applicable, plus phaseout rates from the EITC, the child tax credit, the personal exemption, and itemized deductions.

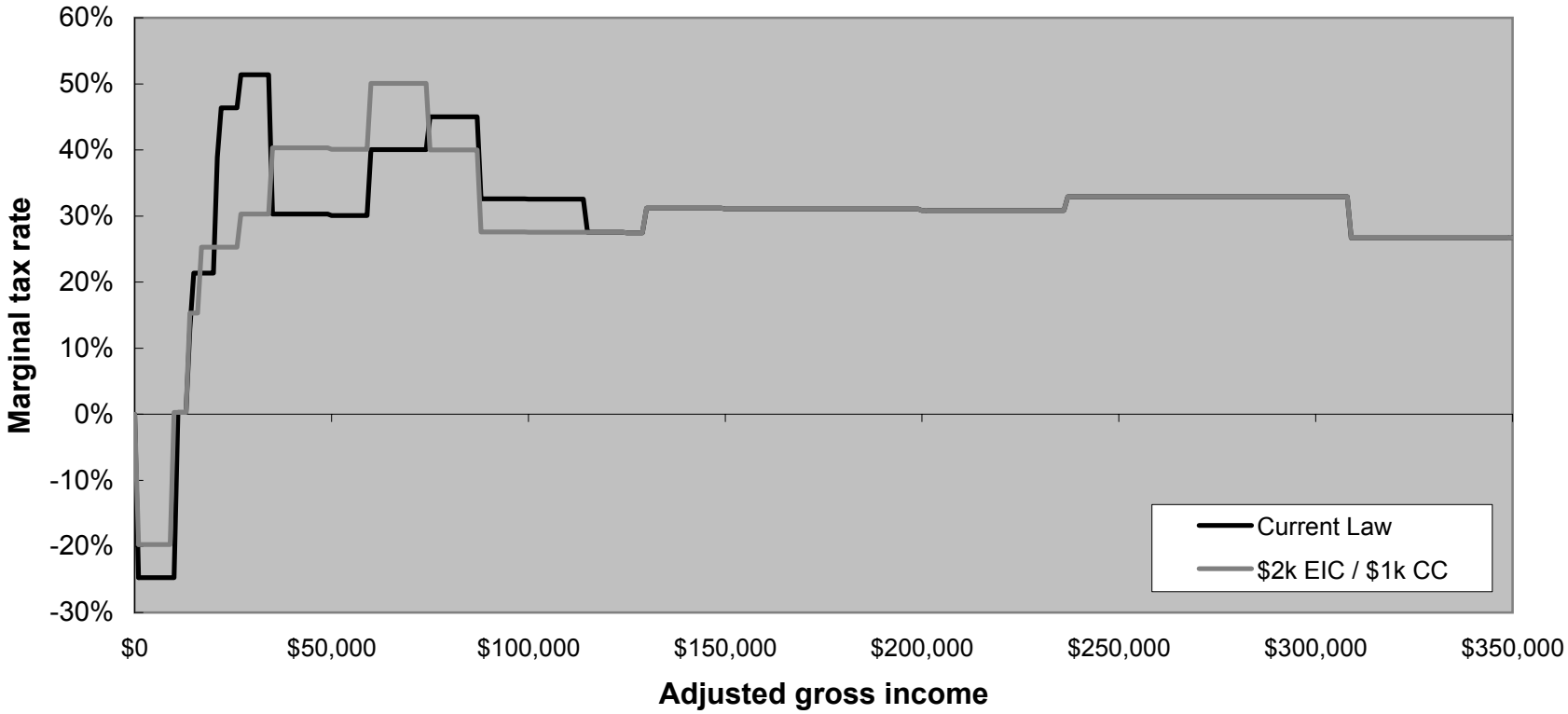
FIGURE 5. Hypothetical $2,000 Per Working Parent Credit for a Head of Household, with and without Phaseout



Source: The Urban-Brookings Tax Policy Center.
Note: The $2,000 per worker earned income credit (EIC) phases in at a 20 percent rate until $10,000 of income. The credit then may phase out at a 5 percent rate between $35,000 and $75,000 (between $60,000 and $100,000 for married couples).

