Family Matters: Pennsylvania's 100% Marginal Income Tax Rate

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According to the National Taxpayers Union, the U.S. Tax Code includes 3,951,104 words. It is more than twice the length of the entire works of Shakespeare (Keating, 2014). Not that I have read the entire works of Shakespeare; not that I have read the entire U.S. Tax Code.

When I file my Form 1040, I have the assistance of 206 pages of instructions. Not that I took the time to read even this, a much shorter document.

The National Taxpayers Union estimates that the nation's economy loses an annual $224 billion and 6.1 billion hours of productivity as a result of the burden of compliance with our complex tax code (Keating, 2014). It is no wonder that every recent election cycle has included proposals to simplify our tax system.

If you are concerned that the tax code is too complicated for you to understand, be assured that the IRS often gets it wrong as well. According to the inspector general's report, the Internal Revenue Service issued more than $11 billion in faulty refunds through its Earned Income Tax Credit (EITC) in Fiscal Year 2012 (Treasury Inspector General for Tax Administration, 2013). The evidence suggests that the EITC overpayment error rate is more than 23% (Cook, 2012).

In spite of the wisdom and foresight of our elected political leaders, it should not surprise you that the four million words of the tax code cause certain unforeseen consequences. As the government uses tax policy to incentivize certain behaviors and disincentivize others, some unfortunate and unforeseen consequences have developed. The issues can become exponentially more troubling when the federal code is placed alongside the tax laws of our various states, counties, and municipalities.

This paper will consider the Pennsylvania Tax Forgiveness program, particularly focusing on the high phase-out rate in the context of the federal EITC program, which for some taxpayers phases out at overlapping levels of income. At first look, it seems as if this is a unique Pennsylvania issue, as Pennsylvania is the only state that has designed a Tax Forgiveness program. Although this paper focuses on the particular numbers as they relate to this confluence in the state of Pennsylvania, the issues are not unique here, as there are 25 other states, the District of Columbia, one county, and one city (Internal Revenue Service, 2014) that juxtapose their own EITC alongside the federal program, causing more pronounced phase-out rates.

The Pennsylvania income tax is unique as a result of the statement in the Constitution of the Commonwealth of Pennsylvania that "all taxes shall be uniform, upon the same class of subjects …." Early attempts to enact a state income tax were found to be unconstitutional by the application of this requirement. A 1935 attempt included graduated tax rates (overturned by Kelley v. Kalodner). More recently, the original 1971 income tax was found to be unconstitutional (as overturned by Amidon v. Kane, in a 5 to 2 decision), in spite of the fact that this law had avoided graduated rates. According to this short-lived proposal, "taxable income" (as quantified by the federal "taxable income") would have been taxed at a flat rate of 3.5%. The commonwealth's Supreme Court, however, ruled that this also violated uniformity. The text of the decision demonstrated that three families earning the same amount of gross income might have very different "taxable incomes," and hence, non-uniform state tax rates because of differing federal deductions and exemptions. "The effect of the Personal Income Tax in these illustrative situations is entirely nonuniform by imposing differing tax burdens upon persons enjoying identical privileges." Taxpayers who had more federal deductions would pay a lower rate (as compared to a percentage of their gross income) than those who had fewer federal deductions, hence, violating uniformity. The effect of overturning the tax legislation was a quick recrafting of the law, resulting in an income tax that is a flat tax based (more or less) on total income, with few deductions or exemptions. The current flat rate is 3.07%.

Based on the uniformity phrase of the constitution which includes the caveat, "… upon the same class of subjects …." the General Assembly, several years later, enacted a Tax Forgiveness program to reduce the tax burden on those with lower incomes. In particular, for the tax year 1974 and thereafter, the General Assembly deemed that a separate class of subjects would be defined for taxation to reduce the burden of those living in poverty, establishing the Tax Forgiveness program. "A claimant who meets the standards of eligibility set forth in this chapter is subject to a separate class of taxation and entitled to the benefit of the special tax provisions…" lest "the imposition of the personal income tax on such persons would deprive them and their dependents of the basic necessities of life" (Pennsylvania General Assembly, 1974). By defining this special "poverty" class, the legislators were able to get around the non-uniformity of taxes that this special provision created.

