Statement of

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on

Labor Force Participation, Taxes, and the Nation's Social Welfare System

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C. Eugene Steuerle is the Richard B. Fisher chair and an Institute Fellow at the Urban Institute. He is indebted particularly to Adam Carasso, Linda Giannarelli, Elaine Maag, Caleb Quakenbush, Gillian Reynolds, and Katherine Toran for past and current work with him on both mobility and marginal tax rates. All opinions expressed herein are solely the author's and should not be attributed to any of these individuals or any organizations with which Steuerle is associated.

Mr. Chairman and members of the Subcommittee:

Thank you for the opportunity to testify before you on the relationship between labor force participation and our nation's tax and social welfare systems. Although there is some disagreement over how these systems affect work efforts, there is almost no disagreement that they are designed in piecemeal fashion, leading to various unfair, inefficient, and somewhat strange effects. Nor do most disagree that whatever the failures or successes of these structures in the past, they must be reformed to meet 21st century demands and economic conditions.

The Economic and Demographic Context

Even before the Great Recession, it was becoming clear that modern society must begin adjusting to a very different labor force dynamic than what prevailed in the last half of the 20th century. Historical sources of labor force growth have now ended as we face new challenges of high unemployment and declining labor force participation among younger workers, the long-term unemployed, and the disabled.

For many decades, our labor force expanded and grew more competitive with the entrance of baby boomers and women into the economy. These new entrants on average had attained higher levels of educational success than those who were leaving the workforce. But boomers are now retiring, and catch-up in the labor force participation of women has leveled off. The trend of retiring elderly workers being replaced by a more educated younger population has largely ended as well; for the first time in modern American history, young workers entering the workforce are not more highly educated than the older age groups they are replacing.

At the same time, the United States is no longer as economically dominant as it once was. Increasing competition from abroad has particularly cut into the incomes possible for those with limited education.

Meanwhile, there has been rising concern about extended joblessness among the young, the unemployed, and the disabled.

Evidence shows that shows that prolonged periods of labor force separation depress future earnings for such workers. Labor force participation among the young, particularly men, and especially young black men has trended downward over the past three decades. Only some of this can be attributed to increased full-time schooling. Even into their late twenties and thirties, many men remain separated from the labor force. Since the 1980s, labor force participation rates among men in this age range have fallen between 5 and 6 percentage points. Among black men, the decline is more than 8 percentage points.

The consequences of prolonged separation from the formal economy often extend beyond the period of unemployment. Work habits can dissipate and feelings of depression can set in. Long-term asset development has also been held in check for both the young and people of color.[1]

Now add to this labor force environment during the Great Recession. Employment rates plummeted and are recovering at an extraordinarily low rate. The effect extends from unemployment to underemployment, including workers moving to part-time work and dropping out of the labor force entirely.

These labor force pressures reinforce each other by reducing demand, including the demand that formerly came from population growth and the formation of more new households who then bought goods and services, including housing.

Social Welfare and Tax Systems Oriented toward Consumption

Many of the forces I just discussed operate independently of government programs. But they raise the broad question of how to reform a social welfare system largely constructed for a period very different from today.

These social welfare systems largely were oriented around providing minimum levels of consumption to people. On many fronts, particularly among the elderly, they successfully reduced poverty, although progress has slowed considerably in recent decades relative to the additional sums that have been spent. Efforts to expand consumption additionally tend to reduce work and saving.

Also, when in the midst of a recession or early in recovering from one, offering tax breaks to the broad middle class may provide both less (Keynesian) demand-side stimulus and less supply-side incentive than efforts focused on job subsidies aimed toward those with low to modest incomes.

One can disagree on the extent of past success, yet still agree that at the margin we ought to be shifting more dollars toward government programs aimed at opportunity—those that tend to favor education, work, and saving.