FIGURE 6. Combined Effective Marginal Tax Rates (Income and Payroll) for a Head of Household with Two Children in 2004

$2,000 Working Parent EIC and $1,000 Child Credit, Both Fully Refundable, Phase Out above $35k

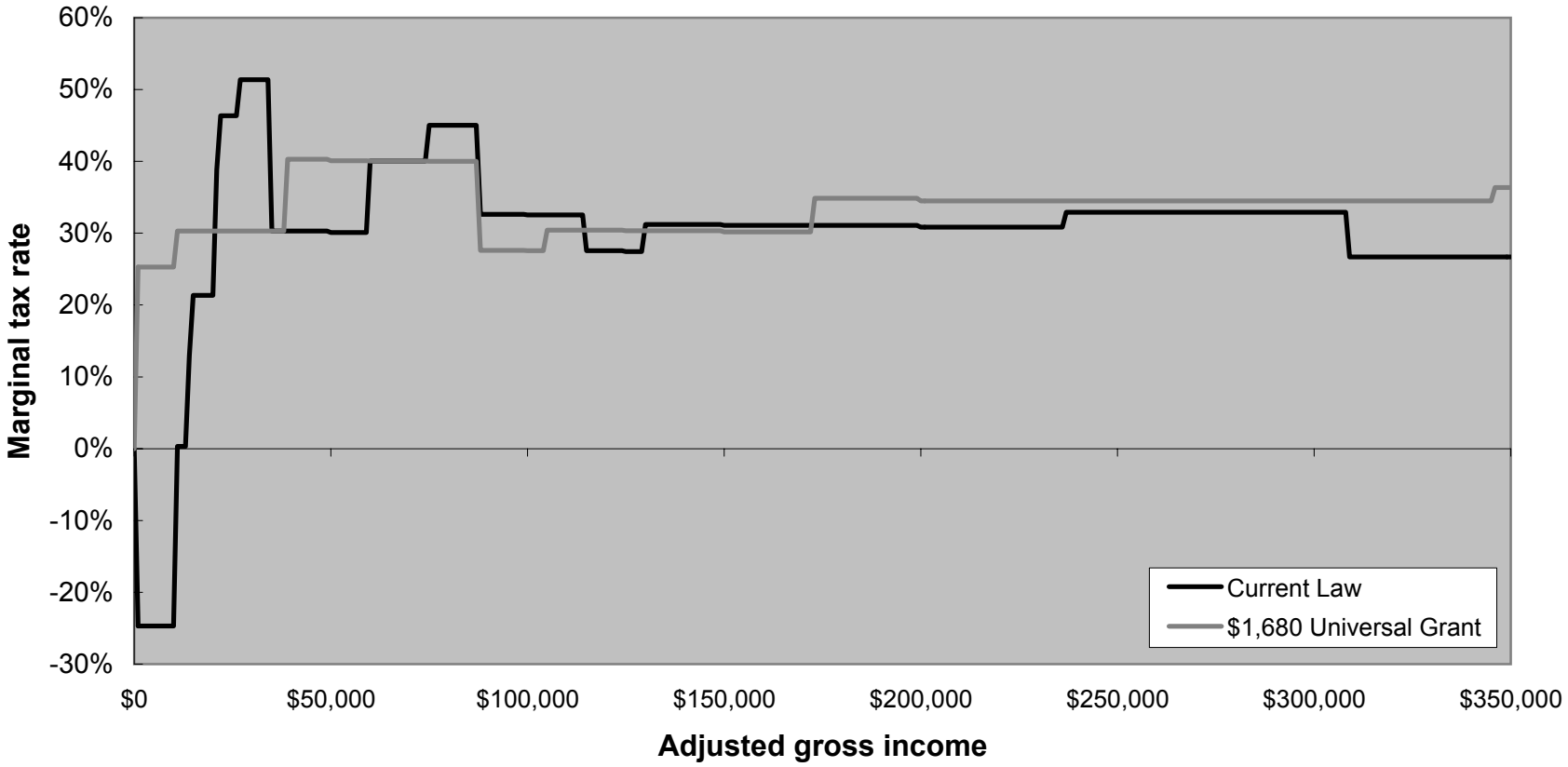


Source: The Urban-Brookings Tax Policy Center.

Notes: Authors' calculations include the AMT and assumptions about itemized deductions and capital gains/dividend income. Children are assumed to be under age 18 and qualify for the dependency exemption, the EITC, and the child tax credit under current law and the fully refundable $1,000 child credit under the reform proposal. Both the $2,000 EIC and the child credit phase out at a 5 percent rate from $35,000 to $75,000. Marginal tax rates include statutory income tax rates in the regular income tax system or the AMT, where applicable, plus phaseout rates from the EITC, the child tax credit, the personal exemption, itemized deductions, and phaseouts contained within provisions of this tax reform option.

