THE HAMILTON PROJECT

DISCUSSION PAPER 2013-07 | DECEMBER 2013

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

Melissa S. Kearney and Lesley J. Turner

MISSION STATEMENT

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth.

We believe that today's increasingly competitive global economy demands public policy ideas commensurate with the challenges of the 21st Century. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by fostering economic growth and broad participation in that growth, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments.

Our strategy calls for combining public investment, a secure social safety net, and fiscal discipline. In that framework, the Project puts forward innovative proposals from leading economic thinkers — based on credible evidence and experience, not ideology or doctrine — to introduce new and effective policy options into the national debate.

The Project is named after Alexander Hamilton, the nation's first Treasury Secretary, who laid the foundation for the modern American economy. Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces. The guiding principles of the Project remain consistent with these views.

THE HAMILTON PROJECT

THE HAMILTON PROJECT

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

Melissa S. Kearney
University of Maryland and National Bureau of Economic Research

Lesley J. Turner
University of Maryland

DECEMBER 2013

NOTE: This discussion paper is a proposal from the authors. As emphasized in The Hamilton Project's original strategy paper, the Project was designed in part to provide a forum for leading thinkers across the nation to put forward innovative and potentially important economic policy ideas that share the Project's broad goals of promoting economic growth, broad-based participation in growth, and economic security. The authors are invited to express their own ideas in discussion papers, whether or not the Project's staff or advisory council agrees with the specific proposals. This discussion paper is offered in that spirit.

BROOKINGS

Abstract

The current structure of the tax and transfer system in the United States makes it particularly challenging for low-income married couples with children to work their way into the middle class. Specifically, the tax and transfer system has an inherent secondary-earner penalty that discourages work efforts and reduces the return to work for a second earner within a married couple. When children are present, a spouse's work efforts often brings associated child-care costs, making the return to work even lower. Our estimates suggest that under the current federal tax and transfer system, and assuming standard child-care costs, a family headed by a primary earner making $25,000 a year will take home less than 30 percent of a spouse's earnings. We propose a secondary-earner deduction for low- to moderate-income families. This incremental modification to the tax code would increase disposable income for affected families.

Table of Contents

Chapter 1: Introduction

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. Many of these families rely on the income from two earners. In roughly two-thirds of married families with dependent children, both parents work. The United States' federal income tax system taxes families as a combined unit. Together with a progressive tax code, family-based taxation penalizes a second earner in a household: the tax rate the second earner in a household pays is higher than the tax rate the first earner pays. As a result, adding a second earner to the labor market does not substantially increase economic resources for many low-income families.

Current tax law pools spousal income for families headed by a married couple. This means that the first dollar earned by a spouse—i.e., the secondary earner—is taxed at the same level as is the last dollar earned by the primary earner. Given the progressive nature of the federal income tax code, additional income is taxed at increasingly higher rates. Furthermore, benefits from transfer programs and tax credits are eliminated, or phased out, as household income increases. This leads to a higher effective tax imposed on the earnings of a second earner within a couple, compared to the earnings of a primary or unmarried earner.

Consider the case of a family headed by a primary earner making $25,000 per year. As this family adds wages from a secondary earner who also earns $25,000 per year, the family sees its payroll taxes double, loses its entire Earned Income Tax Credit (EITC) benefit (approximately $5,000), and pays more in federal income taxes (approximately $2,500 more). This family also loses eligibility for food assistance through the Supplemental Nutritional Assistance Program (SNAP) program (worth over $2,500 a year). Under the current federal tax and transfer system, and assuming standard child-care costs, we estimate that this family will take home less than 30 percent of the secondary earner's earnings. In other words, the effective average tax rate on the secondary earner's earnings is 70 percent. As this example illustrates, low-wage families see the return to work by a secondary earner reduced through the tax and transfer system.

We propose a secondary-earner tax deduction that would allow low- and middle-income couples to take home a greater portion of a secondary earner's earnings. This policy would increase working low- and middle-income families' economic security and mitigate what we label the secondary-earner penalty, which arises from the family-based nature of the progressive U.S. federal income tax system. Our baseline proposal is to allow a secondary earner within a married couple to deduct 20 percent of earnings up to $60,000; eligibility for this deduction would phase out beginning at $110,000 of family income. In addition, to keep revenue costs down and to target the proposal to families most in need of additional disposable income, our baseline proposal limits eligibility to married couples with children. Under our baseline proposal, the hypothetical family introduced above—the one headed by a primary earner making $25,000 a year with a spouse who

We propose a secondary-earner tax deduction that would allow low- and middle-income couples to take home a greater portion of a secondary worker's earnings.

enters the workforce also at an annual salary of $25,000 a year—would see a 4 percent increase in its disposable income.

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; they do impact federal government tax revenues, however. We simulate that the implementation of the secondary-earner deduction, according to our baseline stipulations, would lead to an estimated annual $8.2 billion reduction in federal tax revenue. The benefit side includes an increase in resources of $13.4 billion to families with combined income of $130,000 or less. This has a benefit-to-cost ratio of 1.6. We also provide a (nearly) revenue-neutral policy option that proposes to offset the cost of the secondary-earner deduction by scaling back the allowance of the spousal exemption—equal to about $4,000—for all married-couple families.[1]

We justify the secondary-earner deduction on both fairness and economic grounds. First, a married couple that brings in a certain income with two full-time earners has fewer resources available than does a married couple that brings in the same income with only one earning spouse. This discrepancy is heightened if there are children in the home because the nonearning spouse has more time to devote to household chores and child care. The current federal income tax system does not acknowledge this discrepancy in resources between households with one earning spouse and those with two earning spouses.[2] Our proposal would move the federal income tax system toward a more equitable treatment of two-earner married couples relative to single-earner married couples.

Furthermore, the existing secondary-earner penalty provides disincentives to work. As a result, some potential secondary earners choose not to work outside the home, even if they would prefer to be employed if they were able to take home a greater portion of their earnings. A secondary-earner deduction will improve incentives for spouses to work; as a result, some currently nonearning spouses will choose to take a job or, if already earning, increase their hours in response to the reduction in taxes. This proposal fits squarely within the "make work pay" motivation behind the EITC, which provides incentives for single parents with dependent children to work (Eissa and Liebman 1996; Meyer and Rosenbaum 2001). At the same time, however, the EITC tends to provide a disincentive for married mothers to work, since the combined income of a wife and husband reduces (and sometimes eliminates) a family's EITC benefit (Eissa and Hoynes 2004a, 2004b).[3] Thus, in addition to increasing the economic security of low-wage families, our proposal will also increase economic productivity.

Chapter 2: The Secondary-Earner Penalty

Over a quarter of married families with dependent children have income placing them below 200 percent of the federal poverty level (FPL).[4] 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 whose income falls below a specified income limit—and the EITC. Furthermore, when both spouses choose to work, households devote a large share of their disposable income to work-related expenses, such as child care.[5]

