An LAO Report

Californians and the Marriage Penalty

Background

- The so-called "marriage penalty" has been the focus of considerable attention and interest in recent years.
- Simply expressed, the marriage penalty arises when the income tax liability for a married couple is greater than the spouses' combined liabilities would be were they single.
- In August, Congress passed a provision to reduce the penalty as part of the Tax Reduction Act of 1999. However, the act was vetoed in September by the President.

LAO Findings

- The federal marriage penalty is not the result of any conscious policy decision. Rather, it is the result of trying to achieve three conflicting tax-policy objectives—equal treatment of individual taxpayers, marriage neutrality, and progressive taxation.
- The key determinant of marriage penalties is spousal income differences. The more similar their incomes, the greater the penalty.
- Nationally, over 40 percent of married couples currently incur the penalty, which averages about $1,400 per couple. However, even more couples—over 50 percent—receive federal marriage bonuses, totaling several billion dollars more than the marriage penalties.
- While the likelihood of Californians facing federal marriage penalties is less than nationally, Californians pay a disproportionately large share of such penalties.
- California's own income tax system generally avoids marriage penalties. Most people, in fact, receive bonuses.

LAO Considerations

- The Legislature may wish to review its tax policy objectives regarding the treatment of married couples, including its views on the appropriateness of marriage penalties and bonuses.
- It could then (1) consider whether any of California's specific tax provisions that create penalties and bonuses should be modified, and (2) evaluate whether federal marriage-related tax proposals are consistent with its own objectives.

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INTRODUCTION

The so-called "marriage penalty" inherent in the federal personal income tax (PIT) system has been the focus of considerable attention in recent years on the part of policy makers, economists, and the public at large. Simply expressed, the marriage penalty arises when the income tax liability for a married couple is greater than the spouses combined liabilities would be were they single. Figure 1 displays the typical manner in which a marriage penalty can occur. In this example, the tax liability of the illustrative married couple is greater than the spouses' combined single tax liabilities, resulting in a marriage penalty of $1,470.

The marriage penalty has become increasingly prevalent in recent years, as the percent of married couples where both spouses work has risen and average earnings differentials between spouses have diminished. Numerous proposals have been introduced over the years in Congress to eliminate or lessen the marriage penalty. The most recent legislation was passed by Congress in early August when it adopted the Tax Reduction Act of 1999. However, the measure was vetoed. Thus, the marriage penalty continues to remain in place, the subject of ongoing debate and reform proposals.

This report examines the marriage penalty. It first discusses the inherent dilemma facing policy makers seeking to deal with the marriage penalty. It then addresses the fiscal effects of the marriage penalty in the aggregate as well as on different types of individual taxpayers. The report then examines the causes of the marriage penalty and also reviews the various past and current proposals that have been made to modify or eliminate it. It then looks at the marriage penalty from the perspective of California, including the effects of the federal marriage penalty on Californians, and the extent to which California itself imposes a marriage penalty on its citizens through its own PIT system. Lastly, it considers actions the Legislature may wish to take in response to the issues raised by the marriage penalty.

Figure 1

Illustrative Marriage Penalty Example—Equal Incomes

	Federal Income Tax Liabilities			
	Individual Situations		Combined Situation	
	Person 1	Person 2	Unmarried	Married
Gross Income	$35,000	$35,000	$70,000	$70,000
Less:				
Standard deduction	4,250	4,250	8,500	7,100
Personal exemption	2,700	2,700	5,400	5,400
Equals:				
Taxable income	$28,050	$28,050	$56,100	$57,500
Tax Liability	$4,566	$4,566	$9,132	$10,602
Marriage Penalty				**$1,470**

THE INHERENT DILEMMA FACING POLICY MAKERS

At the outset, it is important to stress that the existence of marriage penalties in our federal income tax system is not due to any intention to discourage or penalize marriage itself. Rather, it is the result of trying to simultaneously achieve three conflicting, and ultimately irreconcilable, tax-policy principles and goals. These are:

- ***Equal Treatment of Married Couples.*** This principle holds that married couples with the same total income should pay the same income tax, regardless of how the earnings are split between the two spouses.
- ***Marriage Neutrality.*** The principle here is that the combined income taxes of two people should be independent of their marital status.
- ***Progressive Taxation.*** This principle holds that as a taxpayer's income increases, a greater proportion of this income should be paid in taxes.

