

## *Executive Summary*

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Over the past two decades, Americans have reached a consensus on eliminating the barriers that stand in the way of working individuals climbing out of poverty. This consensus has been expressed in a number of policy changes that would have seemed impossible in the 1970s: the historic federal tax reform in the 1980s, which reduced marginal rates and eliminated federal income taxes on millions of low-income workers; welfare reform in the 1990s, which changed the fundamental paradigm of welfare that had trapped far too many individuals in a cycle of dependency; and a growing number of smaller experiments that support, through education, training, daycare assistance, transportation, and other needs, the path of a struggling person into the working world, and from there toward the American dream.

### **PAYROLL TAXES: THE PUNISHMENT OF THE WORKER**

Unfortunately, while we have eliminated the most obvious barriers towards working out of poverty, we have inadvertently increased other barriers. These notably take the form of extremely high payroll taxes. These payroll taxes—including unemployment insurance, federal unemployment taxes, OASDI taxes on both the employee and the employer, and Medicare taxes—provide a punishing disincentive to working for those who are trying to climb the ladder into the middle class. Because the effects of these taxes are largely unexamined, many people are unaware of the negative effects they have on workers. Figure 1, “The Workers’ Share of Labor Costs,” on page 7, shows how a married worker making just \$20,000 per year receives only 76% of the labor costs incurred by his or her employer:

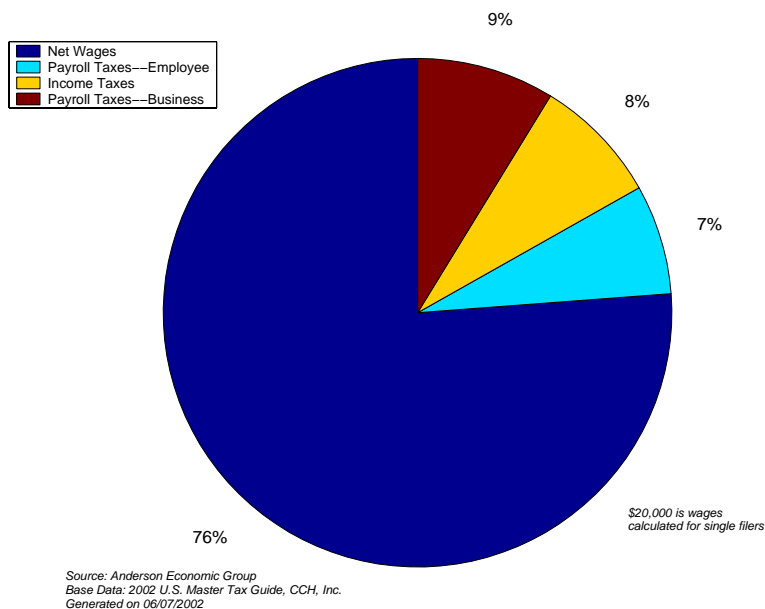
The size of the burden is striking—and the largest share of that burden is payroll taxes, not income taxes. Total payroll taxes on a worker earning just \$5000 per year in Michigan often exceed 22%. Workers earning above \$80,000 per year, however, have a payroll tax burden that drops to 2.9%. While high-income workers pay extremely high federal income tax rates, it is difficult to justify payroll taxes that are *seven times* higher for low-income workers as for high-income workers.

### **THE EARNED INCOME TAX CREDIT**

One powerful way of addressing these punishing disincentives is through an earned income tax credit (EITC). An EITC is exactly that: a *credit* for *income earned*, which is available to workers at the lower end of the income scale. An EITC offsets most or all of the payroll taxes borne by a worker earning a wage around the poverty level, and then phases out as their income increases.

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FIGURE 1. The Workers' Share of Labor Costs



Thus, the EITC is a pro-work, pro-family measure. It provides no benefit to an individual who chooses not to work—but a big boost for someone who, of their own initiative, goes out to work. Many states are now considering increasing the incentives to work through the federal EITC, by adding on a state EITC. This state EITC can offset some of the disincentives to work created by state and local payroll taxes, as well as state and local income taxes. As President Ronald Reagan, who signed into law an EITC expansion in 1986, once stated, the EITC is “the best anti-poverty, the best pro-family, the best job-creation measure to come out of Congress.”<sup>1</sup>

1. "Sweeping Tax Overhaul Now the Law," *Chicago Tribune*, October 23, 1986; cited in Nicholas Johnson, *A Hand Up*, Washington DC, Center for Budget and Policy Priorities, 1999, p. 3.