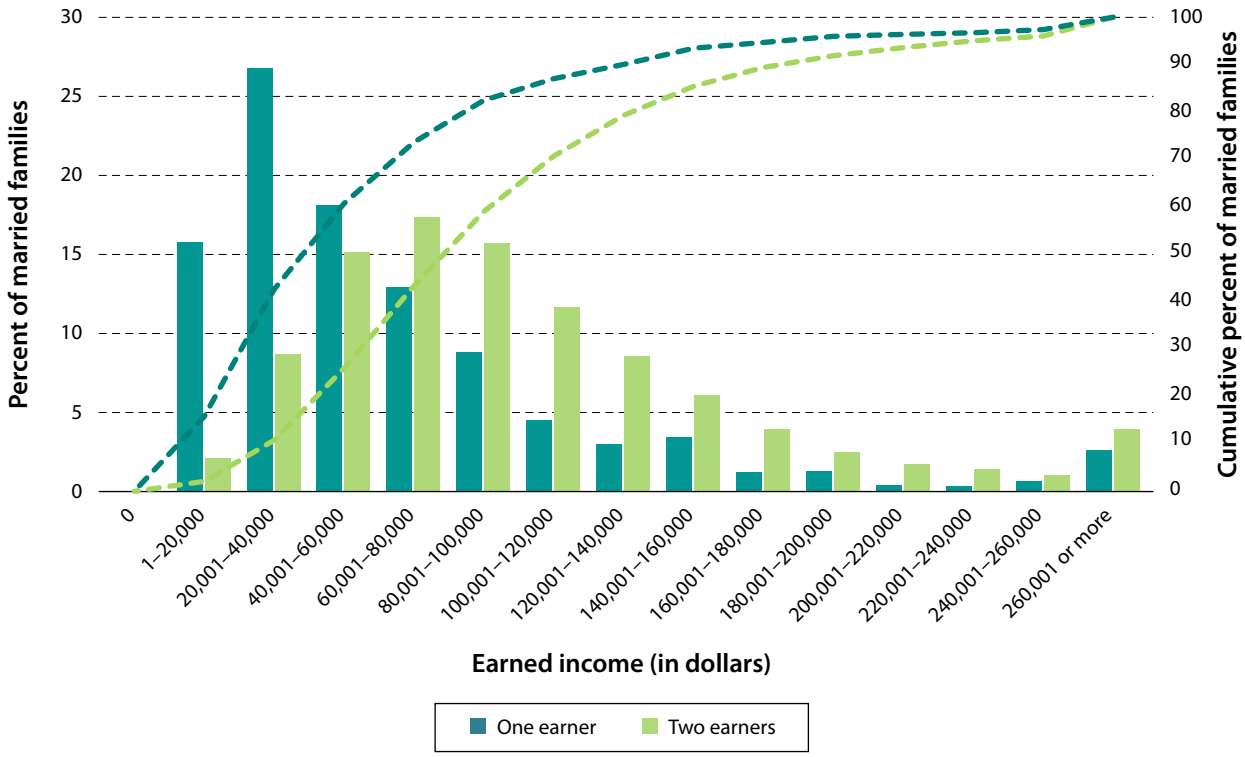
The tax rates on additional earnings are referred to as marginal tax rates. For example, if a worker pays an additional $200 in taxes on $1,000 in additional earnings, the marginal tax rate is 20 percent. Effective marginal tax rates are based on the taxes paid and benefits lost; they are driven by actual tax rates applied to incremental increases in income as well as losses in benefits associated with additional amounts of income. For example, if a taxpayer earns an additional $1,000, incurs an additional $200 in taxes owed, and loses $400 in transfer benefits, the marginal tax rate on those earnings is effectively 60 percent. As discussed below, the U.S. tax system can levy very high marginal tax rates on low-income earners because of the loss in these benefits (often called a phase-out) and not specifically because of high rates of taxes paid. These factors are explained in detail in section B of chapter 2.

A. DEMOGRAPHICS

In 2012 44 percent of all working-age nonelderly married couples with children had income below 300 percent of the

FIGURE 1.

The Distribution of Earned Income for Married Couples with Dependent Children, by Number of Earners



Sources: CPS 2012, March supplement (King et al. 2010); authors' calculations.

FPL, which is $70,650 for a family of four in 2013. Of these households, approximately half have two earners. As shown in figure 1, roughly a quarter of all married-couple families with dependent children face circumstances similar to those we described in our example above. In other words, millions of American families have income levels at which additional income reduces transfer benefits and, subsequently, leads to high tax rates on additional income.

Both spouses in married-couple families with dependent children increasingly are engaged in paid work outside the home. The percentage of nonelderly, married-couple families with two earners increased from 59 percent in 1980 to a peak of 72 percent in 2001, and fell to 66 percent in 2012.[6] Furthermore, earnings received by primary and secondary earners in families headed by two working parents have converged over the past three decades. The percentage of families headed by spouses with similar earnings—those in which each spouse generated at least a quarter of total earnings—increased from 59 percent in 1980 to a peak of 71 percent in 1997, and fell to 64 percent in 2012.

Focusing on lower- and middle-income families reveals similar trends. In 2012, married families with income below 300 percent of the FPL (e.g., $70,650 for a family of four) were approximately equally split between one and two earners (48 versus 46 percent, respectively). Married families with income below 200 percent of the FPL were less likely to have two earners (34 percent), while only 19 percent of married families with income below the poverty line had two earning spouses.

B. THE FEDERAL TAX CODE TREATMENT OF TWO-EARNER COUPLES

In the United States the combination of a progressive tax code and family-based income taxation means that secondary earners effectively face higher marginal and average tax rates relative to both married primary earners and single earners.[7] This occurs because the family-based tax code pools the earnings of married spouses. As a result, the secondary earner's first dollar of earnings is taxed at the same marginal tax rate as the primary earner's last dollar of earnings.[8]

This secondary-earner penalty is related to what is commonly referred to as the marriage penalty, where two unmarried workers with similar earnings pay less in combined federal income taxes than do two married workers with similar earnings. The flip side of this feature of the tax code is that if two individuals with disparate earnings marry—say, a high-earning man and a woman with little or no earnings—they pay less in federal income taxes as a married couple than they would as individuals (i.e., they receive a marriage bonus).

In the United States the combination of a progressive tax code and family-based income taxation means that secondary earners effectively face higher marginal and average tax rates relative to both married primary earners and single earners.

The United States is one of only seven OECD countries with mandatory joint taxation (Alm and Melnik 2005). When the federal income tax system was created in 1918, personal income taxes were based on individual income. Couples were allowed to file joint returns, but faced the same tax schedule as individual filers. Concern about couples shifting nonwage income between spouses to reduce tax burden gave rise to a movement for joint property and income taxation in 1948. At that time, most wives did not earn an income outside the home.[9]

The tax reform act of 1981 introduced a two-earner deduction that went into full effect in 1983. Under this system, joint filers could deduct 10 percent of the lower-earning spouse's income, up to a maximum of $3,000 (Eissa 1996). The actual reduction in taxes due to this deduction depended on the family's marginal tax rate.[10] The deduction was repealed, shortly after its full implementation, as part of the 1986 tax reform bill, which simplified the tax code by removing several deductions and exemptions. Though short lived and not targeted to low-income families, this brief experiment with a two-earner deduction provides a precedent for our proposal and bolsters our claim of feasibility.[11]

To illustrate how the current tax system penalizes secondary earners, consider the simple case 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.[12]

Beyond this higher effective marginal tax rate faced by secondary earners, three main factors reduce the returns to secondary earners' work efforts: (1) the EITC and two-earner couples, (2) means-tested benefit programs and two-earner couples, and (3) work-related expenses, in particular child-care costs. We next discuss these factors in turn.

C. THE EARNED INCOME TAX CREDIT AND TWO-EARNER COUPLES

The EITC—a feature of the tax code commonly referred to as a transfer program—is currently the largest cash benefit program for lower-income families with children. In 2010, 28 million families received an EITC award, with total revenue expenditures of $61 billion. The average family received a credit of approximately $2,200 (Tax Policy Center 2012).

A family's EITC award depends on a family's income, or, more specifically, on a family's adjusted gross income (AGI in tax parlance). It also depends on whether the head of household is married, and the number of qualifying dependent children.

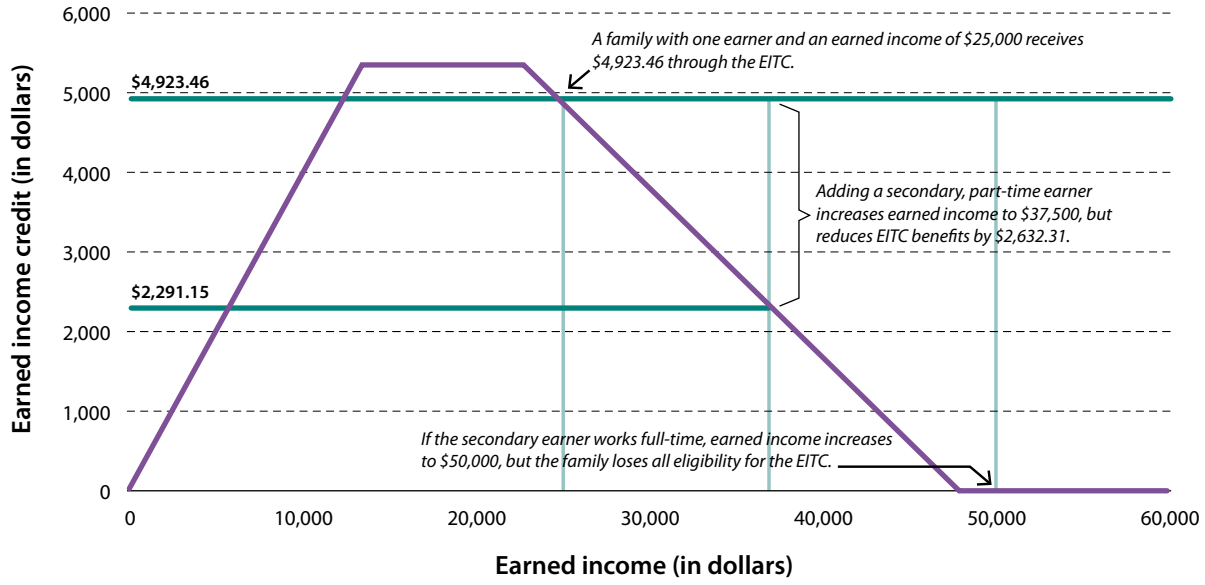
The program is characterized by its plateau design, which features a subsidy phase-in range, a maximum credit range, and a phase-out range. The phase-in range is the income over which taxpayers receive additional benefits for earning higher income. In 2013 the phase-in range for a family with two children was characterized by a 40 percent wage subsidy as long as earned income falls below $13,430. In other words, as long as earned income falls below $13,430, this family will receive $0.40 for each additional $1.00 it earns.