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[1] For instance, my Urban Institute colleagues and I have been examining the limited asset building among people of color and younger people. From 1983 to 2010, black and Hispanic average net worth stagnated at about 1/5 the average net worth of whites, working against traditional patterns of upward mobility among more disadvantaged groups. Meanwhile, despite an economy twice a rich as it was a quarter-century or so ago, young people today have no more net worth than their parents when they were young. By contrast, those of us in older age groups are on average about twice as wealthy as our parents.

Effective "Tax" Rates for Low- and Moderate-Income Households

Our social welfare systems affect work in two ways. First, the additional consumption or income provided is sufficient for some simply to reduce their labor supply.

In addition to the effect of this additional income or consumption support on work efforts, families can face prohibitively high penalties for additional work. Accepting a higher paying job could mean a steep cut in child care assistance for a single worker with children, for instance. For some, the rapid phaseout of benefits can offset or even more than offset additional take-home pay. Asset tests in means-tested programs create similar barriers to saving.

One way to look at the disincentives facing lower-income households is to consider the effective tax rates they face, both from the direct tax system and from phasing out benefits from social welfare programs.

Consider particularly households with children, as Congress has provided many benefit programs that phase out to such households. Right now our combined tax and spending systems encourage labor force participation until family income reaches the poverty level. After that, low- to moderate-income households often face marginal tax rates of about 50 or 60 percent if they participate in universally available programs like SNAP (formerly food stamps), the EITC, and (soon) the new exchange subsidies, while some households face rates of 80 percent or higher if they participate in programs with limited enrollment, like TANF or housing subsidies.

Figures 1 and 2 display the benefits available to a single mother with two children in 2011 under these two cases. The first case, what I call the "universal" case, shows the benefits available to anyone whose income was low enough to qualify for them, namely nutrition assistance and tax benefits. The second case adds to those benefits narrower assistance—TANF and housing subsidies and supplements to nutrition assistance—that is available to some households but not to others based on availability, time limits, and other criteria. Because health reform will soon alter the delivery of health benefits in an important way, in both cases I assume that the provisions of the Affordable Care Act are in effect.

Families are eligible for a large amount of assistance at very low annual incomes but then lose that assistance very quickly as they move into moderate income ranges. Figure 3 shows the effective marginal tax rate that derives from income, Social Security, and state taxes, combined with the phaseout of these benefits. As can be seen, tax rates begin to spike somewhere above $10,000 or $15,000.

These taxes derive largely from a liberal-conservative compromise that emphasizes means testing as a way of both increasing progressivity and saving on direct taxes needed to support various programs. Although low- and moderate-income households are especially affected, middle-income households face these expenditure taxes, too, through the phaseout of Pell grants and child credits, the gradual removal of "preferences" in the alternative minimum

tax and of the exemption of Social Security benefits from taxation, and the forthcoming exchange subsidies under ACA.

Recent work at the Urban Institute has examined this issue in greater detail.[2] Using the Institute's net income change calculator (NICC),[3] we looked at the effective marginal tax rates facing hypothetical families as they moved between levels of poverty. The tables included at the end of this testimony summarize our findings for each state for a joint return with two children participating in SNAP and TANF.

Despite changes to welfare since the end of the AFDC program in the 1990s, the problem of high effective marginal tax rates facing low-income workers looking to move out of poverty toward middle-class status—what I deemed "the twice poverty trap"—appears to have persisted in many states. While households receiving assistance often face negative marginal rates for moving into the labor force, income and payroll taxes and the phaseout of benefits imposes troublingly high rates on them if they move from poverty-level income to 150 or 200 percent of the poverty level.

Note that the effects shown here deal with permanent moves off programs. They exclude some of the effects from temporary support derived from unemployment compensation or delays in some welfare programs before benefits are clawed back.

A recent CBO study largely corroborates our findings.[4] It found that median marginal tax rates were steady in the 30 percent range on incomes between 50 and 350 percent of the poverty level, but many families, particularly at lower income levels, could face rates much higher. Households with earnings less than 150 percent of the poverty level experienced the most variability in the rate they faced, as did single-headed households with children.