Taxpayers who have less than the defined amount of income (which varies according to the number of dependents) are granted a full 100% Tax Forgiveness. Immediately above that threshold, for each additional $250 of income, the taxpayer's Tax Forgiveness calculation is reduced by 10%. Hence, taxpayers who are over the income limit by less than $250 will be granted a partial 90% Tax Forgiveness; those who are over the limit by an amount between $250 and $500 will receive a partial 80% Tax Forgiveness, etc.

To understand both the federal EITC and the Pennsylvania Tax Forgiveness programs, it is essential to consider the phase-out rate for these tax policies. The phase-out rate quantifies the rate at which a taxpayer loses part of the benefit when the income begins to exceed a given amount. It would be inappropriate if, because of only $1 too much in income, an individual lost a $1,000 credit. There needs to be a reasonable phase-out strategy. Before looking at the Pennsylvania Tax Forgiveness phase-out rate, this will be discussed first from the federal EITC perspective, because this has received more attention in the public arena.

The EITC is (at least in part) a refundable credit, so that a qualifying individual can potentially receive a refund in excess of the amount of tax withholdings. This is not true for the Pennsylvania Tax Forgiveness program. For the sake of example, the following numbers (Hungerford & Thiess, 2013) assume that a couple is married, filing jointly, with two dependent children. Because the EITC is a refundable credit, their tax rate for their first job earnings of the year will be a negative amount. On the basis of these first earnings, they would qualify for more tax credits than their tax withholdings. Their tax rate would be negative 55%. For every dollar earned, their income tax filing would result in 55 cents of tax refund, above and beyond the refund of any tax withholdings. As their earnings increase, the numbers would even out, so that their tax rate would become zero at the point where their EITC equals their assessed taxes.

The matter of particular focus here deals with the phase-out rate. As earnings increase to a higher level, individuals approach the top allowable income that would still qualify for some EITC, and the phase-out rate of the EITC comes into play. The phase-out rate of the EITC means that for these additional earnings, taxpayers are paying a higher federal income tax rate than almost anyone in the country, as the EITC is gradually reduced and finally eliminated. The EITC phases out at a rate of 21.06%, while at the same time the assessed income tax is increasing the tax due amount at a rate of 15%. Consequently, for these taxpayers at the phase-out levels of the EITC, they are effectively paying a tax rate of 36.06% on that particular margin of their earnings. If they accept Saturday overtime work, their extra earnings would be reduced substantially, just to cover the federal income tax, not to mention Social Security and Medicare withholdings as well as state and local income taxes.

If you are wondering about the EITC that enables some taxpayers to see their income tax credit be an income item rather than their tax liability being an expense, you should understand that the EITC was signed into law by Gerald Ford and considerably expanded under Ronald Reagan. The logic of these Republicans was that the EITC incentivizes work, in contrast to other welfare programs that disincentivize work. As low income workers earn more income, their EITC first increases (up to a certain limit, when the phase-out begins). The EITC is the largest cash assistance program for low-income families (Joint State Government Commission, 2009). As a result of the EITC, about half of US households now pay no federal income taxes (Cook, 2012).

Most research suggests that the EITC does successfully incentivize work, as it increases labor force participation among single mothers. For those already working, however, there is mixed evidence. The Bipartisan Policy Center (2010) warned that the EITC can discourage work among those with incomes in the phase-out range. Most evidence, however, suggests that this high marginal tax rate in the EITC phase-out range has little negative effect on labor supply. This could be due to most workers being unaware of the EITC tax consequences when making their labor market decisions.

But now it gets even worse. The Pennsylvania Tax Forgiveness program also has a phase-out rate, but one that is considerably higher than the EITC phase-out rate. The Joint State Government Commission reported, “A conspicuous feature … is its drastic phaseout rate” (2009). They were evaluating the phase-out rate at the micro level, where one dollar too much in income could cost a taxpayer $100 (or more) of tax forgiveness money. The following analysis, however, considers the macro level, or the effect of $2,500 of increased income, which will, in some cases, cause a taxpayer to move from 100% tax forgiveness to 0% tax forgiveness.