FIGURE 7. Combined Effective Marginal Tax Rates (Income and Payroll) for a Head of Household with Two Children in 2004

$1,680 Per Person Universal Grant and Repeal of Personal Exemptions and Standard/Itemized Deductions



Source: The Urban-Brookings Tax Policy Center.

Notes: Authors' calculations include the AMT and assumptions about itemized deductions and capital gains/dividend income. Children are assumed to be under age 18 and qualify for the dependency exemption, the EITC, and the child tax credit under current law and the $1,680 per person universal grant under the reform. Marginal tax rates include statutory income tax rates in the regular income tax system or the AMT, where applicable, plus phaseout rates from the EITC, the child tax credit, the personal exemption, and itemized deductions.

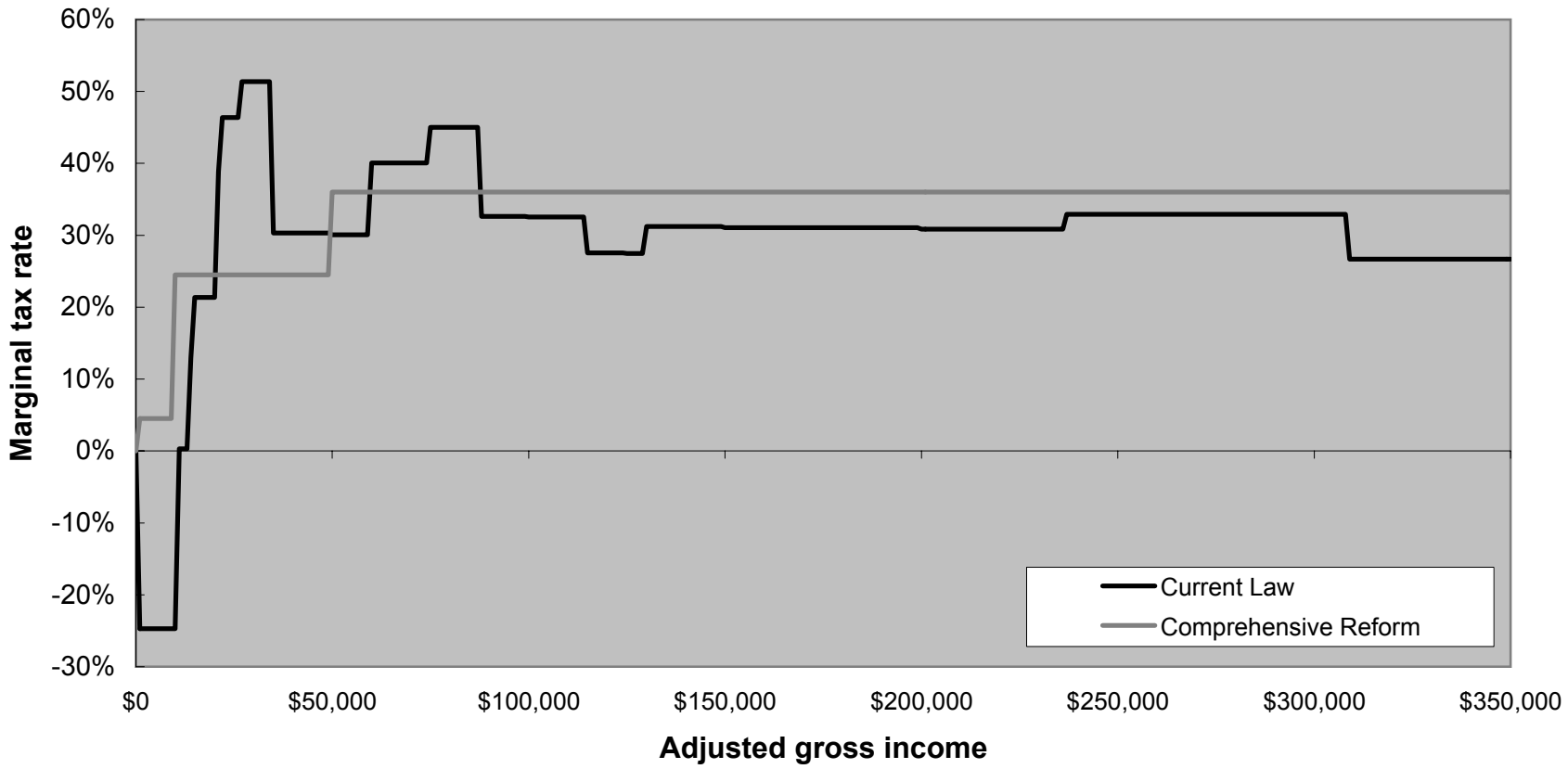
TABLE 3. How an Integrated, Comprehensive Income Tax System Would Affect a Single Parent with Two Children
($1,000 Universal Grants, $2,000 per Working Parent Credit, and 24.5% and 36.0% Tax Rates)