Marriage penalties

One thing we have learned in public finance is that taxes have significant effects on portfolio behavior, even if there is less certain effect on work and saving. Not getting married is the major tax shelter for low- and moderate-income households with children. In many low-income communities around the nation, marriage is now the exception rather than the rule.

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[2] Elaine Maag, C. Eugene Steuerle, Ritadhi Chakravarti, and Caleb Quakenbush, "How Marginal Tax Rates Affect Families at Various Levels of Poverty," http://www.taxpolicycenter.org/UploadedPDF/412722-How-marginal-Tax-Rates-Affect-Families.pdf.

[3] Available at http://nicc.urban.org/. Initial development of NICC was funded by the Annie E. Casey Foundation as part of the Low Income Working Families project. Funding for the update of the 2008 rules was provided, in part, by HHS/ASPE. Additional funding came from the John D. and Catherine T. MacArthur Foundation. NICC's development built on an earlier tool, the Marriage Calculator, developed at the Urban Institute under contract with HHS/ACF. NICC's calculations are performed by an adapted version of the TRIM3 microsimulation model. The standard version of TRIM3 is funded and copyrighted by HHS/ASPE and developed and maintained by the Urban Institute.

[4] "Effective Marginal Tax Rates for Low- and Moderate-Income Workers," http://www.cbo.gov/publication/43709.

Marriage penalties or subsidies are assessed primarily for taking wedding vows, not for living together with another adult.[5] Those who do not feel morally compelled to swear fidelity in religious or public ceremonies for the most part do not suffer the penalties. Our tax and welfare system thus favors those who consider marriage an option—to be avoided when there are penalties and engaged when there are bonuses. The losers tend to be those who consider marriage vows sacred.

At another extreme in this story is another group: young, uneducated, childless men or noncustodial fathers, who have seen their wages in unskilled labor decline in real terms over time.[6] Because many benefits are targeted toward households with children, these men also find themselves shut out from most forms of assistance. The system also makes young men's economic contributions a liability to their parents, relatives, potential spouses, and children in terms of the government benefits that would be lost, essentially reinforcing their noncustodial status. For example, a working young man who marries a working single mother could cause here to lose child care assistance and part of her EITC.

These effects of marginal tax rates extend well beyond the marriage patterns of low-income families. Divorced couples allocate child support to maximize future college aid. Some couples avoid remarriage to avoid losing Social Security or pension benefits. As noted, the disabled sometimes avoid work to keep Medicaid, while some unemployed delay going back to work.

Our Discombobulated System and Options for Reform

The high rates and marriage penalties arising in these systems occur in part because of the piecemeal fashion in which they are considered. Congress has designed so many direct and indirect taxes and phaseouts that it can have little idea of how it is affecting the true returns to work for large portions of the population.

Implicit taxes are everywhere, whether in TANF or SNAP (formerly food stamps), Medicaid or the new exchange subsidy, PEPS (the personal exemption phaseout) or PEASE (the limitation on itemized deductions), Pell grants or student loans, American Opportunity Credits or Lifetime Learning Tax Credits, housing vouchers or low-income housing tax credits, child tax credits or earned income tax credits, Medicare Part B or Medicare Part D, Social Security exemption from taxation or Supplemental Security Income, school lunches or Child Care and Development Fund, Head Start or Early Start, Special Supplemental Nutrition Program for Women, Infants, and Children (WIC) or child and dependent care tax credits (CDCTC), retirement savings contributions credits (saver's credits) or premium assistance credits

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[5] See Adam Carasso and C. Eugene Steuerle, "The Hefty Penalty on Marriage Facing Many Households with Children," http://www.urban.org/UploadedPDF/1000844_marriage_penalty.pdf.

[6] Adam Carasso, Harry J. Holzer, Elaine Maag, and C. Eugene Steuerle, "The Next Stage for Social Policy: Encouraging Work and Family Formation among Men," http://www.urban.org/UploadedPDF/411774_encouragingwork.pdf.

