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Giving Secondary Earners a Tax Break: A Proposal to Help Low- and Middle-Income Families

DECEMBER 2013

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Giving Secondary Earners a Tax Break: A Proposal to Help Low- and Middle-Income Families

Declining real wages for individuals with limited skills and education means that the economic security of low- and middle-income families has eroded in recent decades. Roughly two-thirds of married families with children rely on the income from two workers to make ends meet. Adding to the challenges facing these families is a federal income tax code that treats families as a combined unit and ultimately penalizes a second earner in a household by taxing that worker's income at a higher rate than the tax rate the first earner pays. As a result, adding a second worker to the labor market does not substantially increase the disposable income for, or improve the economic well-being of, many low-income families.

For families headed by a married couple, spousal income under current tax law is pooled. This means that the first dollar earned by a spouse—or secondary earner—is taxed at the same rate as the last dollar earned by the primary earner. Given the progressive design of the federal income tax code, additional income is taxed at increasingly higher rates. Furthermore, benefits from transfer programs and tax credits are phased out as household income increases. This leads to a higher effective tax rate imposed on the earnings of a second worker within a couple, as compared to the primary worker or an unmarried worker. These factors mean that working-class families near the poverty line face some of the highest tax rates on additional income in the country.

In a new Hamilton Project discussion paper, Melissa Kearney and Lesley Turner of the University of Maryland propose a secondary-earner tax deduction that would allow low- and middle-income couples to take home a greater portion of a second worker's earnings. This policy would mitigate the secondary-earner penalty and increase the economic security of low- and middle-income families.

The Challenge

Over a quarter of married families with dependents have incomes placing them below 200 percent of the federal poverty level (FPL). As these families attempt to work their way into the middle class, they face high tax rates on additional earnings. This high rate is caused by the phase-out of means-tested benefits—benefits that are available only to families below a specified income limit such as Medicaid or food assistance—and the phase-out of the Earned Income Tax Credit (EITC). The EITC is a tax credit for low-income couples and individuals, primarily those who have children; when the EITC exceeds the amount of taxes owed, this difference results in a tax refund. Furthermore, when both spouses choose to work, households devote a large share of their disposable income to work-related expenses such as transportation and child care.

Some definitions here are helpful to understand how the progressive income tax code acts as a disincentive to work for struggling low-income families. "Marginal tax rates" refer to the tax rates that apply to additional earnings. For example, if a worker pays an additional $200 in taxes on $1,000 in extra earnings, the marginal tax rate is 20 percent. "Effective marginal tax rates" are based on taxes paid and benefits lost; they are driven by actual tax rates applied to incremental increases in income as well as the phase-out in benefits associated with additional amounts of income. For example, if a taxpayer earns an additional $1,000 and so owes an additional $200 in taxes and loses $400 in transfer benefits, the effective marginal tax rate on her earnings is 60 percent.