Pre-tax earnings	*Less tax imposed*	*Plus worker credit*	*Plus universal grant amount*	*Equals after-tax income*
$0	$0	$0	$3,000	$3,000
$5,000	$1,225	$2,000	$3,000	$8,775
$10,000	$2,450	$2,000	$3,000	$12,550
$20,000	$4,900	$2,000	$3,000	$20,100
$30,000	$7,350	$2,000	$3,000	$27,650
$40,000	$9,800	$2,000	$3,000	$35,200
$50,000	$12,250	$2,000	$3,000	$42,750
$100,000	$30,250	$2,000	$3,000	$74,750
$150,000	$48,250	$2,000	$3,000	$106,750
$200,000	$66,250	$2,000	$3,000	$138,750

Source: Authors' calculations and the Urban-Brookings Tax Policy Center Microsimulation Model.

FIGURE 8. Effective Marginal Tax Rates for a Head of Household with Two Children Under an Integrated, Comprehensive Income Tax System in 2004

Comprehensive Reform: 24.5% and 36.0% Rates, $50k Bracket, $2,000 Working Parent EIC, $1,000 Universal Grant



Source: The Urban-Brookings Tax Policy Center.

Notes: Authors' calculations include the AMT and assumptions about itemized deductions and capital gains/dividend income (see appendix). Children are assumed to be under age 18 and qualify for the dependency exemption, the EITC, and the child tax credit under current law and the $1,000 per person universal grant under the reform. Marginal tax rates include statutory income tax rates in the regular income tax system or the AMT, where applicable, plus phaseout rates from the EITC, the child tax credit, the personal exemption, and itemized deductions.

APPENDIX TABLE 1A

Effect of Federal Income and Payroll Tax Reform: FICA Payroll Tax Exemption and Fully Refundable Child Tax Credit

Distribution of Federal Tax Change by Cash Income Class, 2004

Cash income class (thousands of 2003 dollars)[a]	Tax Units[b]				Percent change in after-tax income[c]	Average tax change ($)	Average Federal Tax Rate[d]	
	Number (thousands)	Percent of total	Percent with tax increase	Percent with tax cut			Current law	Proposal
Less than 10	20,428	14.2	0.0	59.8	5.3	-293	3.4	-1.7
10-20	26,467	18.4	0.1	67.3	3.5	-499	5.3	2.0
20-30	20,379	14.2	0.2	77.4	2.2	-495	10.8	8.8
30-40	15,377	10.7	0.3	81.7	1.6	-482	14.7	13.3
40-50	11,446	8.0	0.3	85.5	1.4	-519	16.7	15.6
50-75	20,054	14.0	0.5	88.2	1.2	-596	18.6	17.7
75-100	11,395	7.9	1.3	90.3	1.0	-678	20.2	19.4
100-200	13,281	9.3	31.1	62.7	-0.3	319	22.3	22.5
200-500	3,339	2.3	60.7	30.8	-3.5	7,572	25.0	27.6
500-1,000	527	0.4	61.0	29.3	-4.4	22,036	26.7	29.9
More than 1,000	257	0.2	65.9	24.1	-4.6	92,501	29.9	33.1
All	143,509	100.0	4.9	73.8	0.0	20	20.1	20.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).

Notes : Calendar year 2004. Baseline is current law. Includes the following provisions: exempting the first $6,800 of Social Security, Disability, and Medicare payroll taxes; eliminating the cap on income ($87,900 in 2004) for the Social Security and Disability payroll tax; making the child credit fully refundable.

a. Tax units with negative cash income are excluded from the lowest income class but are included in the totals.

b. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

c. After-tax income is cash income less individual federal tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and estate tax.

d. Average federal tax, net of refundable credits, as a percentage of average cash income.