(beginning in 2014), unemployment compensation or workers compensation. These implicit taxes combine with explicit taxes to create inefficient and often inequitable, certainly strange and anomalous, incentives for many households.

Efforts to design benefit packages more comprehensively could greatly improve both the incentives faced by families and the quality and choice of benefits they receive.

One option is to integrate the many separate programs for which families are eligible into a single bundle within which recipients would have the flexibility to allocate resources to meet their specific needs.[7] For instance, a worker could opt to spend less of his or her voucher on food in favor of better housing or child care. Such a system could be designed so the selection of services and goods within the bundled set must be agreed to by those directly advising and guiding recipients.

Even without formal restructuring of many of these programs, innovative approaches can be tried. Catholic Charities, for instance, supports a National Opportunity and Community Renewal Act for a pilot project that is people focused and case managed, based on local community opportunities. In the suggested programs under this experiment, a person might qualify for help, but the exact nature would depend on agreement between the case manager and client, allowing them to tie together and reallocate resources for which the client is eligible. That reallocation would likely increase labor force participation, as it would be largely aimed at improving opportunity and addressing issues that cause the poverty in the first place.

Another partially integrated approach by policymakers would involve setting a maximum marginal tax rate across tax and transfer programs for families receiving assistance. Phasing out benefits at one rate instead of several can temper the disincentives to increasing earnings and allow workers to reallocate their remaining assistance in a way suited toward their needs.

Separating childrearing incentives from work incentives could help. The EITC provides wage subsidies to low-income workers raising children, but then leaves out other low-wage workers and usually creates high tax rates when two earners marry. Reform could separate out the subsidy for children from that for low-income workers. As I noted earlier, I think this would be especially appropriate during a recovery from a recession.

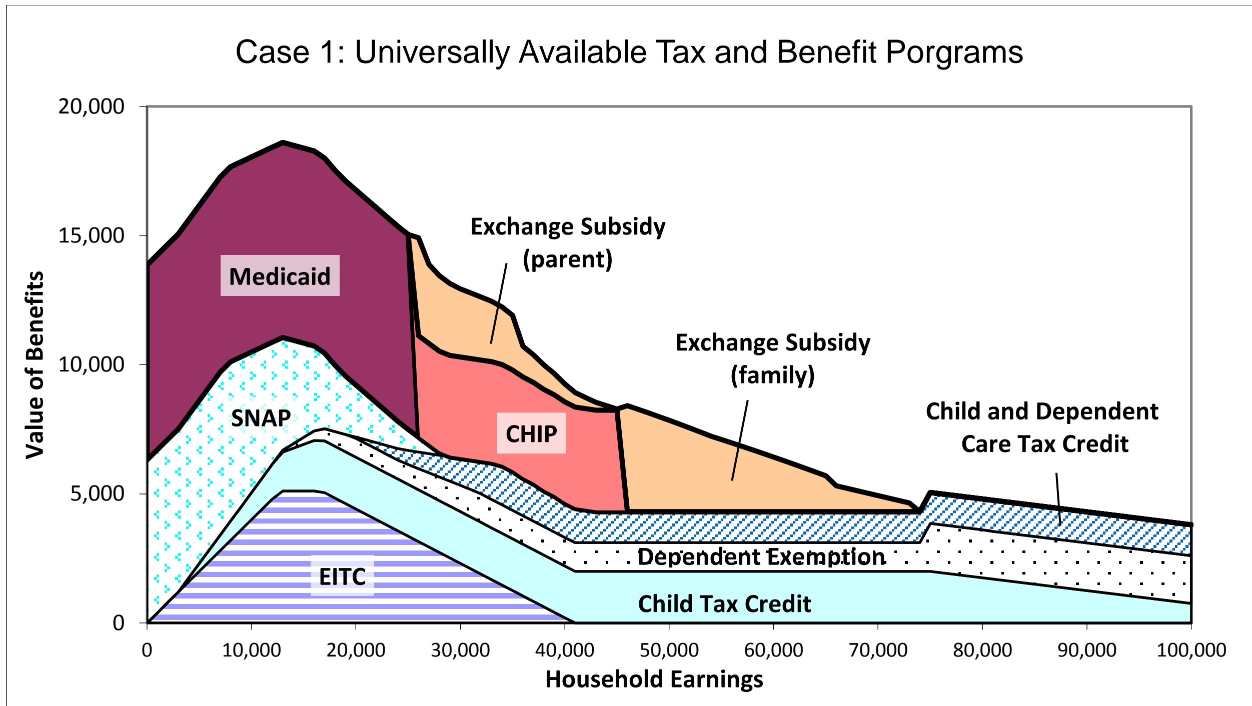
There will inevitably be trade-offs involved in any such reform. A reform that creates only "winners" is unlikely. The process of slower benefit phaseouts will require either more expensive programs explicitly financed by taxpayers or less generous assistance for someone else.