Our present federal tax system currently achieves the first and third objectives. However, marriage neutrality is lacking, since marriage-based differentials in tax liabilities can occur in certain cases; and as we shall see, these marriage differentials can take the form of both marriage penalties and bonuses. Eradicating the marriage differentials of our current system requires either treating married couples with the same income differently, and/or sacrificing the principle of progressive taxation.

Federal policy makers have addressed these tax policy goals in various ways since the income tax was first established in 1913. Generally, their approach has resulted in policies which satisfy the principle of progressive taxation, but have shifted back and forth between satisfying either marriage neutrality or equal treatment of married couples. Figure 2 (see page 4) summarizes the major shifts in federal tax policy that have occurred over the years regarding the treatment of married couples. (Additional details regarding these changes are provided in Appendix A.)

THE MARRIAGE PENALTY TODAY

How Pervasive Is Our Federal Marriage Penalty?

Figure 3 (see page 5) provides information on the prevalence of the federal marriage penalty in our country today, based on a 1997 Congressional Budget Office (CBO) analysis of the tax returns of U.S. joint-return married taxpayers. (The shaded box on page 4 comments on the extent to which other countries impose marriage penalties.)

Figure 3 indicates that marriage penalties currently are imposed on a significant share and number of couples in the country. In 1996, for example, approximately 21 million couples (42 percent of married filers) incurred marriage penalties averaging nearly $1,400. Thus, in the aggregate, the marriage penalty cost these taxpayers $29 billion. It also should be noted that the marriage penalty affects more people today than ever before. As discussed below, this is because two-earner households have become increasingly common, and the average earnings differentials between spouses has tended to narrow over time.

Less publicized, however, is the fact that marriage

Figure 2

History of Key Federal Marriage-Related Tax Developments

1913 Through 1999

1913	Federal personal income tax established, based on individual filing.
1918	Married couples first allowed to file joint returns.
1930	Income splitting between spouses permitted in community property states.
1948	All married couples allowed to file jointly using separate tax schedule, thereby eliminating inter-couple inequities.
1951	Income splitting benefits extended to heads-of-households.
1969	Tax-schedule revisions, including separate tax table for couples, produce marriage penalties for couples with similar incomes.
1975	Earned Income Tax Credit (EITC) created, causing marriage penalties for some couples and bonuses for others.
1981	New 10 percent second-earner deduction reduces marriage penalties for some couples and increases bonuses for others.
1986	Marriage penalties sharply reduced through fewer tax brackets and lower marginal tax rates.
1990-93	Marriage penalties increase for many couples, due to more brackets and higher marginal tax rates.
1995	Congressional provision vetoed to reduce marriage penalties by doubling joint-return standard deduction.
1999	President vetoes Congressional doubling of joint-return standard deduction and broadening width of 15 percent joint-return tax bracket intended to lessen marriage penalties.

Do Other Countries Have Marriage Penalties?

Currently, only a few developed nations levying personal income taxes have marriage penalties. For example, over two-thirds of the nearly 30 member countries of the Organisation for Economic Cooperation and Development (OECD) tax spouses as individuals and four others use families as the taxable unit, thereby avoiding imposition of marriage penalties. Furthermore, the trend over the past 20 years has been to move away from imposing marriage penalties, as ten OECD nations have switched from joint to individual taxation of married couples and none has done the opposite. At present, only four member nations (Germany, Norway, Ireland, and the United States) tax couples jointly, thereby potentially being susceptible to imposing marriage penalties.

bonuses also are widespread. Specifically, as Figure 3 shows, CBO estimated that another 25 million couples (51 percent of married filers) received marriage bonuses in 1996. These bonuses averaged $1,300, reducing their aggregate income tax liabilities by approximately $33 billion below what they would have paid had they been single. Thus, both in number and aggregate dollar magnitude, marriage bonuses actually are *more* common at the federal level today than marriage penalties.