APPENDIX TABLE 1B

Effect of Federal Income and Payroll Tax Reform: FICA Payroll Tax Exemption and Fully Refundable Child Tax Credit

Distribution of Federal Tax Change by Cash Income Class, 2004

Cash income class[a]	Percent of tax units with tax increase	Percent of tax units with tax cut	Percent change in after-tax income[b]	Average income tax change ($)	Average Federal Tax Rate[c]	
					Current law	Proposal
Lowest quintile	0.0	60.6	4.8	-345	3.3	-1.3
Second quintile	0.1	71.6	2.9	-505	7.5	4.8
Middle quintile	0.3	80.8	1.7	-486	13.9	12.5
Fourth quintile	0.4	87.5	1.2	-575	18.2	17.2
Top quintile	23.7	68.9	-1.6	1,996	23.9	25.1
All	4.9	73.8	0.0	20	20.1	20.1
Addendum						
Top 10 percent	42.7	50.6	-2.5	4,630	25.2	27.1
Top 5 percent	54.6	37.6	-3.4	9,137	26.3	28.8
Top 1 percent	61.2	28.7	-4.4	30,098	28.2	31.4
Top 0.5 percent	63.0	27.2	-4.5	47,843	28.9	32.1
Top 0.1 percent	68.7	21.4	-4.7	136,881	30.5	33.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).

Notes: Calendar year. Baseline is current law. Includes the following provisions: exempting the first $6,800 of Social Security, Disability, and Medicare payroll taxes; eliminating the cap on income ($87,900 in 2004) for the Social Security and Disability payroll tax; making the child credit fully refundable.

a. Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

b. After-tax income is cash income less, individual federal tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and estate tax.

c. Average federal income tax, net of refundable credits, as a percentage of average cash income.

APPENDIX TABLE 2A
Effect of Federal Income Tax Reform: $2,000 Per Working Parent Earned Income Credit
Distribution of Federal Tax Change by Cash Income Class, 2004

Cash income class (thousands of 2003 dollars)[a]	Tax Units[b]				Percent change in after-tax income[c]	Average tax change ($)	Average Federal Tax Rate[d]	
	Number (thousands)	Percent of total	Percent with tax increase	Percent with tax cut			Current law	Proposal
Less than 10	20,428	14.2	27.5	2.4	-2.1	116	3.4	5.4
10-20	26,467	18.4	20.6	7.7	-1.3	185	5.3	6.6
20-30	20,379	14.2	10.7	16.8	0.2	-51	10.8	10.6
30-40	15,377	10.7	2.8	20.8	1.3	-380	14.7	13.6
40-50	11,446	8.0	1.3	25.0	1.2	-470	16.7	15.7
50-75	20,054	14.0	11.9	19.7	0.5	-251	18.6	18.2
75-100	11,395	7.9	31.3	7.8	-0.6	390	20.2	20.6
100-200	13,281	9.3	31.9	0.6	-0.4	425	22.3	22.6
200-500	3,339	2.3	1.6	0.2	0.0	14	25.0	25.0
500-1,000	527	0.4	0.9	0.0	0.0	14	26.7	26.7
More than 1,000	257	0.2	0.2	0.0	0.0	2	29.9	29.9
All	143,509	100.0	16.8	11.8	0.0	1	20.1	20.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).

Notes: Calendar year. Baseline is current law. Includes the following provisions: earned income credit per working parent phasing in at 20 percent up to a maximum of $2,000, making the child credit fully refundable, child credit phasing in at 20 percent and phasing out at 5 percent for AGI above $60,000 for married couples and $35,000 for all others.

a. Tax units with negative cash income are excluded from the lowest income class but are included in the totals.

b. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

c. After-tax income is cash income less individual federal tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and

d. Average federal income tax, net of refundable credits, as a percentage of average cash income.