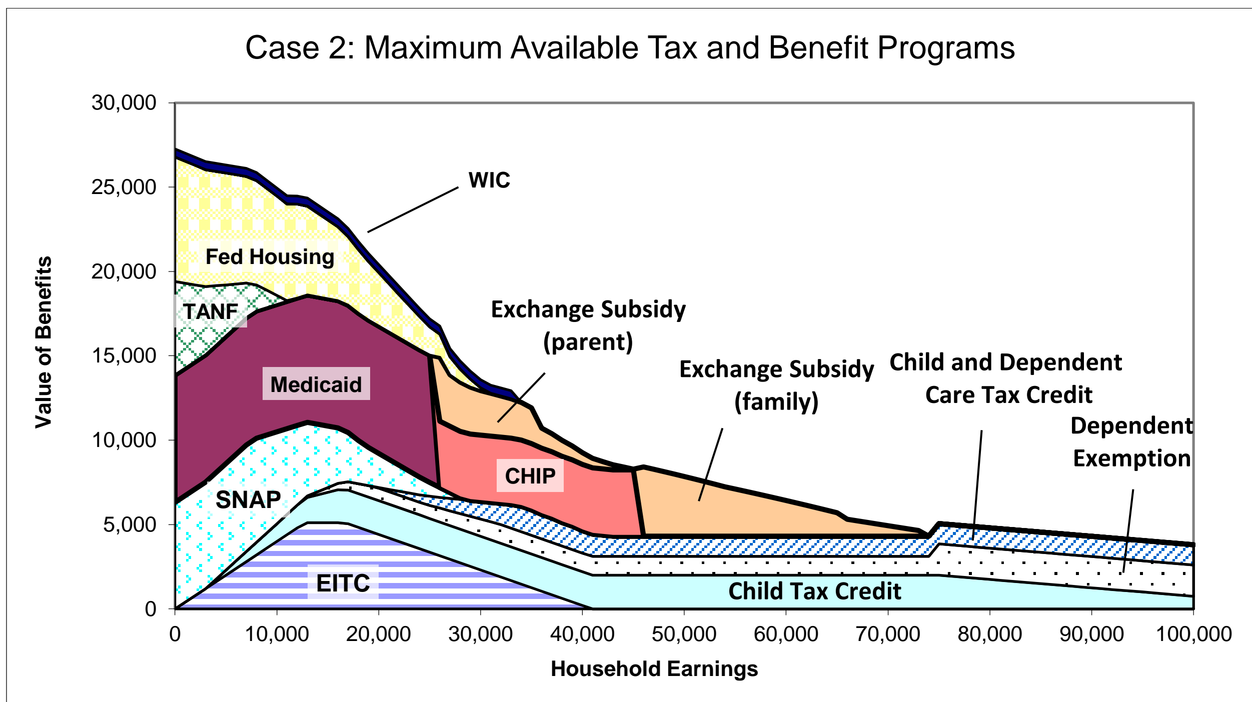
[7] See Robert Lerman and C. Eugene Steuerle, "Structured Choice versus Fragmented Choice: Bundling of Vouchers," from *Vouchers and the Provision of Public Services* (Washington, DC: Urban Institute Press, 2000).