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 credit until earned income reaches $17,530 for a single filer and $22,870 for a married filer. In this range of income, 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 the phase-out 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 a single filer and $48,378 for a married filer; filers receive no EITC benefit if their earnings exceed these thresholds.

The corresponding thresholds, phase-out rates, and maximum credit amounts are lower for families with one child and higher for those with three or more children. Crucially, the EITC is refundable, which means that if the family qualifies

FIGURE 2.

EITC Benefits Lost with the Addition of a Second, Full-Time Earner: Spouses with Earnings of $25,000 Each



Note: The purple solid line represents the EITC schedule for a married filing-jointly couple with two qualifying children in 2013. The left-most vertical line represents the income and EITC for a married-couple family of four with a $25,000 per year primary worker and no secondary worker. The two right-most vertical line segments represent this family's lost EITC benefits due to the secondary worker's earned income, assuming part-time work and full-time work, respectively (annual earnings = $25,000).

for a credit amount that exceeds the amount owed in federal income taxes, the Internal Revenue Service (IRS) refunds the family that balance.[13]

The EITC is generally understood to increase incentives for single heads of household to enter into paid work outside the home, due to the generous wage subsidy in the phase-in range. This is generally not the case for potential secondary earners within married couples, however. Many married couples are likely to be in the phase-out range of the EITC structure, which imposes high marginal tax rates on work effort. Previous academic research suggests that the decision to work by secondary earners, typically married women, is particularly sensitive to taxes (e.g., Triest 1990).

The high sensitivity to taxes among secondary earners combined with the fact that many married couples lose EITC benefits by earning more leads to the likely possibility that this program discourages work for both spouses in married couples. Eissa and Hoynes (2004a) find that EITC expansions during the 1980s and 1990s actually reduced the likelihood of work by married women by over a full percentage point, while increasing the likelihood of married men earning only slightly. Eissa and Hoynes (2004b) show that EITC expansions between 1984 and 1996 led to modest reductions in hours worked by married men and married women. Overall, married women in the labor force are estimated to decrease their work hours by between 1 and 4 percent. Women in the phase-out range of the credit experience the greatest reductions, between 3 and 17 percent. The bottom line of this research is that in contrast to the positive effects on work found for single earners, the EITC expansions actually lead to a modest reduction in work and earnings among married couples.

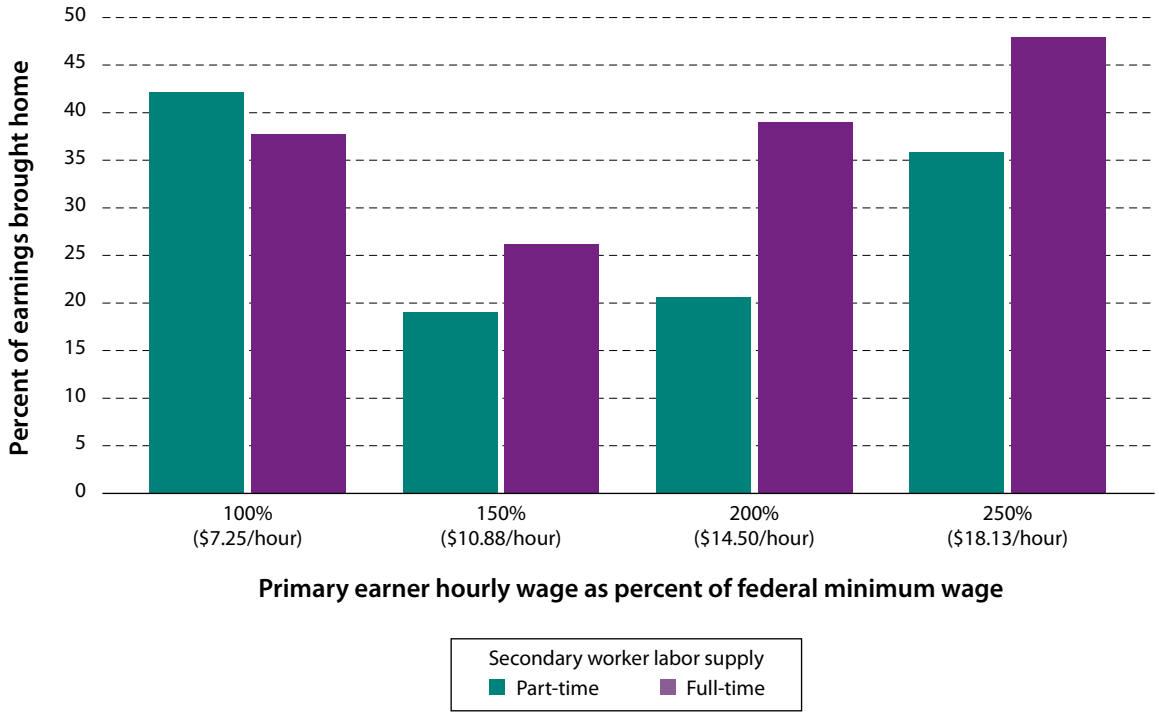
To illustrate the penalties imposed on two-earner families by the structure of the EITC, we focus on our hypothetical married couple with two children, headed by a full-time worker earning $25,000 per year and a nonearning spouse. This family's income—which entitles it to an EITC of approximately $4,900—is represented by the first vertical thick line below the purple EITC schedule in figure 2. If the spouse goes to work part time, receiving the same hourly wage as the primary earner, the family's increased income moves it along the phase-out portion of the EITC schedule (represented by the second vertical line). Under this scenario, the family would lose approximately $2,600 in EITC benefits, as represented by the bracket above the EITC schedule and between the two horizontal green lines. Full-time work for the spouse is even more costly, because this family would then lose eligibility for any EITC benefits, as represented by the third vertical line.

D. MEANS-TESTED BENEFIT PROGRAMS AND TWO-EARNER COUPLES

The federal tax code is only part of what makes some families' climb to the middle class so difficult. The secondary-earner penalty is exacerbated by the family-income-based phase-outs

FIGURE 3.

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



Source: Authors' calculations using TAXSIM (see Feenberg and Coutts 1993).

Note: See table A2 in the appendix for calculations.

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 (food stamps) and Medicaid benefits. According to the Congressional Budget Office (CBO; 2012), on average, working taxpayers with income below 450 percent of the FPL face a marginal tax rate of 30 percent. The CBO estimate takes into account federal and state individual income taxes, federal payroll taxes, and the reductions in food assistance (SNAP) benefits that occur when earnings increase.

Losing program benefits inhibits low-income families from improving their economic well-being through increased work effort. Given that many states have flexibilty in designing a number of transfer programs that target working low-income families, however, a push to reform individual state-level policies would be substantially more challenging in practice than would our suggestion of a single incremental reform to the federal tax code.

E. WORK-RELATED EXPENSES

Even as families lose eligibility for means-tested benefits as they add a secondary earner, their work-related expenses increase. One of the most important work-related costs faced by married-couple families with dependent children is child care. According to the U.S. Census Bureau (2011), on average, married families with an earning mother spent 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.

To provide a descriptive picture of the work-related expenses associated with adding a secondary earner, we compare expenditure patterns for married families with children under age eighteen with one versus two earners, among married families with minor children with family income below 300 percent of the FPL using data from the Consumer Expenditure Survey. We focus on work-related expenses as a share of total expenses, and also break out major categories of work-related expenses. Differences in expenditures are descriptive, since families that choose to have one versus two earners may face different work-related costs or have different preferences.

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. Furthermore, two-earner families spend 24 percent more on adult clothing and personal care and 260 percent more on child care. The large difference in child-care costs stems both from a higher usage rate (22 percent of two-earner families versus 10 percent of single-earner households pay for child care) and higher expenses for those who do use child care ($3,800 versus $2,200). Finally, two-earner families spend 36 percent more on food away from home relative to families with a single earner.[14]

F. PUTTING IT ALL TOGETHER: SECONDARY EARNERS FACE LOW RETURNS TO WORK

Figure 3 displays the percentage of income generated by the addition of a secondary earner's 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 (two adults, two children) 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 take-home earnings generated from adding a part-time and full-time secondary earner, respectively, with the same hourly wage. In all eight scenarios represented in figure 3, a family ultimately keeps less than half of the earnings generated by the secondary earner.[15]

To illustrate how the rates reported in figure 3 are calculated, we first return to our initial example of a family of four headed by a primary worker earning $25,000 and a nonearning spouse. As shown in the first column of table A1 in the appendix, with only one earner this family pays about $3,800 in payroll taxes, but receives $2,000 from the Child Tax Credit (CTC) and $4,923 from the EITC.[16] Adding an additional full-time secondary worker with the same hourly wage (table A1, column 2) doubles both gross earnings and payroll taxes. At the same time, the secondary worker's additional earnings both reduce the family's EITC to $0 and increase what the family owes in federal income taxes.