APPENDIX TABLE 2B

Effect of Federal Income Tax Reform: $2,000 Per Working Parent Earned Income Credit

Distribution of Federal Tax Change by Cash Income Percentiles, 2004

Cash income class[a]	Percent of tax units with tax increase	Percent of tax units with tax cut	Percent change in after-tax income[b]	Average income tax change ($)	Average Federal Tax Rate[c]	
					Current law	Proposal
Lowest quintile	26.9	3.8	-1.9	132	3.3	5.1
Second quintile	16.9	10.1	-0.8	136	7.5	8.2
Middle quintile	4.5	20.6	1.1	-303	13.9	13.0
Fourth quintile	8.8	21.3	0.7	-312	18.2	17.7
Top quintile	27.3	3.4	-0.3	353	23.9	24.1
All	16.8	11.8	0.0	1	20.1	20.1
Addendum						
Top 10 percent	21.9	0.3	-0.2	277	25.2	25.3
Top 5 percent	5.9	0.2	0.0	51	26.3	26.3
Top 1 percent	0.5	0.1	0.0	6	28.2	28.2
Top 0.5 percent	0.7	0.0	0.0	10	28.9	28.9
Top 0.1 percent	0.2	0.0	0.0	1	30.5	30.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).
Notes: Calendar year. Baseline is current law. Includes the following provisions: earned income credit per working parent phasing in at 20 percent up to a maximum of $2,000, making the child credit fully refundable, child credit phasing in at 20 percent and phasing out at 5 percent for AGI above $60,000 for married couples and $35,000 for all others.
a. Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
b. After-tax income is cash income less individual federal tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and estate tax.
c. Average federal income tax, net of refundable credits, as a percentage of average cash income.

APPENDIX TABLE 3A

Effect of Federal Income Tax Reform: $1,680 Universal Grant Per Person in the Tax Unit

Distribution of Federal Tax Change by Cash Income Class, 2004

Cash income class (thousands of 2003 dollars)[a]	Tax Units[b]				Percent change in after-tax income[c]	Average tax change ($)	Average Federal Tax Rate[d]	
	Number (thousands)	Percent of total	Percent with tax increase	Percent with tax cut			Current law	Proposal
Less than 10	20,428	14.2	1.8	98.2	35.8	-1,997	3.4	-31.3
10-20	26,467	18.4	14.9	85.1	8.2	-1,166	5.3	-2.4
20-30	20,379	14.2	16.1	83.9	4.3	-968	10.8	7.0
30-40	15,377	10.7	20.6	79.3	3.0	-893	14.7	12.2
40-50	11,446	8.0	44.2	55.7	1.2	-436	16.7	15.7
50-75	20,054	14.0	45.2	54.8	0.1	-53	18.6	18.5
75-100	11,395	7.9	84.3	15.7	-2.0	1,376	20.2	21.7
100-200	13,281	9.3	94.0	6.0	-3.1	3,285	22.3	24.7
200-500	3,339	2.3	92.2	7.8	-3.4	7,327	25.0	27.5
500-1,000	527	0.4	88.7	11.3	-3.3	16,565	26.7	29.1
More than 1,000	257	0.2	90.5	9.5	-4.0	81,193	29.9	32.7
All	143,509	100.0	35.4	64.6	0.0	4	20.1	20.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).

Notes: Calendar year. Baseline is current law. Includes the following provisions: replace personal exemptions, standard deductions, child tax credit, and the child-related portion of earned income credit with a refundable $1,680 universal grant for every person in the tax unit.

a. Tax units with negative cash income are excluded from the lowest income class but are included in the totals.

b. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

c. After-tax income is cash income less individual federal tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and

d. Average federal income tax, net of refundable credits, as a percentage of average cash income.

APPENDIX TABLE 3B

Effect of Federal Income Tax Reform: $1,680 Universal Grant Per Person in the Tax Unit

Distribution of Federal Tax Change by Cash Income Percentiles, 2004

Cash income class[a]	Percent of tax units with tax increase	Percent of tax units with tax cut	Percent change in after-tax income[b]	Average income tax change ($)	Average Federal Tax Rate[c]	
					Current law	Proposal
Lowest quintile	4.1	95.9	25.8	-1,839	3.3	-21.6
Second quintile	16.8	83.2	5.9	-1,026	7.5	2.0
Middle quintile	20.7	79.3	3.1	-897	13.9	11.2
Fourth quintile	45.4	54.6	0.3	-142	18.2	18.0
Top quintile	89.9	10.1	-3.1	3,946	23.9	26.2
All	35.4	64.6	0.0	4	20.1	20.1
Addendum						
Top 10 percent	93.9	6.1	-3.4	6,329	25.2	27.7
Top 5 percent	93.2	6.9	-3.5	9,491	26.3	28.9
Top 1 percent	88.3	11.7	-3.6	24,620	28.2	30.8
Top 0.5 percent	89.5	10.5	-3.8	40,071	28.9	31.6
Top 0.1 percent	90.3	9.7	-4.2	121,485	30.5	33.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).
Notes: Calendar year. Baseline is current law. Includes the following provisions: replace personal exemptions, standard deductions, child tax credit, and the child-related portion of earned income credit with a refundable $1,680 universal grant for every person in the tax unit.
a. Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
b. After-tax income is cash income less individual federal tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and estate tax.
c. Average federal income tax, net of refundable credits, as a percentage of average cash income.