Returning to our example family, married with two children, the phase-out rate of the Pennsylvania Tax Forgiveness program is 42.4% (see Table 1). As their income increases from the amount that qualifies for a 100% Tax Forgiveness to the amount that qualifies for no Tax Forgiveness, their increased earnings at that margin of $2,500 would result in an increase in the Pennsylvania income taxes of $1,059. A family with three children would pay a phase-out rate of 54%. A family with seven children, with income at the critical range, would pay a phase-out rate of 100.7%. For an increase in earnings of $2,500, they would owe an additional $2,517 in state taxes (not to mention the other payroll taxes).

If the commonwealth chooses to use the Tax Forgiveness program, there will of necessity be some income thresholds and some phase-out rate. The current phase-out rates have worsened, however, as both the qualifying income limits and the commonwealth tax rate have increased. The result is that the 10% graduated cuts in Tax Forgiveness do, in some cases, exceed the amount of increased income, resulting in a marginal tax rate that is above 100%.

Table 1: Pennsylvania Tax Forgiveness Phase-Out Rates

Number of Children	Income at 100% Tax Forgiveness	PA State Income Tax	Income at 0% Tax Forgiveness	PA State Income Tax	Phase-Out Rate
0	$ 13,000	$ 0	$ 15,500	$ 476	19.0%
1	$ 22,500	$ 0	$ 25,000	$ 768	30.7%
2	$ 32,000	$ 0	$ 34,500	$ 1,059	42.4%
3	$ 41,500	$ 0	$ 44,000	$ 1,351	54.0%
4	$ 51,000	$ 0	$ 53,500	$ 1,642	65.7%
5	$ 60,500	$ 0	$ 63,000	$ 1,934	77.4%
6	$ 70,000	$ 0	$ 72,500	$ 2,226	89.0%
7	$ 79,500	$ 0	$ 82,000	$ 2,517	100.7%

Because the income limits for the Pennsylvania Tax Forgiveness and the limits for the federal EITC overlap, the phase-out rate for the state taxes needs to be combined with the phase-out rate for the EITC to understand the magnitude of the overall marginal tax rate. These taxpayers, who make just enough money so that they are no longer considered by the commonwealth's General Assembly to be within the class of people deemed to be in poverty, will experience a marginal tax rate that could approach or exceed 100%. Although they thought they would be getting a $2,500 raise, all of that money (and more) could end up being part of their tax bill as they experience the simultaneous phase-out of the EITC and the Pennsylvania Tax Forgiveness.

A family of five is used here as an illustration (Larger families do qualify for increases in Pennsylvania Tax Forgiveness, but families larger than five do not receive any increase in the

EITC.). An increase in family income from $41,500 to $44,000, an increase of $2,500 in gross wages, will result (based on 2013 tax rates) in a total increased tax burden of $2,344. This includes $777 in federal income taxes (largely because of the phase-out of the EITC), $1,351 in Pennsylvania income taxes (largely because of the phase-out of the Tax Forgiveness eligibility), $25 in local wage taxes (though much more in some locales in the commonwealth), and $191 in Social Security and Medicare taxes. As a result, the wage increase of $2,500 would net the family only $156 after increased taxes. This represents a marginal tax rate of 93.8%.

In some working-class families with small children, a full-time stay-at-home parent might make a decision, because of financial pressures, to take on a part-time job at minimum wage to increase the family resources. If the increase in family income of $2,500 fell at the critical threshold to qualify for Pennsylvania Tax Forgiveness as used in the previous example, and if it came from a part-time job at minimum wage ($7.25), the part-time employee would actually be bringing home only $0.45 per hour after the 93.8% marginal tax rate.