Adding a secondary earner also increases our hypothetical couple's work-related expenses—in particular, child-care costs. We assume that a family with a secondary earner spends 10 percent of its gross earnings on child care (in this case, $5,000). With the addition of a full-time secondary earner, this family receives a $1,000 Child and Dependent Care Credit (CDCTC), leading to a net increase in child-care costs of $4,000.

Finally, additional earnings from a secondary earner decrease food stamp (SNAP) eligibility from approximately $2,600 per year to $0.[17] We do not model changes in eligibility for other means-tested benefits, such as cash assistance and subsidized housing, because the parameters of these programs vary substantially across states. In general, however, eligibility limits for these programs are similar to SNAP parameters. Even without taking into account reductions in other means-tested benefits, our family benefits from only 29 percent of the secondary earner's gross earnings.

Table A2 repeats this exercise, focusing on three hypothetical married-family households, with varying earnings levels. Again, we assume that each family has two children and that, when working, the secondary worker receives the same hourly wage as the primary worker. The family described in the first panel is headed by a full-time, full-year minimum-wage

primary worker who earns $15,080 per year. As we move from the first to the second column, we examine how the family's taxes, means-tested benefits, and, ultimately, take-home pay change as the family adds a secondary full-time earner. As this family adds another full-time minimum-wage earner, it sees its combined gross earnings double (to $30,160), its payroll taxes also double (to approximately $4,600), its income tax liability increase from $0 to $236, and its EITC fall by approximately $1,500. This family also loses approximately half of its SNAP benefits and sees its net child-care costs increase by close to $3,000.[18] As a result, this family experiences only a $0.38 increase in disposable income for every $1.00 increase in secondary earnings.

In the second panel of table A2 we present the same information for a family headed by individuals who earn 150 percent of the federal minimum wage ($10.90/hour). In the third panel we present the information for a family headed by individuals who would earn 200 percent of the federal minimum wage ($14.50/hour). Each of these families takes home less than $0.50 of the secondary earner's $1.00 of earnings. Our second family (headed by a primary worker earning 150 percent of the minimum wage) faces the worst secondary-earner penalty and sees only a $0.26 increase in disposable income for every $1.00 of earnings received by the secondary earner. This family's secondary-earner penalty stems from a loss of EITC benefits, an increase in federal income tax, and a full loss of SNAP benefits.

Chapter 3: Proposal: A Secondary-Earner Deduction

We recommend the implementation of a secondary-earner deduction for married couples with dependent children. Specifically, in our baseline option we propose a secondary-earner deduction that allows families to deduct up to 20 percent of the first $60,000 earned by a secondary worker, with a phase-out starting at a family income of $110,000. (This income threshold is the same as that applied to the existing CTC.) Specifically, for every $1,000 increase in AGI above $110,000, the secondary-earner deduction rate would be reduced by 1 percentage point.[19]

Our baseline proposal targets low- to moderate-income families. To be clear, it does not target the lowest-earning families in the population, those with less than approximately $13,000 in annual earnings. Earners in that range currently benefit from the 40 percent subsidy of the maximum EITC. Our proposal is focused on earners whose family income places them beyond the subsidy range of the EITC. These earners are subject to some of the highest effective marginal tax rates in the entire population. To be clear, even a family with two full-time minimum-wage earners will benefit from a 2 to 3 percent increase in disposable income from our proposal.

For families with income between $20,000 and $50,000, the primary means through which this deduction affects their disposable income is by increasing their EITC, as they are likely to pay little or no income taxes. Conversely, families with income above $50,000, but below the phase-out, will benefit via a reduction in federal income taxes. Therefore, families with very low incomes with two earners (e.g., families with minimum-wage earners working sporadically) will not benefit from this proposal because they already receive the maximum EITC.

The effect of the secondary-earner deduction on a family's income will not directly affect its eligibility for means-tested benefits. This occurs because eligibility for means-tested benefits is based on income before accounting for tax deductions. Changing the amount of a tax deduction, therefore, will not alter the amount of benefits received. The only way the proposed secondary-earner deduction will affect payroll taxes or means-tested transfer payments is by inducing behavioral changes that increase earnings.

BOX 1.

Secondary-Earner Deduction Policies

1. Baseline proposal: 20 percent of the first $60,000, phase-out beginning at $110,000.
2. Revenue-neutral option: 20 percent of first $60,000 plus 75 percent reduction in spousal exemption.

As detailed in the box, we focus on two versions of a secondary-earner deduction: a baseline proposal and a (nearly) revenue-neutral option.

Before presenting estimates of the impact of the above policies on federal revenue and family resources, we return to our initial example of a family of four with a primary earner earning $25,000 per year to illustrate the impact of a secondary-earner deduction on a family's disposable resources.

Table A1 walks us through the example of our hypothetical family with a primary earner who earns $25,000 and a secondary earner with the same earnings potential. Column 3 shows the tax change due to our baseline secondary-earner deduction proposal, while column 4 shows the effects of our proposed revenue-neutral option. With the deduction, this family's federal income tax bill falls by $718 ($1,720 versus $2,438), and its EITC increases from $0 to $711—an increase of $1,429 (4 percent) in disposable income. Our 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. Finally, our hypothetical family sees a slightly smaller benefit from our revenue-neutral option, experiencing a 3 percent increase in disposable income. This is primarily due to the smaller decrease in this family's federal income tax bill ($1,980 versus $1,720 under our baseline proposal).

The third and fourth columns of table A2 present the tax implications of our proposed policies for the three hypothetical families introduced in the previous section. The three panels show results for a family with both spouses who would make the federal minimum wage of $7.25 per hour, 150 percent of the federal minimum wage ($10.90/hour), or 200 percent of

the federal minimum wage ($14.50/hour), respectively. All examples assume the primary and secondary earner enters the workforce at the same wage.

As shown in table A2, each of these families experiences an increase in disposable income under both our baseline proposal and our revenue-neutral option, as compared to current policy. For the first two families, the main benefit is a sizable increase in their EITC awards. For the higher-earning primary worker ($14.50/hour), the addition of a secondary earner yields too much income for the family to qualify for the EITC, even under our proposed reforms. That couple in the third panel, however, benefits from the secondary-earner tax deduction through reduced federal income taxes. Under both the baseline proposal and the revenue-neutral option, the family in the third panel sees an increase of approximately $900 and $600, respectively, in disposable income.

Table A3 summarizes the simulated impacts of both the baseline proposal and the revenue-neutral option on these three families, highlighting the magnitude of the increase in disposal income and the source(s) of the increase.

A. SIMULATED COSTS AND BENEFITS

As part of our analysis, we conducted simulations to estimate the revenue costs to the federal government and the economic gains to affected families from the implementation of the secondary-earner deduction. In implementing the secondary-earner tax deduction, revenue costs increase with both the earnings limit and the deduction percentage. For example, a deduction equal to 30 percent of the secondary earner's first $60,000 of earned income will be more expensive for the federal government in terms of lost tax revenue than would a deduction equal to 10 percent of the first $30,000. The work incentives will be greater, however, and ultimately the amount of earnings retained by lower-income families will be greater if larger amounts of earnings are deductible. That is the trade-off inherent in the design of the policy.

Our baseline simulations assume that some secondary earners will respond to the increased return to their work efforts by increasing the amount of hours they work. We incorporate estimates from well-regarded published academic research.[20] Table A4 displays our estimates of the revenue cost of the baseline proposal and the (nearly) revenue-neutral option. For a given policy, we calculate both the overall costs and benefits if the policy is applied to all married families and the costs and benefits if the policy is limited to married families with dependent children.

Our baseline secondary-earner deduction, which allows married couples with children to reduce their taxable income by up to $12,000 (i.e., 20 percent of the first $60,000), leads to a $13.8 billion loss in federal income tax revenue ($9 billion of which targets families with dependent children). Federal revenue losses (federal income tax and payroll taxes) are smaller because the reduction in average and marginal tax rates leads to an increase in both hours and participation of secondary earners. Since the secondary-earner deduction has no direct impact on payroll taxes, payroll tax revenue increases due to this increased labor supply. On net, we estimate that our baseline proposal would lead to an annual $8.2 billion reduction in federal tax revenue. The revenue costs would be $12.7 billion if the secondary-earner deduction were made available to married couples without dependent children.