APPENDIX TABLE 4A

Effect of Federal Income and Payroll Tax Restructuring: Comprehensive Reform (24.5% and 36.0% Tax Rates)

Distribution of Federal Tax Change by Cash Income Class, 2004

Cash income class (thousands of 2003 dollars)[a]	Tax Units[b]				Percent change in after-tax income[c]	Average tax change ($)	Average Federal Tax Rate[d]	
	Number (thousands)	Percent of total	Percent with tax increase	Percent with tax cut			Current law	Proposal
Less than 10	20,428	14.2	7.9	92.1	17.8	-992	3.4	-13.8
10-20	26,467	18.4	29.9	70.0	2.3	-332	5.3	3.2
20-30	20,379	14.2	29.3	70.7	1.6	-368	10.8	9.3
30-40	15,377	10.7	21.3	78.6	2.4	-717	14.7	12.7
40-50	11,446	8.0	25.8	74.2	2.1	-812	16.7	14.9
50-75	20,054	14.0	28.0	72.0	1.8	-901	18.6	17.2
75-100	11,395	7.9	27.1	72.9	1.7	-1,153	20.2	18.8
100-200	13,281	9.3	38.1	61.9	0.2	-216	22.3	22.1
200-500	3,339	2.3	80.9	19.1	-4.4	9,557	25.0	28.3
500-1,000	527	0.4	87.4	12.6	-5.7	28,652	26.7	30.9
More than 1,000	257	0.2	91.3	8.7	-10.3	206,643	29.9	37.1
All	143,509	100.0	27.1	72.9	-0.1	51	20.1	20.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).

Notes: Calendar year. Baseline is current law. Replace current law with the following provisions: 24.5 percent and 36 percent brackets with the 36 percent bracket starting at $100,000 for married filing jointly ($50,000 for everyone else), individual filing only, earned income credit with a phase-in rate of 20 percent up to a maximum of $2,000, $1,000 universal grant per person in the tax unit.

a. Tax units with negative cash income are excluded from the lowest income class but are included in the totals.

b. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

c. After-tax income is cash income less individual income tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and estate tax.

d. Average federal income tax, net of refundable credits, as a percentage of average cash income.

APPENDIX TABLE 4B

Effect of Federal Income and Payroll Tax Restructuring: Comprehensive Reform (24.5% and 36.0% Tax Rates)

Distribution of Federal Tax Change by Cash Income Percentiles, 2004

Cash income class[a]	Percent of tax units with tax increase	Percent of tax units with tax cut	Percent change in after-tax income[b]	Average income tax change ($)	Average Federal Tax Rate[c]	
					Current law	Proposal
Lowest quintile	11.4	88.5	12.2	-867	3.3	-8.4
Second quintile	33.0	66.9	1.5	-260	7.5	6.1
Middle quintile	23.5	76.5	2.2	-632	13.9	12.0
Fourth quintile	27.6	72.4	1.8	-868	18.2	16.7
Top quintile	40.1	59.9	-2.3	2,932	23.9	25.6
All	27.1	72.9	-.0.11	51	20.1	20.2
Addendum						
Top 10 percent	53.7	46.3	-3.9	7,169	25.2	28.1
Top 5 percent	72.5	27.5	-5.6	15,044	26.3	30.4
Top 1 percent	86.0	14.0	-7.9	54,129	28.2	33.9
Top 0.5 percent	88.9	11.1	-8.9	93,237	28.9	35.2
Top 0.1 percent	90.9	9.1	-11.1	323,121	30.5	38.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).

Notes: Calendar year. Baseline is current law. Replace current law with the following provisions: 24.5 percent and 36 percent brackets with the 36 percent bracket starting at $100,000 for married filing jointly ($50,000 for everyone else), individual filing only, earned income credit with a phase-in rate of 20 percent up to a maximum of $2,000, $1,000 universal grant per person in the tax unit.

a. Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

b. After-tax income is cash income less individual income tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and estate tax.

c. Average federal income tax, net of refundable credits, as a percentage of average cash income.