Conclusion

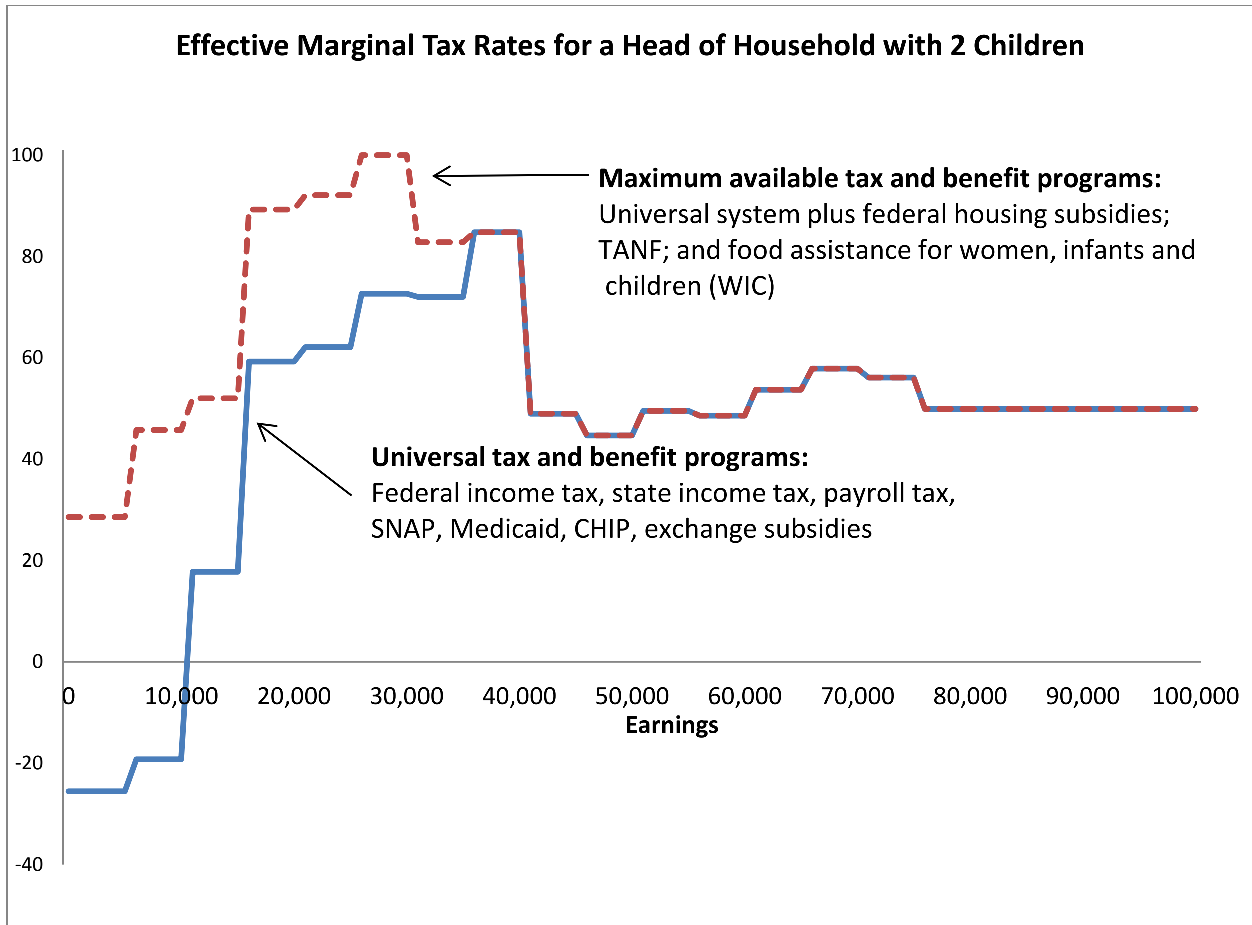
Our modern economy requires modern approaches to social welfare and taxation. Many compromises can cut across traditional liberal and conservative boundaries by maintaining a progressive agenda, yet emphasizing better the work, education, and saving requirements for today's economy.