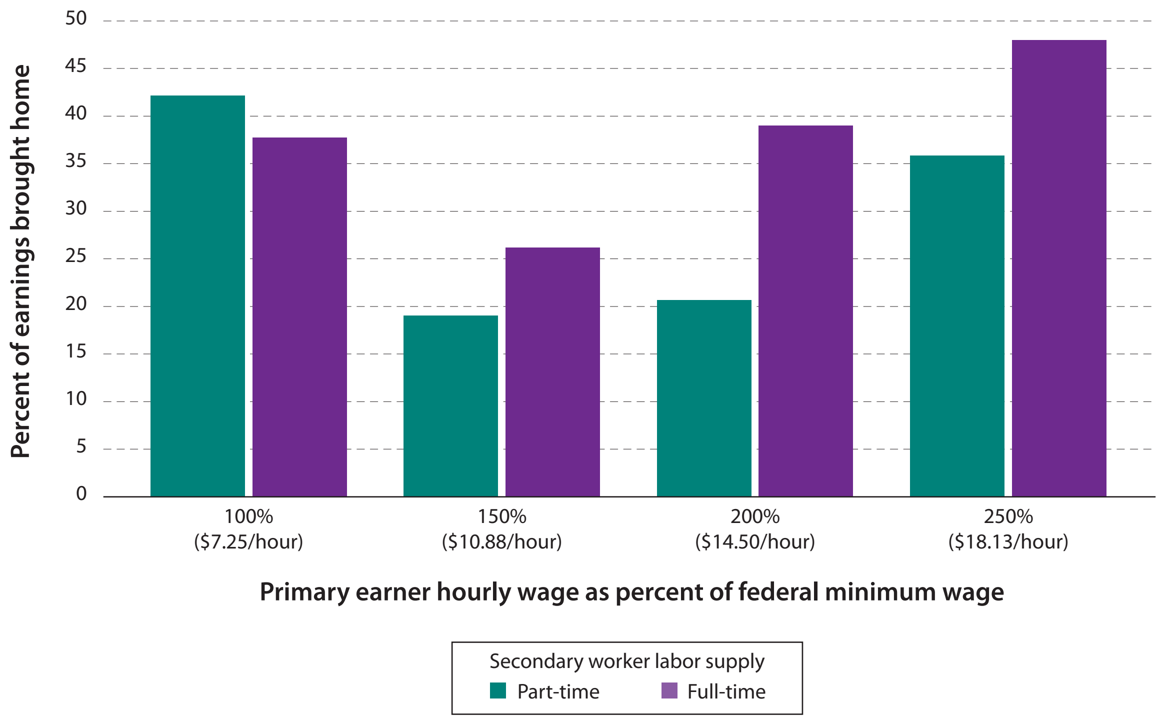
In the United States the combination of family-based income taxation, and a progressive tax code in which the tax rate rises as incomes increase, means that secondary earners effectively face higher marginal and average tax rates relative to both married primary earners and single workers. (Average tax rates are simply the total taxes paid as a share of income.) This occurs because the family-based tax code pools the earnings of married spouses. As a result, secondary earners are taxed at relatively higher rates and have less of an incentive to work compared to primary earners.

To illustrate how the current tax system penalizes secondary earners, consider a simple example of applying federal income tax rates to a couple's joint income, setting aside the issue of the EITC for this example. In 2013 married couples faced a tax rate of 10 percent on the first $17,850 of their taxable income—which is typically defined as the income that exceeds the sum of the $12,200 standard deduction and the $3,900 per person exemption—and a tax rate of 15 percent on the next $54,650 of taxable income. Consider the childless spouse of an individual who generates $25,000 in taxable income in a given year: the first dollar earned by that spouse would be taxed at 10 percent, as compared to zero percent for the primary earner within the family, or as compared to an unmarried individual.

In addition to this higher effective marginal tax rate faced by secondary earners, Kearney and Turner highlight three main factors that reduce the returns to secondary earners' work efforts: (1) the particular structure of the EITC, (2) the phase-out of means-tested benefits, and (3) work-related expenses, in particular child-care costs.

FIGURE 1.

Low- and Middle-Income Families See Little Benefit from Adding a Second Earner



Source: Authors' calculations using TAXSIM (available at http://www.nber.org/taxsim/).

The EITC is currently the largest cash benefit program for lower-income families with children. The program is characterized by its plateau design that features a subsidy phase-in range, a maximum credit range, and a phase-out range. The phase-in range is the income over which taxpayers receive additional benefits for earning higher income. For a family with two children, the maximum credit of $5,372 is awarded when family income reaches $13,430; a family is eligible for that maximum tax credit until earned income reaches $17,530 for a single filer and $22,870 for married filers. In this range, taxpayers do not gain additional EITC benefits for higher earnings and receive only the maximum credit. At higher levels of earnings, the amount of EITC that taxpayers can claim begins to decline. This is called the phase-out range. In this range, the credit is reduced at a rate of 21.06 percent for each extra dollar earned. This phase-out rate ends at $43,038 for single filers and $48,378 for married filers; filers receive no EITC benefit if their earnings exceed these thresholds. Crucially, the EITC is refundable, which means that if the family qualifies for a credit that exceeds the amount owed in federal income taxes, the Internal Revenue Service (IRS) refunds that balance to the family.

