**IRET Congressional Advisory**

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# GRAMM PROPOSAL ILLUSTRATES DIFFICULTY IN STRUCTURING MARRIAGE PENALTY RELIEF

The marriage penalty in today's income tax code has emerged recently as a major political topic. Senator Phil Gramm (R-Texas) introduced a proposal to aid those hurt by the penalty and attached it to the failed Tobacco Settlement Bill. Despite the demise of that legislation, the issue will not fade. In constructing future marriage penalty relief plans, the Gramm proposal illustrates a number of what-not-to-do's from an economic standpoint.

His proposal would have granted an additional deduction of $3,300, phased-in over ten years, to all couples with adjusted gross incomes (AGI) below $50,000. While providing relief for some couples currently hurt by the existing marriage penalty, the deduction would have withheld relief from many couples hurt by the marriage penalty, given aid to many couples already receiving a marriage bonus, and created severe work and saving disincentives for couples in a moderate income range. The deduction's structure would have damaged the economy.

Couples subject to a marriage penalty have higher tax liability than if they were two single people with the same income. Those likely to be hurt are two-income couples whose incomes are roughly comparable, that is, each spouse contributes between 30% and 70% of the couple's income. Two-earner couples with less-equal earnings may receive a marriage bonus. Their tax liability is less than that of two single workers with corresponding incomes. One-earner couples receive a marriage bonus as well. Their tax is less than that of a single worker with the same income as the working spouse.

Marriage penalties and bonuses stem from the fact that the tax brackets and the standard deduction for married couples filing jointly, while larger than for single taxpayers, are not fully twice as large. For example, two single taxpayers would each be entitled to a standard deduction of $4,250, for a total of $8,500, versus a standard deduction for a married couple of $7,100. Furthermore, two single taxpayers, each earning $30,000, would find all of their taxable income falling within the 15% tax bracket; filing jointly, some of their combined taxable income would likely be taxed at 28%. Consider two taxpayers with no children and claiming the standard deduction. As singles, they would each pay $3457.50 in income taxes for a total of $6915. As a couple, they would pay $7794, meaning that marriage would cost them $879.50 in added income tax.

> ***Marriage penalties and bonuses... [occur because] the tax brackets and the standard deduction for married couples filing jointly, while larger than for single taxpayers, are not fully twice as large.***

The marriage penalty does more than take extra tax money from two-worker couples. As illustrated above, it often increases the marginal tax rate on additional wage and saving income that the couple might earn, compared to the marginal tax rate the couple would have faced as individuals. The higher tax rate, regrettably, discourages work and saving, damaging family income and reducing economic output. Any good fix for the marriage penalty would reduce the higher marginal tax rates that the penalty imposes on income-earning activity.


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Senator Gramm's proposal would not have assisted the couple described above because the extra deduction would have been income-tested. When the couple's income hit $50,000, they would have lost the deduction. Only couples with incomes below that threshold would have been eligible for the deduction, regardless of whether they suffered a marriage penalty or enjoyed a marriage bonus. While the Gramm proposal would have bestowed assistance on many couples already receiving marriage bonuses, its low cut-off point would have excluded the very couples pushed up the progressive rate schedule by marriage.

> ***While providing relief for some couples...hurt by the...marriage penalty, the deduction would have withheld relief from many [other] couples...given aid to many couples already receiving a marriage bonus, and created severe work and saving disincentives for couples in a moderate income range.***

Furthermore, Senator Gramm's plan would have created a marginal tax rate "cliff" for both spouses in couples near the $50,000 income cap. Couples, whether they consist of one or two workers, would have had little or no incentive to work additional hours as their combined AGI approached $50,000 because they would have risked losing a substantial deduction. The sudden cut-off would have made it possible for a couple to earn additional before-tax income from extra work or saving and end up losing income after taxes.

> ***Senator Gramm's plan would have created a marginal tax rate "cliff" for both spouses in couples near the $50,000 income cap...[making] it possible for a couple to earn additional before-tax income from extra work or saving and end up losing income after taxes.***

Take, for example, a couple with $49,750 in taxable income. A modest $500 in extra pay to either spouse or additional interest or dividend income would push them over the $50,000 threshold, causing them to lose their deduction. Despite the $500 in additional earnings, the couple actually would lose $108.25 in after-tax income. The added income would effectively be taxed at a marginal rate of 122%.

Likewise, a one dollar income increase from $49,999.50 to $50,000.50 in AGI, would cause a couple to pay an additional $495.15 in income taxes, an effective marginal tax rate of 49,515%. The proposal would not have changed the marginal tax rate of couples with earnings below $50,000 in taxable income prior to the Gramm deduction and greater than $3,300. Although their tax bill would have fallen, an extra dollar of income would have been taxed at the same rate as before.

The increases in marginal tax rates, where they occur, reduce incentives for couples close to the $50,000 limit to earn beyond that. The result is a decreased supply of labor, which reduces aggregate production in the economy.

The Economic Recovery Tax Act of 1981 provides an example of a superior approach to marriage penalty relief. Unfortunately, Congress repealed the provision in the Tax Reform Act of 1986. The 1981 provision reduced the marriage tax's dollar impact while improving work incentives by excluding from taxable income ten percent of the first $30,000 of wages or salary of the lower earning spouse (maximum exclusion $3,000). The exclusion was not eliminated at higher income levels; it was simply capped at $3,000. If the lower earning spouse had $30,000 or less in wages, his or her marginal tax rate was effectively lowered by 10% (e.g., from 15% to 13.5%, from 28% to 25.2%, from 36% to 32.4%, or from 39.6% to 35.64% in terms of today's tax brackets). The provision did not affect

the marginal income tax rate of the higher-earning spouse. For couples in which both spouses had earnings above $30,000, marginal tax rates were neither reduced nor increased, but they still experienced a reduction in total tax. Because the provision reduced marginal tax rates for some workers and raised them for none, it modestly increased work incentives and labor supply.

Neither the structure of the deduction in Senator Gramm's proposal nor its phase-out makes good economic sense. The fixed deduction would have extended benefits to many couples not suffering a marriage penalty while failing to lower marginal tax rates. Reducing the extra deduction to zero when income exceeded $50,000, which would have penalized many medium-income couples if they earned extra income, would have had grave consequences on the margin for many couples. In today's competitive job market and global economy, fiscally punishing couples for working extra hours can only hurt the labor market.

Ultimately, the solution to the marriage penalty is to enact a flat rate tax with fixed exempt amounts per person. Until then, care must be taken in designing marriage penalty relief to target those truly injured and to avoid enacting disincentives to earn additional income.

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*Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.*