Next, we estimate the extent to which families will benefit from this proposal. To do so, we sum the total increase in earnings due to secondary earners responding to the lower tax on their employment decisions and the increase in take-home pay due to the reduction in federal income taxes. We also allow primary earners' hours worked to decrease due to the increase in total family income. The baseline policy would lead to an estimated increase in total resources of $13.4 billion. When extended to married couples without children, the secondary-earner deduction would lead to a $20.3 billion increase in resources for married filers.

Finally, we display a measure of the cost effectiveness of this proposal. Specifically, we take the ratio of the estimated benefits to families and divide it by the proposal's cost in terms of the impact on federal revenue (income and payroll taxes). We estimate that for our baseline secondary-earner deduction policy, an additional dollar of federal revenue loss leads to a $1.60 increase in the resources available to married-couple families with annual incomes of $130,000 or less.

We next simulate the benefits of the revenue-neutral option, which aims to pay for some of the secondary-earner deduction by scaling back the spousal exemption granted to married families. Our intention is to hold harmless lower- and middle-income families targeted by the policy, and recoup lost revenue by increasing the taxes owed by families with only one earner. This makes the tax code treatment of married couples symmetric to the treatment of unmarried taxpayers, in that unmarried taxpayers can benefit from their personal exemption only if they have earned income. Thus, by replacing the spousal exemption with a secondary-earner deduction for secondary earners in married families, we reduce one of the channels through which the U.S. tax code privileges married families with only one earner. This policy is revenue neutral when extended to all married households, and leads to a $0.8 billion (or $800 million) reduction in federal revenue if limited to families with dependent children. Under this policy, married families with dependent children would receive the vast majority of benefits ($5.4 billion out of $9.0 billion).

B. DISTRIBUTIONAL CONSEQUENCES

In this subsection of the paper we discuss how the secondary-earner deduction would affect family resources at different points in the income distribution. In table A5 we report the average increase in disposable income received by two-earner families with earnings in a given interval. We simulate these changes assuming that both the baseline proposal and the revenue-neutral option are applied only to married couples with dependent children (and not to married couples without children).

Under our baseline proposal, two-earner households with dependent children in the lowest income bracket (e.g., 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.

Finally, we examine the impact of the revenue-neutral option on the distribution of benefits. Results are reported in columns 4 and 5, table A5. This implementation of the secondary-earner deduction leads to the largest increases in disposable income for families with dependent children who have income of $100,000 or less. These benefits are offset by an increase in the tax owed by families with dependent children who have income between $100,000 and $500,000 and by increases in taxes paid by families with a single earner (not shown in table A5).

Chapter 4: Questions and Concerns

Why not propose individual taxation?

On both fairness and economic grounds, we would favor treating two earners within a family as separate earners, essentially undoing the marriage and secondary-earner penalties imposed by our 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. We have thus not proposed that here.

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, we refer the reader to McCaffery (1999).

Why not propose a separate EITC structure for two-earner couples?

There are obvious benefits to generating the effect of our proposed secondary-earner tax deduction within the existing structure of the tax system, in particular, the existing EITC. One simple change would be to apply a separate (and more generous) EITC schedule to families with two earners. One reason we did not propose this is because we are very concerned with the issue of tax cliffs that arise whenever a strict categorical requirement is implemented.

Specifically, it would be necessary to determine at which level of earnings a spouse qualifies as a secondary earner. Would the secondary earner be required to work one week in a year, or four weeks, or should we define a secondary earner in terms of meeting some threshold level of earnings? However we chose to do it, we could come up against the problem that there would be extreme penalties for working at particular levels of income, as well as the sizable potential (and reward) for fraudulent reporting.

We thus determined it to be preferable to design a secondary-earner tax deduction that is proportional to earnings. As described in the text, for families with levels of earnings that are moderately low (but not too low), the main benefit of the secondary-earner deduction comes through an increased EITC award. As we move up the income distribution, families continue to benefit from our proposal beyond the EITC phase-out rate through a reduced federal income tax burden.

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

We could make a compelling economic case for extending a 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. We have simulated the revenue costs and economic benefits of a universal secondary-earner deduction—allowing any family with dependent children to deduct 20 percent of a secondary earner's earnings up to $60,000.

The overall revenue cost of this proposal is $10.2 billion. The increase in disposable income to families totals $41.5 billion. That implies that if the secondary-earner deduction were extended to all married families with dependent children, these families would see their disposable resources rise by $4.10 for every dollar of federal tax revenue lost. By our 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 accrues to families with income below $100,000.

What about cash-strapped families with immediate income needs?

With the secondary-earner deduction, low-income families would receive benefits only after the end of tax year, rather than while working and incurring additional expenses such as child-care costs. The timing of benefits matters if households have immediate needs for cash (e.g., to pay for work-related expenses). Furthermore, the deduction is potentially less salient if it is combined with other credits and deductions.

The secondary-earner deduction could be paired with a small change to default withholding for targeted households to ensure two-earner households are able to benefit from the reduction in their tax liability throughout the year. For instance, the W-4 withholding form could be modified to include an additional box that allows married families to indicate whether they have two earners. Families that are slated to receive a refund due to the EITC, however, would not see an increase in their take-home earnings.

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 EITC when both spouses work do not benefit from our current proposal. A modified proposal that would target these families would be to make the CDCTC fully refundable. This would allow families with a nonpositive tax bill to benefit from this existing feature of the tax code. The Tax Policy Center estimates that in 2006 making the CDCTC fully refundable would increase the annual cost of the credit by 50 percent, from $3.3 billion to $5.0 billion (Rohaly 2007).

Are there additional targeting possibilities that would lessen the revenue-cost implications?

Another possibility to offset the costs of our proposed secondary-earner deduction would be to make the existing CDCTC conditional on having a qualifying child below a certain age—say younger than six years old. These are the families that tend to have the highest child-care expenses. We could also consider a secondary-earner deduction only when a family has children under a specific age—say five or twelve years old.

What about the Affordable Care Act subsidy provisions?

An additional policy issue going forward is how the Affordable Care Act (ACA) plays into this 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 CBO estimates that under provisions of the ACA 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 (CBO 2012).

Doesn't the tax code help working-parent families with child-care credits and subsidies?

The federal tax code provides a limited amount of support to families that incur child-care–related expenses. First, there is the CDCTC, enacted in 1976 and last expanded in 2001. Under current law, families can claim up to $3,000 in child-care expenses per child for up to two children (i.e., up to $6,000 maximum).[21] Families receive a credit that covers between 20 and 35 percent of these expenses, where the percentage covered is decreasing in AGI. For instance, in 2012 only households with an AGI below $15,000 were eligible for a credit equal to 35 percent of qualifying expenses.[22] Families with an AGI of $43,000 or greater were eligible for a credit equal to 20 percent of qualifying expenses (at most $600 for one child or $1,200 for two or more children). Expenses must be related to the care of children less than thirteen years of age. Additionally, in married-couple households, both parents must be earning and/or full-time students to claim the credit.

A key feature of the CDCTC is that, unlike the EITC, it is nonrefundable. This means that taxpayers without a positive federal income tax liability do not benefit from this credit. In fact, most of the families who would qualify for the largest credits do not receive the CDCTC due to a lack of a positive tax liability. According to the Tax Policy Center, only 8 percent of CDCTC benefits go to families with income below $30,000, whereas 65 percent are received by families with income between $50,000 and $200,000 (Rohaly 2007). Many families without a positive tax liability have expenses that would qualify for a CDCTC, if the credit were refundable.

> As we move up the income distribution, families continue to benefit from our proposal beyond the EITC phase-out rate through a reduced federal income tax burden.

An additional tax-related benefit targeting earning parents with child-care costs is the employer-sponsored child and dependent care flexible spending account (FSA). If offered by an employer, an individual can exclude up to a set amount of earned income from income and payroll taxes. This income is placed into an account and can be used to pay for child-care costs. Under current law, parents can place up to $5,000 in child- and dependent-care FSAs, but only if this benefit is offered by their employer. Unlike the CDCTC, married parents with a nonearning spouse can still benefit from the dependent-care FSA. Families that take advantage of a dependent-care FSA can only claim child-care expenses for the CDCTC to the

extent that these expenses exceed the amount contributed to the FSA.

Lower-income families tend to have limited access to child-care FSAs. According to the Bureau of Labor Statistics (BLS), in 2012 only 37 percent of earners were offered the option to participate in a dependent-care FSA and only 17 percent in the lowest quartile of earnings had access to this benefit (U.S. Department of Labor 2012). Finally, even if offered by an employer, parents must decide how much to contribute to their child-care FSA at the beginning of the year, and any unused benefits are returned to the employer. Thus, families with variable earnings and uncertain child-care expenses may choose to forgo this benefit rather than risk losing these funds.