These features of the federal tax code are only one part of what makes the climb to the middle class so difficult for families. The secondary-earner penalty is exacerbated by family-income-based phase-outs of federal transfer programs. Additional income brought into a family by a secondary earner can place a family on the phase-out range of a number of other transfer programs, including SNAP (Supplemental Nutrition Assistance Program, or food stamps) and Medicaid benefits. According to the Congressional Budget Office, on average, working taxpayers with income below 450 percent of the FPL, face a marginal tax rate of 30 percent; this estimate takes into account federal and state individual income taxes, federal payroll taxes, and the reductions in food assistance benefits that occur when earnings increase.

Even as families lose eligibility for means-tested benefits after adding a secondary worker, their work-related expenses increase. One of the most important work-related costs faced by married-couple families with dependents is child care. According to the U.S. Census Bureau, in 2010 married families with a working mother spent on average 7 percent of monthly income and 17 percent of the mother's income on child care. In families with at least one child under five years of age, child-care expenditures equaled 9 percent of monthly household income and 22 percent of the mother's income. In addition to child-care costs, families headed by a two-earner married couple spent 30 percent more on transportation than did families with only one earner.

Figure 1 displays the share of the secondary-earner income that a family takes home after accounting for payroll and federal income taxes, SNAP benefits, and the cost of child care. Each set of bars represents a family of four headed by a full-time worker that earns between 100 and 250 percent of the federal minimum wage (i.e., $15,080 to $37,700 annually). The green and purple bars represent the share of earnings brought home by an added part-time and full-time secondary worker, respectively, with the same hourly wage. In all eight scenarios represented in figure 1, a family ultimately keeps less than half of the earnings generated by the secondary worker.

A New Approach

Kearney and Turner's baseline proposal is a secondary-earner deduction for married couples with dependent children to increase the return to work and raise working families' disposable income. Specifically, they propose a secondary-earner deduction that allows families to deduct up to 20 percent of the first $60,000 earned by a second worker, with a phase-out starting at a family income of $110,000. In addition, they put forth a revenue-neutral option that incorporates the secondary-earner deduction but scales back other tax deductions to offset the lost revenue.

Table 1 walks us through the example of a hypothetical family with a primary worker who earns $25,000 and a secondary worker with the same earnings. Column 3 shows the tax change due to the baseline proposal while column 4 shows the effects

Roadmap

- Congress will enact a law implementing the secondary-earner tax deduction in the tax code. The IRS will subsequently make slight modifications to existing tax forms and associated instructions.
- Married taxpayers will be required to report earnings by spouse when filing taxes. In the Tax and Credits section of the 1040, the size of any secondary-earner deduction will be calculated along with other tax deductions and credits. The deduction will equal 20 percent of earnings—up to $60,000—by secondary earners. Tax forms and instructions will account for the phase-out of the credit on joint income over $110,000.
- The IRS will alter W-4 withholding forms to adjust the amount of income tax withheld by employers from employee paychecks. Employers will receive updated instructions on how to adjust their withholding formulas.

TABLE 1.

Taxes and Take-Home Income by Secondary-Earner Employment

	(1) Spouse does not work	(2) Spouse works full-time	(3) Baseline proposal	(4) Revenue-neutral option
Primary worker earns $25,000				
Total earnings	$25,000	$50,000	$50,000	$50,000
Payroll taxes	-$3,825	-$7,650	-$7,650	-$7,650
Federal income tax	$0	-$2,438	-$1,720	-$1,980
CTC	$2,000	$2,000	$2,000	$2,000
EITC	$4,923	$0	$711	$711
Child-care costs	$0	-$5,000	-$5,000	-$5,000
CDCTC	$0	$1,000	$1,000	$1,000
SNAP benefits	$2,592	$0	$0	$0
Total disposable income	$30,690	$37,912	$39,341	$39,081
Disposable income as a percent of FPL	130%	161%	167%	166%
Percent of earnings family takes home	—	29%	35%	34%
Increase in disposable income	—	—	$1,429	$1,169
Percent	—	—	4%	3%

Sources: Data in columns 1 and 2 come from authors' calculations using TAXSIM (available at http://www.nber.org/taxsim/). Data in columns 3 and 4 come from authors' calculations using a special modification of TAXSIM. SNAP benefits based on eligibility guidelines available at U.S. Department of Agriculture (USDA), "Supplemental Nutrition Assistance Program" (n.d.), http://www.fns.usda.gov/snap/applicant_recipients/eligibility.htm.