At a minimum, we need to begin approaching our wide assortment of programs, benefit phaseouts, and tax rates in a more integrated fashion. It's hard to design programs well if we lack even basic understanding of all the ways they operate and combine.





Source: Caleb Quakenbush and C. Eugene Steuerle, 2012. Based on earlier work with Adam Carasso and Stephanie Rennane.
Notes: Heath benefits are calculated as if the Affordable Care Act had been fully implemented in 2011.



Source: Caleb Quakenbush and C. Eugene Steuerle, 2012. Based on earlier work with Adam Carasso and Stephanie Rennane.

Notes: Includes TANF, food stamps, federal and state income taxes, and the employee portion of payroll taxes. The effective marginal rate is the marginal tax rate faced in the formal tax system (federal, state, and payroll) in addition to the rates arising from the reduction in disposable income from the loss of transfer benefits. The tax rules used for federal and state income taxes are for calendar year 2011. The payroll tax rate does not include the temporary reduction of the employee portion of the tax. Health benefits calculated as if the Affordable Care Act had been fully implemented in 2011.

Table 1. Married with Two Children - Effect of Moving from Various Earnings Levels for People Receiving TANF and Food Stamps; Equal Earnings in 12 Months

	$0 Earnings to Half Poverty	Half-Poverty to Poverty	Poverty to 150 Percent of Poverty	150 Percent of Poverty to Twice Poverty	$0 to Poverty	$0 to Twice Poverty
Alabama	-78.8%	22.8%	51.2%	61.4%	-28.0%	6.5%
Alaska	-44.8%	49.9%	75.0%	55.8%	2.5%	29.3%
Arizona	-40.9%	18.5%	57.1%	63.7%	-11.2%	16.0%
Arkansas	-59.7%	19.2%	64.1%	59.9%	-20.3%	13.8%
California	-32.0%	53.6%	59.7%	66.4%	10.8%	27.5%
Colorado	-55.3%	34.5%	57.1%	61.8%	-10.4%	16.9%
Connecticut	-65.1%	69.2%	55.0%	62.9%	2.0%	22.7%
Delaware	-71.4%	42.0%	61.8%	56.6%	-14.7%	17.1%
District of Columbia	-66.1%	44.2%	68.4%	52.0%	-10.9%	21.7%
Florida	-46.9%	18.5%	54.1%	66.4%	-14.2%	13.1%
Georgia	-49.9%	20.6%	59.8%	60.4%	-14.7%	15.7%
Hawaii	-71.0%	55.9%	102.9%	59.5%	-7.6%	29.3%
Idaho	-52.9%	18.5%	56.0%	60.4%	-17.2%	13.5%
Illinois	-48.9%	34.6%	58.0%	62.3%	-7.2%	18.7%
Indiana	-58.9%	30.9%	58.7%	61.8%	-14.0%	15.4%
Iowa	-49.7%	38.1%	61.9%	58.2%	-5.8%	21.3%
Kansas	-52.7%	34.7%	62.7%	59.0%	-9.0%	19.6%
Kentucky	-53.8%	21.9%	68.3%	60.6%	-15.9%	16.9%
Louisiana	-78.8%	42.0%	58.2%	61.7%	-18.4%	13.0%
Maine	-48.8%	47.7%	55.3%	60.4%	-0.6%	22.0%
Maryland	-32.4%	31.7%	62.8%	55.7%	-0.3%	25.0%
Massachusetts	-38.9%	44.4%	62.1%	57.8%	2.7%	25.9%
Michigan	-27.6%	23.4%	60.3%	59.9%	-2.1%	22.5%
Minnesota	-47.2%	31.7%	64.3%	50.9%	-7.7%	22.7%
Mississippi	-65.5%	19.1%	57.9%	61.3%	-23.2%	10.5%
Missouri	-59.2%	29.3%	59.3%	60.4%	-14.9%	15.4%
Montana	-24.4%	20.4%	58.6%	60.6%	-2.0%	22.0%
Nebraska	-47.7%	23.5%	58.4%	60.7%	-12.1%	16.6%
Nevada	-72.1%	18.6%	36.8%	66.4%	-26.7%	2.6%
New Hampshire	-29.2%	36.4%	54.1%	66.4%	3.6%	22.5%
New Jersey	-79.7%	21.2%	41.6%	60.0%	-29.3%	4.0%
New Mexico	-45.7%	34.7%	57.7%	61.3%	-5.5%	19.8%
New York	-40.5%	46.7%	64.8%	55.4%	3.1%	27.4%
North Carolina	-55.5%	19.8%	60.7%	59.2%	-17.8%	14.5%
North Dakota	-86.9%	18.5%	55.5%	64.3%	-34.2%	3.5%
Ohio	-44.8%	33.6%	57.5%	62.7%	-5.6%	19.3%
Oklahoma	-47.7%	19.7%	60.2%	59.8%	-14.0%	16.2%