As shown in Figure 3, the incidence of marriage penalties rises with income level, while generally the opposite is true in the case of marriage bonuses. For example, over half of married taxpayers with aggregate incomes over $50,000 are penalized, versus about 12 percent for incomes under $20,000. In contrast, while nearly two-thirds of couples with incomes under $20,000 receive bonuses, far less than half with incomes over $50,000 do.

What Causes Marriage Penalties and Bonuses?

The most important factor affecting marriage penalties and bonuses is the distribution of income within the marriage. Generally, when incomes within the marriage are similar, a marriage *penalty* will occur, as shown in Figure 1 (see page 2). All other factors being equal, the largest marriage penalty will occur when incomes within the marriage are equal.

On the other hand, a marriage *bonus* occurs when a couple's individual incomes are different. Figure 4 (see page 6) shows a situation similar to

Figure 3

Prevalence of the Federal Marriage Penalty[a]

	Level of Adjusted Gross Income				
	Less than $20,000	$20,000 to $50,000	$50,000 to $100,000	More than $100,000	All Income Levels
Number of Married Taxpayers (*In Millions*)					
With penalty	1.1	8.1	9.0	2.7	20.9
With bonus	5.8	10.0	7.2	2.3	25.3
Unaffected	2.3	0.3	0.5	—	3.1
Total for income group	9.2	18.4	16.7	5.0	49.3
Share of Married Taxpayers (*Percent*)					
With penalty	12.0%	44.1%	53.9%	54.0%	42.4%
With bonus	63.0	54.3	43.1	46.0	51.3
Unaffected	25.0	1.6	3.0	—	6.3
Total for income group	100.0%	100.0%	100.0%	100.0%	100.0%
Average penalty or bonus *(In Dollars)*					
With penalty	$770	$1,190	$1,240	$2,640	$1,380
With bonus	680	870	1,880	2,970	1,300
Aggregate Penalties and Bonuses (*In Billions*)					
Penalties (increased liabilities)	$0.9	$9.6	$11.1	$7.2	$28.8
Bonuses (decreased liabilities)	-3.9	-8.7	-13.5	-6.8	-32.9
Net Effect on Tax Liability	-$3.0	$0.9	-$2.4	$0.4	-$4.1

[a] These estimates are based on standard assumptions about the taxes married couples would pay if they filed individually. They also assume that: (1) unearned income and itemized deductions are divided between spouses in proportion to their individual incomes; (2) both spouses can file as head of household and claim the EITC; and (3) one child is assigned to the higher-earning spouse, two children are assigned one to each parent, and any additional children are assigned to the higher earner.

Figure 1—a couple making $70,000 in total income. The difference, however, is that in Figure 4 one spouse makes $60,000 and the other $10,000. In this situation, marriage produces a tax reduction—or bonus—of $1,425. This bonus occurs primarily because the income of the $60,000 single individual was being taxed at a higher marginal rate. Marriage allows some of this income to be "pushed down" into a lower marginal tax bracket.

Thus, the general relationship between a couple's income level and the likelihood and amount of a marriage penalty or bonus occurring is reflective of the *relative incomes* of the two spouses. Namely, the more similar are these incomes, the more likely and greater are marriage penalties. In contrast, the more disparate the two incomes, the more likely and greater are marriage bonuses.

In addition to the joint-return tax bracket structure used in the illustrative examples, there are numerous other individual federal tax code provisions that can give rise to marriage penalties. A particularly important one is the standard deduction (which is incorporated in the examples shown in Figure 1 and Figure 4). For joint returns this deduction is less than twice that for single taxpayers. The principal federal tax provisions that can significantly contribute to producing marriage penalties are itemized in Figure 5. Because there are a variety of tax law provisions that can produce marriage-related tax impacts, it should be stressed that estimating the number of individuals and amounts of tax liabilities affected by marriage-related provisions—and thus the aggregate marriage penalty itself—depends on which of the provisions identified in Figure 5 are considered in the calculation. It also should be noted that under certain circumstances, these same provisions can result in marriage bonuses.