Notes: The gray font applies to cells with values that do not change under the proposal. The black font applies to cells with values that change. CTC refers to the Child Tax Credit. EITC refers to the Earned Income Tax Credit. CDCTC refers to the Child and Dependent Care Tax Credit. SNAP refers to the Supplemental Nutrition Assistance Program. FPL refers to the federal poverty level, equal to $23,550 for a family of four in 2012. Illustrative family has two dependent children and a secondary earner with the same hourly wage as the primary earner. Federal income tax category excludes EITC, CTC, and CDCTC. The CTC category includes Additional Child Tax Credit. Total disposable income is equal to the sum of earned income, tax credits, and SNAP benefits less federal income and payroll taxes. Percent of earnings kept by a secondary earner is equal to the change in total disposable income divided by the change in total earnings. The baseline proposal is a secondary-earner deduction equal to 20 percent of the first $60,000 in secondary earnings. The revenue-neutral option is a secondary-earner deduction equal to 20 percent of the first $60,000 in secondary earners plus a 75 percent reduction in the spousal exemption.

Learn More about This Proposal

This policy brief is based on The Hamilton Project discussion paper, "Giving Secondary Earners a Tax Break: A Proposal to Help Low- and Middle-Income Families," which was authored by:

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of the revenue-neutral option. Under the baseline proposal, this family's federal income tax bill falls by $718 ($1,720 versus $2,438), and their EITC increases from $0 to $711—an increase of $1,429 (4 percent) in disposable income. The baseline proposal increases the take-home rate of the secondary earner's wages from 29 to 35 percent—still low, but a sizable improvement, nonetheless. This hypothetical family sees a slightly smaller benefit from the revenue-neutral option, experiencing a 3 percent increase in disposable income, primarily due to the smaller decrease in the family's federal income tax bill.

Kearney and Turner's analysis includes the impact on family income and the national budget. Their baseline simulations assume that some secondary workers will respond to the increased return to their work efforts by increasing the amount of hours they work. Extra taxes paid on additional hours of work help to offset some of the cost of the proposal. On net, they estimate that the baseline proposal would lead to an annual $8.2 billion reduction in federal tax revenue, but would increase family resources by $13.4 billion. The authors assert, therefore, that the proposal is cost effective, with each $1.00 of revenue loss leading to a $1.60 increase in the resources available to married-couple families with annual incomes of less than $130,000.

Under the baseline proposal, two-earner households with dependents in the lowest income bracket (i.e., with annual income below $25,000) experience a $92 (0.4 percent) increase in disposable income. Families with income between $25,000 and $50,000 see their disposable income rise by $556 (2.2 percent), while families with income between $50,000 and $75,000 see a $591 (1.2 percent) increase in resources. Higher-income families—those with earnings above $75,000 per year—see their disposable income rise as well, although families with income above $200,000 per year do not benefit from the secondary-earner deduction due to the phase-out.

Conclusion

In their Hamilton Project discussion paper, Kearney and Turner propose a secondary-earner tax deduction with the goal of allowing struggling lower-middle-class families to keep more of their earnings. Implementation of the secondary-earner deduction would move the U.S. federal income tax system toward a more equitable treatment of two-earner married couples relative to single-earner married couples. The reform would also help to mitigate the impact of declining real wages for families with limited education and training.

The proposal would also lead to more equitable treatment of a family with two earners as compared to a family with the same total income brought in by one higher-earning spouse. Couples with two earners have fewer resources available to them as compared to a couple with the same total income and one nonworking spouse, since the nonworking spouse has more time to devote to household chores and child care. The authors suggest that the current tax system fails to acknowledge this additional burden faced by families with two working parents.

Furthermore, the existing system's secondary-earner penalty serves as a disincentive to work. The proposed policy will not only allow two-earner couples to keep more of their income, but it will also provide incentives for nonworking spouses to enter the workforce and for working spouses to work more hours.

Kearney and Turner argue that the secondary-earner deduction is hardheaded and compassionate at the same time. It allows low-income working families to keep more of their earnings and therefore experience greater economic security. Just as the EITC has won popular support because it "makes work pay" for single earners, a targeted secondary-earner tax deduction will help make work pay for secondary earners. It helps low- to moderate-income families help themselves.