Finally, a limited number of low-income families have access to federally funded (but state-administered) child-care subsidies funded through the federal Child Care and Development Block Grant and, in some cases, Temporary Assistance for Needy Families (TANF). Eligibility requirements vary across states; as of 2012 close to 75 percent had set limits at or below 200 percent FPL (Schulman and Blank 2012). According to the U.S. Department of Health and Human Services (HHS), in 2011 close to 1 million families and 1.6 million children benefitted from child-care subsidizes in a given month (HHS 2012). Half of these familes were below the poverty line and 17 percent were receiving cash assistance through their state's TANF program. Due to funding limitations, however, eligible families may be placed on a waiting list rather than receiving immediate access to assistance. In 2012 families did not receive immediate access to child-care subsidies in twenty-three states (Schulman and Blank 2012).

In summary, few tax-related benefits target two-earner low-income families. Most families in this range receive a refundable CTC, but this benefit does not depend on whether the household has one versus two earners. In theory, the lowest-income families are eligible for the largest CDCTC, but since this credit is nonrefundable, many low-income families do not benefit from it in practice due to a zero federal income tax liability.

Chapter 5: Conclusion

This discussion paper proposes 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 closer to treating the earnings of a spouse as it treats the earnings of the primary earner in a family or an individual earner. This would also be a more equitable treatment of a family that brings in a certain amount of income with two earners as compared to a family with the same total income brought in by one higher-earning spouse.

A couple with two earners has fewer resources available compared to a couple with the same total income and one nonearning spouse, since the nonearning spouse has more time to devote to household chores and child care. Our current tax system fails to acknowledge this additional burden on two-earner families.

Furthermore, the existing system's secondary-earner penalty serves as a disincentive to work. Economic reasoning implies that individuals with less strong attachment to the labor force should face lower marginal tax rates. By this logic, secondary earners—understood to mean the earner in the family who brings in less than half the family's income and/or the earner in the family with weaker labor force attachment—should face marginal tax rates that are lower than rates for primary earners. But our tax code does just the opposite. Our proposed policy will not only allow two-earner couples to keep more of their income, but it also will provide incentives for nonearning spouses to enter the workforce and for earning spouses to work more hours.

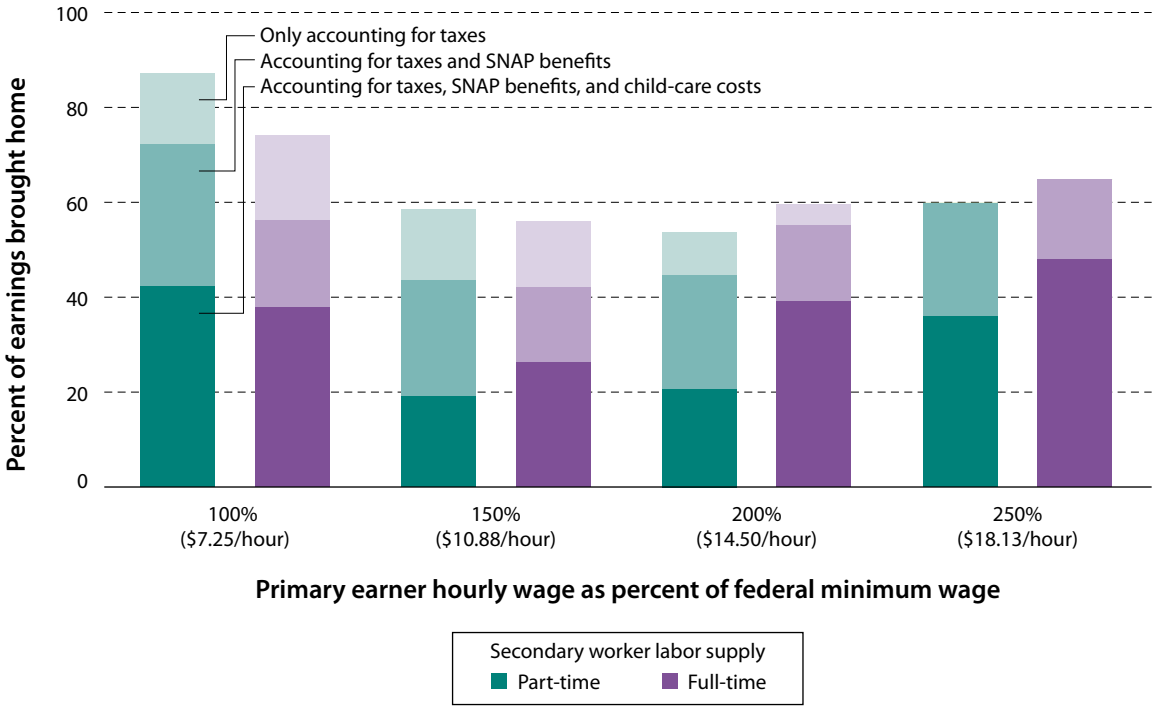
Our revenue estimates place cost of the secondary-earner deduction well below that of other major tax-related initiatives that target low- and middle-income families. To compare our estimated revenue costs with current tax expenditures on the two largest tax credits targeting families, the CBO estimates that tax expenditures in 2013 on the EITC and CTC will be $61 billion and $57 billion, respectively (CBO 2013). To put these numbers in even broader context, the annual tax expenditure cost of employer-provided health insurance is $248 billion and the mortgage interest deduction is $70 billion (CBO 2013).

The secondary-earner deduction should hold wide political appeal. It allows low-income working families to keep more of their earnings and experience greater economic security. The EITC is politically popular because it "makes work pay" for single earners. A targeted secondary-earner tax deduction will help make work pay for secondary earners, and will help low- to moderate-income families help themselves. It is hardheaded and compassionate at the same time.

Appendix

FIGURE A1.

Percent of Secondary-Earner Earnings Families "Take Home" after Accounting for Taxes and SNAP Benefits



Source: Authors' calculations using TAXSIM (see Feenberg and Coutts 1993).

Notes: The darkest bars represent take-home earnings after accounting for changes in taxes (federal and FICA), SNAP benefits, and child-care costs. The second-darkest bars represent take-home earnings after accounting for changes in taxes and SNAP benefits. The lightest bars represent take-home earnings after accounting for only taxes.

TABLE A1.

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 (see Feenberg and Coutts 1993). Data in columns 3 and 4 come from authors' calculations using a special modification of TAXSIM. SNAP benefits based on eligibility guidelines available at USDA (n.d.).

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.

TABLE A2.

Taxes and Take-Home Income by Hourly Wage and Secondary-Earner Employment

	(1) Spouse does not work	(2) Spouse works full-time	(3) Baseline proposal	(4) Revenue-neutral option
A. Minimum Wage ($7.25/hr)				
Total earnings	$15,080	$30,160	$30,160	$30,160
Payroll taxes	-$2,307	-$4,614	-$4,614	-$4,614
Federal income tax	$0	-$236	$0	-$129
CTC (incl. refundable part)	$1,812	$2,000	$2,000	$2,000
EITC	$5,372	$3,837	$4,472	$4,472
Child-care costs	$0	-$3,016	-$3,016	-$3,016
CDCTC	$0	$236	$0	$129
SNAP benefits	$4,973	$2,258	$2,258	$2,258
Total disposable income	$24,930	$30,625	$31,260	$31,260
% FPL (disposable income)	106%	130%	133%	133%
% of earnings kept by secondary worker	--	38%	42%	42%
B. 150% Minimum Wage ($10.90/hr)				
Total earnings	$22,670	$45,340	$45,340	$45,340
Payroll taxes	-$3,469	-$6,937	-$6,937	-$6,937
Federal income tax	$0	-$1,754	-$1,300	-$1,496
CTC (incl. refundable part)	$2,000	$2,000	$2,000	$2,000
EITC	$5,372	$640	$1,595	$1,595
Child-care costs	$0	-$4,534	-$4,534	-$4,534
CDCTC	$0	$907	$1,002	$1,002
SNAP benefits	$3,151	$0	$0	$0
Total disposable income	$29,724	$35,662	$37,166	$36,970
% FPL (disposable income)	126%	151%	158%	157%
% of earnings kept by secondary worker	--	26%	33%	32%
C. 200% Minimum Wage ($14.50/hr)				
Total earnings	$30,160	$60,320	$60,320	$60,320
Payroll taxes	-$4,614	-$9,229	-$9,229	-$9,229
Federal income tax	-$236	-$3,986	-$3,081	-$3,373
CTC (incl. refundable part)	$2,000	$2,000	$2,000	$2,000
EITC	$3,837	$0	$0	$0
Child-care costs	$0	-$6,032	-$6,032	-$6,032
CDCTC	$0	$1,200	$1,200	$1,200
SNAP benefits	$1,354	$0	$0	$0
Total disposable income	$32,501	$44,273	$45,178	$44,886
% FPL (disposable income)	138%	188%	192%	191%
% of earnings kept by secondary worker	--	39%	42%	41%

Sources: Data in columns 1 and 2 come from authors' calculations using TAXSIM (see Feenberg and Coutts 1993). Data in columns 3 and 4 come from authors' calculations using a special modification of TAXSIM.