APPENDIX TABLE 4C

Effect of Federal Income and Payroll Tax Restructuring: Comprehensive Reform (22.0% and 34.6% Tax Rates)

Distribution of Federal Tax Change by Cash Income Class, 2004

Cash income class (thousands of 2003 dollars)[a]	Tax Units[b]				Percent change in after-tax income[c]	Average tax change ($)	Average Federal Tax Rate[d]	
	Number (thousands)	Percent of total	Percent with tax increase	Percent with tax cut			Current law	Proposal
Less than 10	20,428	14.2	27.1	72.8	17.8	-302	3.4	-1.9
10-20	26,467	18.4	44.5	55.5	2.3	259	5.3	7.1
20-30	20,379	14.2	40.9	59.1	1.6	93	10.8	11.2
30-40	15,377	10.7	27.5	72.4	2.4	-464	14.7	13.4
40-50	11,446	8.0	27.2	72.8	2.1	-741	16.7	15.1
50-75	20,054	14.0	27.2	72.8	1.8	-1,070	18.6	16.9
75-100	11,395	7.9	24.4	75.6	1.7	-1,704	20.2	18.2
100-200	13,281	9.3	31.3	68.7	0.2	-1,481	22.3	21.2
200-500	3,339	2.3	69.4	30.6	-4.4	6,492	25.0	27.3
500-1,000	527	0.4	77.7	22.3	-5.7	21,484	26.7	29.9
More than 1,000	257	0.2	80.6	19.4	-10.3	173,757	29.9	35.9
All	143,509	100.0	33.7	66.3	-0.1	19	20.1	20.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).

Notes: Calendar year. Baseline is current law. Replace current law with the following provisions: 22 percent and 34.6 percent brackets with the 34.6 percent bracket starting at $100,000 for married filing jointly ($50,000 for everyone else), individual filing only, earned income credit with a phase-in rate of 20 percent up to a maximum of $2,000, $500 universal grant per person in the tax unit.

a. Tax units with negative cash income are excluded from the lowest income class but are included in the totals.

b. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

c. After-tax income is cash income less individual income tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and estate tax.

d. Average federal income tax, net of refundable credits, as a percentage of average cash income.

APPENDIX TABLE 4D

Effect of Federal Income and Payroll Tax Restructuring: Comprehensive Reform (22.0% and 34.6% Tax Rates)

Distribution of Federal Tax Change by Cash Income Percentiles, 2004

Cash income class[a]	Percent of tax units with tax increase	Percent of tax units with tax cut	Percent change in after-tax income[b]	Average income tax change ($)	Average Federal Tax Rate[c]	
					Current law	Proposal
Lowest quintile	30.8	69.0	2.7	-192	3.3	0.7
Second quintile	45.4	54.6	-1.7	290	7.5	9.0
Middle quintile	31.0	69.0	1.2	-329	13.9	12.9
Fourth quintile	27.4	72.6	2.1	-975	18.2	16.5
Top quintile	34.3	65.7	-1.1	1,346	23.9	24.7
All	33.7	66.3	0.0	19	20.1	20.1
Addendum						
Top 10 percent	44.8	55.2	-2.5	4,621	25.2	27.1
Top 5 percent	61.3	38.7	-4.2	11,155	26.3	29.4
Top 1 percent	75.0	25.0	-6.4	43,623	28.2	32.8
Top 0.5 percent	79.1	20.9	-7.3	76,700	28.9	34.1
Top 0.1 percent	80.7	19.3	-9.4	274,181	30.5	37.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-3).

Notes: Calendar year. Baseline is current law. Replace current law with the following provisions: 22 percent and 34.6 percent brackets with the 34.6 percent bracket starting at $100,000 for married filing jointly ($50,000 for everyone else), individual filing only, earned income credit with a phase-in rate of 20 percent up to a maximum of $2,000, $500 universal grant per person in the tax unit.

a. Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

b. After-tax income is cash income less individual income tax net of refundable credits, corporate income tax, payroll taxes (Social Security and Medicare), and estate tax.

c. Average federal income tax, net of refundable credits, as a percentage of average cash income.

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1	Designing Tax Cuts to Benefit Low-Income Families	Frank Sammartino	June 2001