It has been noted by many that joining the work force, even part-time, often necessitates additional personal expenditures, such as increased transportation costs, increased clothing costs, and, due to the reduction in domestic flexibility, increased restaurant costs. If indeed our sample family fails to recognize the steep tax burdens of their new income, they could easily experience a decline in their family financial situation because of the new employment. Families who recognize that their income places them at these critical levels will understand that the 93.8% marginal tax rate disincentivizes their additional labor.

The current Pennsylvania Tax Forgiveness program results in phase-out rates that are sometimes above 100%. Our lawmakers need to reevaluate the current phase-out rates, perhaps reducing the Tax Forgiveness in 5% increments rather than the current 10% increments.

As it exists, this marginal tax bracket arguably represents the highest tax bracket in the American income tax system. It raises questions about disincentives to work for some working-class Americans. It also raises questions about decisions that parents make as they seek to be strong role models and responsible citizens. Sometimes an increase in income can come at too high a cost.

Although the EITC and the Pennsylvania Tax Forgiveness programs were developed to assist working families, the conjunction of their phase-out rates creates the highest marginal tax rate in the country. Such unintended consequences need to be addressed to create a more uniform tax system.

One Proposal for Change

The General Assembly has defined the class of poverty in Pennsylvania for the purposes of the Tax Forgiveness program in a manner that is unrelated to federal guidelines (see Table 2). In order to qualify for 100% Pennsylvania Tax Forgiveness, a married couple without children would have to have an income 16.2% below the federal poverty level (Office of The Assistant Secretary for Planning and Evaluation, 2013). A married couple with one child would qualify for 100% Tax Forgiveness with an income 15.2% above the federal poverty level. A married couple with three children would qualify with an income 50.5% above the federal poverty level. The commonwealth's definition of poverty, therefore, is not uniform when compared to the federal guidelines. If the commonwealth defined poverty using the federal standards, couples without children would receive some additional Tax Forgiveness benefit, while couples with children would receive a lower Tax Forgiveness benefit.

If the commonwealth adopted the federal definition of poverty, the resulting reduction in Tax Forgiveness benefit for couples with children would allow the commonwealth to use a lower phase-out rate without losing any tax revenue. For example, instead of forgoing 10% of Tax Forgiveness for each additional $250 in income, the increment could be changed to a 5% reduction of Tax Forgiveness for each additional $250 in income.

Table 2: A Comparison of Federal and State Poverty Guidelines

Number of Children	Poverty Defined by Federal Guidelines	Poverty Defined by Pennsylvania Tax Forgiveness	Pennsylvania Definition of Poverty as Compared to Federal Guidelines
0	$ 15,510	$ 13,000	83.8%
1	$ 19,530	$ 22,500	115.2%
2	$ 23,550	$ 32,000	135.9%
3	$ 27,570	$ 41,500	150.5%
4	$ 31,590	$ 51,000	161.4%
5	$ 35,610	$ 60,500	169.9%
6	$ 39,630	$ 70,000	176.6%
7	$ 43,650	$ 79,500	182.1%

Simultaneously adopting these two changes would dramatically reduce the phase-out rates noted in this paper. In the current system, the Pennsylvania Tax Forgiveness phase-out rates are 19% (with no children) increasing to 100.7% (with seven children). Using these two proposed changes, the phase-out rates (see Table 3) would vary from 12.6% (with no children) to 29.9% (with seven children). These lower phase-out rates would create less concern about disincentivizing labor among the working class in the commonwealth. Overall, these changes would somewhat increase the tax revenues for the commonwealth because of the use of the federal definition for poverty, rather than using the very generous definition that is used in the commonwealth under the current system. The one exception is that couples without children would pay somewhat less tax, because the commonwealth's definition for these individuals is currently more stringent than the federal guidelines.

Table 3: A Comparison of Current and Proposed Phase-Out Rates for the Pennsylvania Tax Forgiveness

Number of Children	Current Phase-Out Rate	Phase-Out Rate under Proposed Changes
0	19.0%	12.6%
1	30.7%	15.1%
2	42.4%	17.5%
3	54.0%	20.0%
4	65.7%	22.5%
5	77.4%	24.9%
6	89.0%	27.4%
7	100.7%	29.9%

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