Notes: 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 worker with the same hourly wage as the primary worker. See table A1 notes for additional details. 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.

TABLE A3.

Increase in Disposable Income under Secondary-Earner Deduction

	(1) Baseline proposal	(2) Revenue-neutral option
A. Minimum Wage ($7.25/hr)		
Increase in disposable income	$635	$635
Percent	2%	2%
Source of income increase:	EITC	EITC
B. 150% Minimum Wage ($10.90/hr)		
Increase in disposable income	$1,504	$1,308
Percent	4%	4%
Source of income increase:	Income taxes (30%)	Income taxes (20%)
	EITC (63%)	EITC (73%)
	CDCTC (7%)	CDCTC (7%)
C. 200% Minimum Wage ($14.50/hr)		
Increase in disposable income	$905	$613
Percent	2%	1%
Source of income increase:	Income taxes	Income taxes

Sources: Data come from authors' calculations using a special modification of TAXSIM and the 2007 Statistics of Income (IRS 2011).

Notes: Illustrative family has two dependent children and a secondary worker with the same hourly wage as the primary worker. See table A1 notes for additional details.

TABLE A4.

Revenue Cost and Income Increases under Secondary-Earner Deduction for Families with Dependent Children

	(1) Baseline proposal	(2) Revenue-neutral option
Policy parameters		
Deduction rate	20%	20%
Maximum earnings	$60,000	$60,000
Start of phase-out	$110,000	$110,000
Reduction in spousal exemption	--	75%
Revenue loss (in billions)		
Federal income tax only	-$9.0	-$1.5
Federal income tax + payroll taxes	-$8.2	-$0.8
Income increase (in billions)		
Total (taxes and earnings)	$13.4	$5.4
Effectiveness (benefit-to-cost ratio)	1.6	6.8

Sources: Data come from authors' calculations using a special modification of TAXSIM and the 2007 Statistics of Income (IRS 2011).

Notes: Phase–out policy implies a 1 percentage point decrease in the secondary-earner deduction for every $1,000 increase in AGI above the specified limit. Policy effectiveness is calculated as additional family income divided by revenue lost by the federal government.

TABLE A5.

Income Increases under Secondary-Earner Deduction, by Income Level

	Percent of two-earner households	(1) Baseline proposal		(2) Revenue-neutral option	
		$	%	$	%
Income Bracket:					
Less than $25,000	53.9%	$92	0.4%	$75	0.3%
$25,001-$50,000	71.2%	$556	2.2%	$91	0.4%
$50,001-$75,000	71.4%	$591	1.2%	$345	0.7%
$75,001-$100,000	76.0%	$910	1.3%	$642	0.9%
$100,001-$200,000	75.1%	$400	0.4%	-$25	0.0%
$200,001-$500,000	69.8%	$0	0.0%	-$153	-0.1%
Greater than $500,001	60.6%	$0	0.0%	$0	0.0%

Sources: Data come from authors' calculations using a special modification of TAXSIM and the 2007 Statistics of Income (IRS 2011).

Notes: See table A4 for parameters of three policies. Increase in disposable income is equal to the increase in total earnings plus reduction in federal income tax due to secondary-earner deduction.

Authors

Melissa S. Kearney

Associate Professor, University of Maryland

Research Associate, National Bureau of Economic Research

Melissa S. Kearney is an Associate Professor in the Department of Economics at the University of Maryland, where she has been on the faculty since 2006. Since October of 2013, she is also the Director of the Hamilton Project and Senior Fellow at the Brookings Institution. She is a Research Associate at the National Bureau of Economic Research (NBER) and a Faculty Affiliate of the Lab for Economic Opportunities (LEO). Professor Kearney received her Ph.D. in Economics from the Massachusetts Institute of Technology in 2002 and her BA from Princeton University in 1996. She studied on a National Science Graduate Research Fellowship and a Harry S Truman Scholarship. Past positions include Fellow at Brookings Institution and Assistant Professor at Wellesley College. Kearney's research focuses on issues of social policy, poverty, and inequality. Her research has been published in leading economics journals and has been profiled in numerous press outlets. She teaches Public Economics at both the undergraduate and Ph.D. level at the University of Maryland.

Lesley Turner

Assistant Professor, University of Maryland

Lesley J. Turner, Assistant Professor of Economics and Faculty Associate of the Maryland Population Research Center, received her Ph.D. from Columbia University in 2012. Her research applies theory and methods from labor and public economics to topics in the economics of education and broadly considers the role government should play in providing and financing education. Dr. Turner received her BA from the University of Michigan in 2004 and her MPP from the Gerald R. Ford School of Public Policy at the University of Michigan in 2005. She was awarded the Upjohn Institute Dissertation award for the best Ph.D. dissertation in labor economics in 2012.

Acknowledgments

The authors are grateful to Ben Harris, Adam Looney, Karen Anderson, and Michael Greenstone for helpful guidance and feedback on this project. We thank Hilary Hoynes, Nada Eissa, Elaine Maag, and the participants of The Hamilton Project authors' conference for their expert judgment and suggestions. We gratefully acknowledge the capable research assistance of Stephanie Rennane. The simulations included in this paper were conducted using a specially modified version of the TAXSIM model maintained by the National Bureau of Economic Research. We are extremely grateful to Dan Feenberg at the National Bureau of Economic Research for coding our proposed changes into the TAXSIM model.

