

How does the federal tax system affect low-income households?

Most low-income households do not pay federal income taxes, typically because their incomes are lower than the combination of their allowed standard deduction and their personal and dependent exemptions, or because they receive substantial rebates via refundable tax credits. However, nearly all low-income workers are subject to the payroll tax.

WHAT FEDERAL TAX RATES DO LOW-INCOME HOUSEHOLDS PAY?

Low-income households typically pay some federal tax. The Tax Policy Center estimates that, on average in 2015, households in the lowest income quintile (the bottom fifth) will owe federal taxes equal to 3.6 percent of their incomes, much lower than the average 19.8 percent tax rate for all households.

But the income tax is not the reason these households owe federal taxes. In fact, TPC estimates that in 2015, households in the lowest income quintile have a *negative* average income tax rate thanks to refundable credits—namely the earned income tax credit (EITC) and the child tax credit (CTC). That is, the payments they receive from refundable credits exceed any income tax they owe.

In contrast, the average payroll tax rate for households in the lowest income quintile is 6.4 percent (very similar to the average rate of 6.9 percent for all households). The payroll tax is by far the most significant federal tax for households in the lowest income quintile, in terms of how much they pay.

Of course, low-income households pay federal excise taxes on their purchase of specific products, including cigarettes, alcohol, and gasoline. Low-income households also indirectly pay some corporate income tax, to the extent that corporations pass tax burdens back to workers' wages.

WHAT SHARE OF LOW-INCOME HOUSEHOLDS OWE FEDERAL INCOME OR PAYROLL TAX?

Only 11.3 percent of households in the bottom income quintile will pay federal income tax in 2015. In contrast, 59.3 percent of households in the lowest income quintile will owe payroll taxes. Combined, 60.3 percent of households in the lowest income quintile will owe federal income or payroll taxes.

In many cases, low-income households owe no income tax. That's because, in 2015, a married couple with two children can exempt \$28,600 from income using the standard deduction and personal and dependent exemptions. Generally, smaller amounts can be exempted from smaller households and larger amounts from larger households.

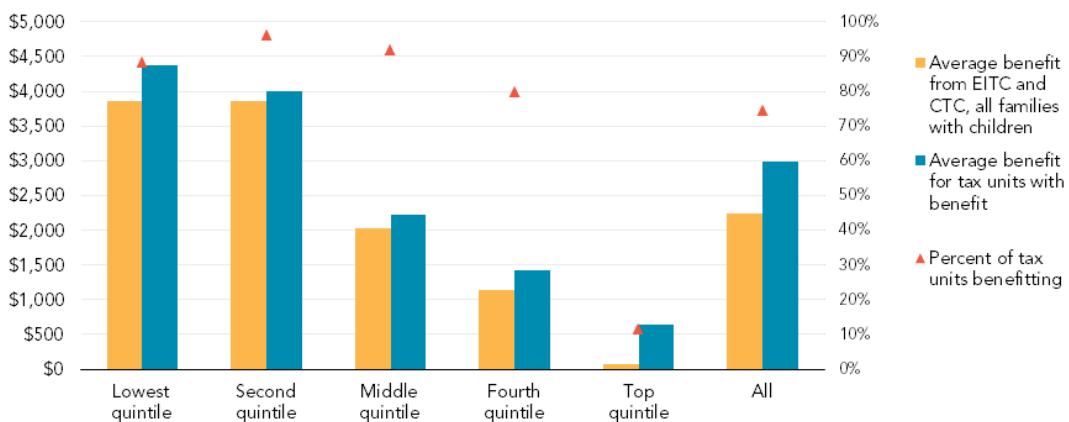
WHY DO LOW-INCOME HOUSEHOLDS FACE NEGATIVE AVERAGE FEDERAL INCOME TAX RATES?

The EITC is a refundable credit that subsidizes earnings, particularly for workers with children. The CTC is partially refundable, providing up to \$1,000 per child for workers with children. Together, these credits deliver substantial assistance to low-income families with children. (A relatively small EITC is also available to childless workers.) The net refunds created by these credits show up as negative average tax rates.

Together, the Tax Policy Center estimates that in 2015, the CTC and the EITC will provide tax-filing parents in the lowest income quintile an average refund of almost \$4,000. The credits will benefit 88.3 percent of these households (figure 1).

FIGURE 1

Average Benefits and Participation in the Earned Income Tax Credit and Child Tax Credit
2015



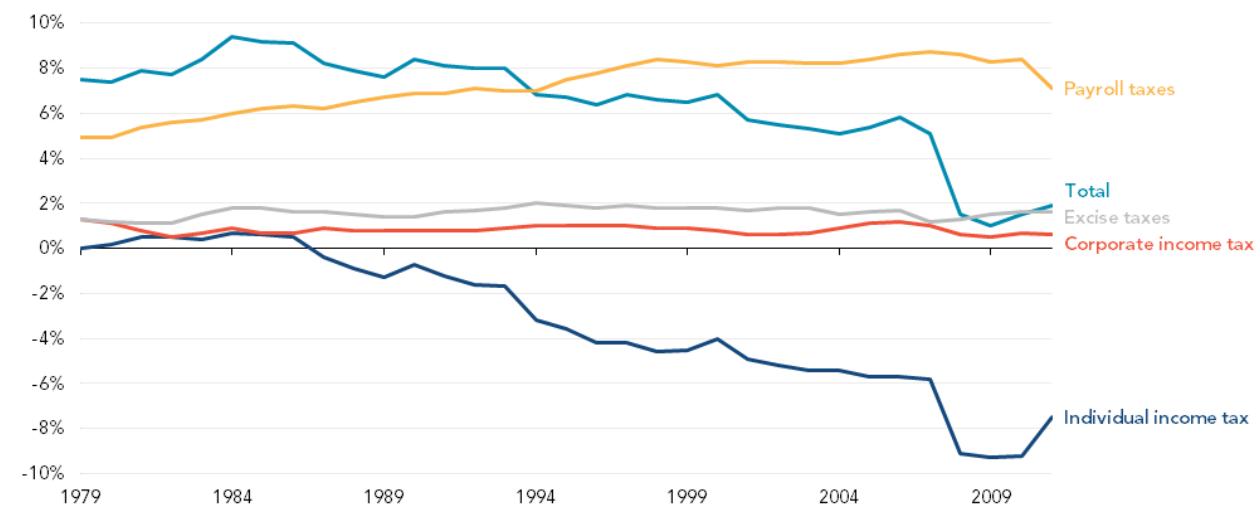
Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0515-1).

HOW HAVE EFFECTIVE TAX RATES FOR LOW-INCOME HOUSEHOLDS CHANGED OVER TIME?

Average tax rates for low-income households have changed markedly over the past quarter-century (see figure 2). Creation of the CTC and expansion of the EITC both lowered the effective individual income tax rate for these households from about 0.5 percent in the early 1980s to its negative value today. In contrast, the effective payroll tax rate for households in the lowest income quintile increased by more than half over

the same period (setting aside the temporary payroll tax reduction in 2011 and 2012). The effective corporate income tax rate borne by low-income households has also fallen since 1979, while the effective excise tax rate rose slightly.

FIGURE 2
Effective Federal Tax Rates for Households in the Lowest Income Quintile
1979–2011



Source: Congressional Budget Office, "The Distribution of Household Income and Federal Taxes 2011," November 2014.

DATA SOURCES

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MICROSIM MODEL

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