Table 1. Married with Two Children - Effect of Moving from Various Earnings Levels for People Receiving TANF and Food Stamps; Equal Earnings in 12 Months

	$0 Earnings to Half Poverty	Half-Poverty to Poverty	Poverty to 150 Percent of Poverty	150 Percent of Poverty to Twice Poverty	$0 to Poverty	$0 to Twice Poverty
Oregon	-25.6%	23.5%	64.3%	56.1%	-1.1%	24.9%
Pennsylvania	-32.2%	18.5%	54.1%	54.2%	-6.9%	20.0%
Rhode Island	-38.9%	38.9%	55.3%	59.5%	0.0%	22.6%
South Carolina	-76.4%	42.9%	54.1%	64.9%	-16.7%	12.2%
South Dakota	-21.5%	18.5%	54.1%	66.4%	-1.5%	19.8%
Tennessee	-79.4%	35.9%	54.1%	66.4%	-21.7%	9.2%
Texas	-70.9%	35.6%	54.1%	66.4%	-17.7%	11.3%
Utah	-42.0%	34.7%	57.9%	60.0%	-3.7%	21.1%
Vermont	-33.8%	35.8%	63.3%	56.2%	1.0%	25.7%
Virginia	-72.0%	53.3%	59.7%	56.3%	-9.4%	19.4%
Washington	-30.0%	34.4%	54.1%	66.4%	2.2%	21.7%
West Virginia	-44.7%	19.7%	61.5%	62.0%	-12.5%	16.8%
Wisconsin	-23.3%	20.4%	62.7%	56.0%	-1.5%	24.3%
Wyoming	-49.5%	18.5%	54.1%	66.4%	-15.5%	12.4%
Simple Average	-51.2%	31.8%	59.2%	60.6%	-9.7%	18.1%
High	-21.5%	69.2%	102.9%	66.4%	10.8%	29.3%
Low	-86.9%	18.5%	36.8%	50.9%	-34.2%	2.6%

Source: Elaine Maag, C. Eugene Steuerle, Ritadhi Chakravarti, and Caleb Quakenbush, 2012, "How Marginal Tax Rates Affect Families at Various Levels of Poverty," *National Tax Journal* 65(4): 759–82.

Notes: Includes TANF, food stamps, federal and state income taxes, and the employee portion of payroll taxes. Calculations performed using the Urban Institute's net income calculator.