Questions and Concerns

1. What would be the revenue implications of implementing the secondary-earner deduction universally?

The authors believe that a compelling economic case could be made for extending the secondary-earner deduction to earners at all levels of family income, thereby removing the disincentive to work faced by many highly educated wives of high-income husbands. The productivity gains would be greatest under such an implementation. Kearney and Turner have simulated the revenue costs and economic benefits of a universal secondary-earner deduction, thus allowing any family with dependent children to deduct 20 percent of a secondary worker's earnings up to $60,000.

The overall revenue cost of this proposal is $10.2 billion. The benefits that families receive total $41.5 billion. That implies that if the secondary-earner deduction were extended to all married families with dependents, these families would see their disposable resources rise by $4.10 for every $1.00 of federal tax revenue lost. By the authors' calculations, the universal implementation of the secondary-earner deduction is more cost effective than the baseline proposal described in the main body of the paper. But with the universal policy, not surprisingly, a reduced percentage of the benefits accrue to families with income below $100,000.

2. Why not propose individual taxation?

On both fairness and economic grounds, the authors would favor treating two earners within a family unit as separate earners, essentially undoing the marriage and secondary-earner penalties imposed by the system of family taxation. Moving to individual-based taxation, however, would constitute a radical change in current tax law and is likely not implementable in the near future. The authors have thus not proposed this option in their paper. For a review of the history surrounding the shift from a system of individual- to family-based taxation, and the motivating concerns about shifting of assets to the spouse with the lower tax rate, the authors refer the reader to McCaffery.

3. Could the proposal be modified to help families with close to zero earnings?

Two-earner couples who lack a positive tax liability and have earnings placing them in the phase-in or plateau of the Earned Income Tax Credit when both spouses work do not benefit from the authors' proposal. A modified proposal that would target these families would be to make the Child and Dependent Care Tax Credit fully refundable. This would allow families who owe no taxes to benefit from this existing feature of the tax code. The Tax Policy Center estimates that, in 2006, making the Child and Dependent Care Tax Credit fully refundable would have increased the annual cost of the credit by more than 50 percent, from $3.3 billion to $5.0 billion.

4. What about the Affordable Care Act subsidy provisions?

One policy issue going forward will be how the Affordable Care Act plays into the issue of a secondary-earner penalty, since eligibility for health insurance subsidies will phase out, making the marginal tax rate on secondary earners even higher. The Congressional Budget Office estimates that, under provisions of the Affordable Care Act law that are scheduled to go into effect in 2014, 11 percent of taxpayers with low- to moderate-incomes will receive premium assistance credits and will therefore see an increase in marginal tax rates by an average of 12 percentage points.

Highlights

Melissa Kearney and Lesley Turner of the University of Maryland propose a secondary-earner deduction as a reform to the tax code. The proposal would let the secondary earners of a family keep more of the money it earns and increase the family's take-home pay. This measure would incentivize secondary earners to work, and would lower marginal tax rates for America's low- and middle-income families.

The Proposal

A secondary-earner deduction for married couples with dependent children. In order to increase the return to work and to raise working families' disposable incomes, the authors propose a secondary-earner deduction for married couples with children. Tax reform will allow a married couple's secondary earner to deduct 20 percent of earnings up to $60,000, with eligibility for this deduction phasing out beginning at $110,000 of family income. The proposed deduction targets low- to moderate-income families with two earners who are now subject to some of the highest effective marginal tax rates in the country.

A (nearly) revenue-neutral option for the secondary-earner deduction. The authors also propose a revenue-neutral option that incorporates the secondary-earner deduction but offsets its cost by scaling back other tax deductions.

The cost-effectiveness of the proposal. The authors' baseline secondary-earner deduction proposal would put $1.60 into the hands of American families with annual incomes of $130,000 or less for every $1.00 in lost federal revenues. The secondary-earner deduction can be easily implemented within the existing tax code; the changes are transparent and do not substantially add to the complexity of the system.

Benefits

The secondary-earner deduction will ease the tax burden on low- and middle-income families with two earners. In particular, alleviating the penalty imposed on secondary earners' income will increase incentives for secondary earners to work. Ultimately, this proposal allows working families to keep more of their earnings and enjoy greater economic security.

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