Endnotes

1. The personal exemption is an exemption for each family member. In 2013 the exemption was $3,900. The revenue-neutral option reduces the value of the spousal exemption for married couples.
2. Additionally, the federal social security system provides for a spousal retirement benefit for spouses with no earnings of their own, or with earnings sufficiently less than that of their spouses. A spouse who earns roughly the same or more than her spouse forfeits this benefit. From a lifetime perspective, this makes the secondary-earner penalty even greater than is evident in the snapshot presented in this paper.
3. A family of four headed by two full-time, full-year workers earning minimum wage falls into the phase-out portion of the EITC schedule. If both parents earned 200 percent of the federal minimum wage ($14.50/hour), this family would not qualify for the EITC.
4. Authors' calculations using 2012 Current Population Survey (CPS) data via Integrated Public Use Microdata Series (IPUMS)–CPS (King et al. 2010). In 2012 the FPL was $23,550 for a family of four.
5. Though the federal tax code includes a nonrefundable credit for child- and dependent-care expenses, most low-income households do not substantially benefit from it because it is both modest in size and capped at very low income levels. Please see chapter 4, where we explain this concept in detail.
6. These figures are based on the authors' calculations using the 1980–2012 CPS via IPUMS-CPS (King et al. 2010). A family is considered to have two earners if both spouses received earned income (i.e., wages, salary, or income from self-employment) during the calendar year. All statistics presented in the remainder of section A of chapter 2 refer to nonelderly, married-couple families with dependent children.
7. Average tax rates are simply the total taxes paid as a share of income.
8. Although the option for a couple to file as married filing separately (MFS) exists in the United States, this is not the same as a system that taxes spouses as individuals. First, the thresholds under an MFS scheme are half the thresholds of the married filing jointly (MFJ) scheme, rather than the thresholds that apply to individual filers. Furthermore, MFS families cannot claim many credits that target the working, so it is not financially advantageous for couples to claim MFS status except under extenuating circumstances, such as spousal estrangement.
9. LaLumia (2008) estimates that the 1948 change from individual taxation to joint taxation reduced the employment rate of wives in highly educated couples by 2 percentage points, from a base of approximately 20 percent.
10. For instance, a family with a 15 percent marginal tax rate and secondary earnings in excess of $3,000 would have experienced a $450 reduction in its federal income tax liability.
11. Feldstein and Feenberg (1996) describe the federal income tax treatment of married women in similar terms to those we highlight in this paper. Their academic paper examines the efficiency and revenue effects of several alternative tax treatments of two-earner families that, by design, would reduce the marriage penalty and the tax on two-earner couples relative to the tax on single-earner couples with the same total income.
12. The Social Security system exacerbates the high marginal tax faced by secondary earners. Under Social Security, a married person's benefits are the greater of an earner's own benefits or one-half her spouse's benefits. Thus, an earning spouse whose own Social Security benefit exceeds one-half her spouse's benefit forfeits her spousal benefit entirely.
13. Current EITC parameters are available from the Tax Policy Center (2013).
14. Married families with two earners have after-tax income similar to after-tax income for a single earner. Therefore, expenditures as a percentage of after-tax income are also higher for two-earner households.
15. Appendix figure A1 displays the percentage of secondary-worker earnings a family takes home, setting both child-care costs and SNAP benefits to $0.
16. The following discussion refers to tables A1 through A5, all found in the appendix to this paper.
17. Our calculations of SNAP benefits are based on current federal eligibility guidelines, available at the USDA (n.d.).
18. Again, we assume that a family with two full-time earners spends 10 percent of its gross income on child care.
19. The earnings limit is the amount of wages against which the secondary-earner deduction can be applied. The deduction percentage is the share of each dollar earned that families can deduct. For example, if the earnings limit is $60,000 and the deduction percentage is 20 percent, families can deduct $0.20 from each $1.00 earned up to $60,000 by the secondary earner, with a maximum deduction amount of $12,000. A phase-out threshold of $110,000 means that families with an AGI exceeding that amount can deduct a lower amount. For example, a qualifying couple with an AGI of $111,000 would be able to deduct up to 19 percent of the first $60,000 of the secondary worker's earnings. Families with an AGI of $112,000 would be able to deduct up to 18 percent of the first $60,000 of the secondary worker's earnings. Families with an AGI of $130,000 or higher would not be eligible to take the secondary-earner deduction.
20. Our simulation procedure incorporates estimated changes to hours worked taken from the research of Eissa and Hoynes (2004a, 2004b), described in chapter 2 of this paper. Based on their studies, we assume the following employment responses to changes in the relevant tax rate: secondary-earner participation elasticity: 0.3; secondary-earner hours elasticity: 0.25; income effect: negative 0.15. The participation elasticity of 0.3 means that if the average tax rate decreases by x percent, then the labor force participation rate among the spouses of primary earners increases by 0.3 times x percent. For example, a 10 percent fall in the average tax rate would increase secondary earners' labor force participation by 3 percent. Likewise, an hours elasticity of 0.25 means that if the marginal tax rate decreases by 10 percent, secondary earners will increase the number of hours they work by 2.5 percent, in response to the fact that their take-home pay on additional work effort has increased. The income effect of negative 0.15 reflects the fact that an increase in income associated with higher wages leads individuals to essentially buy more leisure time by working less. This offsets the positive effect of lower tax rates, and correspondingly greater take-home rates of pay. This is a fundamental prediction of standard labor theory in economics; importantly, however, the numbers we are using here are empirical estimates from rigorous empirical work.
21. Additionally, as of 2010 twenty-three states and the District of Columbia have state-specific CDCTCs that are based mostly on federal eligibility guidelines (Campbell et al. 2011).
22. For every $2,000 increase in AGI, the percentage of expenses that parents can claim as a credit falls by one point.

References

Alm, James, and Mikhail I. Melnik. 2005. "Taxing the Family in the Individual Income Tax." *Public Finance and Management* 5 (1): 56–101.

Campbell, Nancy Duff, Amy K. Matsui, Julie G. Vogtman, and Anne W. King. 2011. "2011 Making Care Less Taxing: Improving State Child and Dependent Care Tax Provisions." National Women's Law Center (NWLC) Report, NWLC, Washington, DC. Available at http://www.nwlc.org/resource/2011-making-care-less-taxing-improving-state-child-and-dependent-care-tax-provisions.

Congressional Budget Office (CBO). 2012. "Effective Marginal Tax Rates for Low- and Moderate-Income Workers." Author, Washington, DC. Available at http://www.cbo.gov/publication/43709.

———. 2013. "The Distribution of Major Tax Expenditures in the Individual Income Tax System." Author, Washington, DC. Available at http://www.cbo.gov/publication/43768.

Eissa, Nada. 1996. "Labor Supply and the Economic Recovery Tax Act of 1981." In *Empirical Foundations of Household Taxation*, edited by Martin Feldstein and James M. Poterba. Chicago: University of Chicago Press.

Eissa, Nada, and Hilary Hoynes. 2004a. "Taxes and the Labor Market Participation of Married Couples: The Earned Income Tax Credit." *Journal of Public Economics* 88 (9–10): 1931–1958.

Eissa, Nada, and Hilary Hoynes. 2004b. "The Hours of Work Response of Married Couples: Taxes and the Earned Income Tax Credit." In *Tax Policy and Labor Market Performance*, edited by Jonas Agell and Peter Birch Sørensen. Cambridge, MA: MIT Press.

Eissa, Nada, and Jeffrey B. Liebman. 1996. "Labor Supply Response to the Earned Income Tax Credit." *Quarterly Journal of Economics* 111 (2): 605–637.

Feldstein, Martin, and Daniel R. Feenberg. 1996. "The Taxation of Two-Earner Families." In *Empirical Foundations of Household Taxation*, edited by Martin Feldstein and James Poterba. Chicago: University of Chicago Press.

Feenberg, Daniel Richard, and Elizabeth Coutts. 1993, Winter. "An Introduction to the TAXSIM Model." *Journal of Policy Analysis and Management* 12 (1): 189–194. Available at http://www.nber.org/taxsim/.

Internal Revenue Service (IRS). 2011. "General Description Booklet for the 2007 Public Use Tax File." Compiled by Victoria Bryant. Individual Statistics Branch, author, Washington, DC. Available from http://users.nber.org/~taxsim/gdb/gdb07.pdf.

King, Miriam, Steven Ruggles, J. Trent Alexander, Sarah Flood, Katie Genadek, Matthew B. Schroeder, Brandon Trampe, and Rebecca Vick. 2010. Integrated Public Use Microdata Series (IPUMS), Current Population Survey (CPS): Version 3.0. [Machine-readable database]. Minneapolis: University of Minnesota.

LaLumia, Sara. 2008. "The Effects of Joint Taxation of Married Couples on Labor Supply and Non-wage Income." *Journal of Public Economics* 92: 1698–1719.

McCaffery, Edward. 1999. *Taxing Women*. Chicago: University of Chicago Press.

Meyer, Bruce D., and Dan T. Rosenbaum. 2001. "Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers." *Quarterly Journal of Economics* 116 (3): 1063–1114.

Schulman, Karen, and Helen Blank. 2012. "Downward Slide: State Child Care Assistance Policies 2012." National Women's Law Center (NWLC) Report, NWLC, Washington, DC. Available at http://www.nwlc.org/resource/downward-slide-state-child-care-assistance-policies-2012.

Rohaly, Jeff. 2007. "Reforming the Child and Dependent Care Tax Credit." Tax Policy Center Report. Tax Policy Center, Urban Institute and Brookings Institution, Washington, DC. Available at http://www.urban.org/publications/411474.html.

Tax Policy Center. 2012, November 20. "Historical EITC Recipients." Tax Policy Center, Urban Institute and Brookings Institution, Washington, DC. Available at http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=37&Topic2id=40&Topic3id=42.

———. 2013, January 28. "Historical EITC Recipients." Tax Policy Center, Urban Institute and Brookings Institution, Washington, DC. Available at http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=36.

Triest, Robert K. 1990. "The Effect of Income Taxation on Labor Supply in the United States." *Journal of Human Resources* 25 (3): 491–516.

U.S. Census Bureau. 2011. "Who's Minding the Kids? Child Care Arrangements: Spring 2010—Detailed Tables." Author, Washington, DC. Available at http://www.census.gov/hhes/childcare/data/sipp/2010/tables.html.

U.S. Department of Agriculture (USDA). n.d. "Supplemental Nutrition Assistance Program." Available at http://www.fns.usda.gov/snap/applicant_recipients/eligibility.htm.

U.S. Department of Health and Human Services (HHS). 2012, September 19. "Characteristics of Families Served by Child Care and Development Fund (CCDF) Based on Preliminary FY 2011 Data." Office of Child Care, author, Washington, DC. Available at http://www.acf.hhs.gov/programs/occ/resource/characteristics-of-families-served-by-child-care-and-development-fund-ccdf.

U.S. Department of Labor. 2012. "2012 National Compensation Survey Publications List: Employee Benefits in the United States, March 2012." Bureau of Labor Statistics, author, Washington, DC. Available at http://www.bls.gov/ncs/ncspubs_2012.htm.

THE HAMILTON PROJECT

ADVISORY COUNCIL

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.

THE HAMILTON PROJECT

1775 Massachusetts Ave., NW
Washington, DC 20036

(202) 797-6484

BROOKINGS

Printed on recycled paper.

WWW.HAMILTONPROJECT.ORG