Federal Marriage Penalty Reform Proposals

A number of federal tax reforms have been proposed in recent years in order to address the marriage penalty (see shaded box on pages 8-9).

Figure 4

Illustrative Marriage Bonus Example—Unequal Incomes

	Federal Income Tax Liabilities			
	Individual Situations		Combined Situation	
	Person 1	Person 2	Unmarried	Married
Gross Income	$60,000	$10,000	$70,000	$70,000
Less:				
Standard deduction	4,250	4,250	8,500	7,100
Personal exemption	2,700	2,700	5,400	5,400
Equals:				
Taxable income	$53,050	$3,050	$56,100	$57,500
Tax liability	$11,566	$461	$12,027	$10,602
Marriage Bonus				**$1,425**

These proposals are generally based on one of the following basic alternatives:

- ***Marital Deductions for Second Earners.*** Would allow all or a portion of the lower-earning spouse's income to be deducted when a couple is computing its taxable income.

- ***Separate Filing for Married Couples.*** Would allow spouses to file their own individual tax returns, with their combined deductions allocated between them according to one of various alternative approaches.

- ***Income-Splitting by Married Couples.*** Would divide equally the income of a couple between the two spouses—along with all exemptions, credits, and deductions. Spouses would then be allowed to file separate returns as though they were single. This is the equivalent of making the joint-return standard deduction and tax-bracket widths double that for single taxpayers.

Under each of the above three general reform approaches, the "solution" offered to the marriage penalty issue comes into conflict with one or more of the other objectives and principles of the current income tax system, as previously discussed. In addition, the reform proposals all result in absolute reductions in tax liabilities, as opposed to being coupled with a redistribution of the existing overall tax burden so as to make the reforms more revenue neutral. The result is that these attempts to lessen or eliminate the marriage penalty carry a large "price tag" in terms of reduced revenues, given the $30 billion in marriage penalties currently imposed.

Figure 5

Key Federal Tax Provisions That Can Produce Marriage Penalties

- ✔ ***Tax Brackets***. Penalty can occur when the two incomes of a couple are similar, due to the fact that married tax brackets are less than twice as wide as single-return brackets.
- ✔ ***Standard Deduction***. Penalty can occur when the combined use of the two allowable single deductions exceeds the value of the married deduction.
- ✔ ***Earned Income Tax Credit (EITC)***. Penalty can result when spouses have different incomes, and the lower-earning spouse's EITC is limited by the other spouse's higher income.
- ✔ ***Exemption Phase-Outs***. Penalty can occur when spouses have similar incomes, and more of their combined income falls into the phase-out range.
- ✔ ***Itemized Deduction Limitation***. Penalty can occur when spouses have similar incomes, and more of their combined income falls into the limitation range.

Alternatively, a revenue neutral approach to eliminating the marriage penalty would certainly be theoretically feasible to accomplish within the subset of married taxpayers themselves. As noted earlier, although 21 million couples experience nearly $30 billion in marriage penalties, marriage bonuses total even higher—by about $4 billion. Thus, if *both* marriage penalties and bonuses were simultaneously eliminated, the penalties could be removed at no net cost. The practical problem for policy makers in doing this is that, although 21 million taxpayers would see tax reductions at no net cost, the 25 million taxpayers currently receiving bonuses would be worse off.

Federal Reform Proposals

Although a number of proposals to eliminate or reduce the federal marriage penalty were proposed by the 105th Congress in 1997 and 1998, none was adopted. Many of these same or similar proposals were reintroduced in 1999. In early August, Congress passed the Tax Reduction Act of 1999, which would have provided relief from the marriage penalty. This would have been accomplished through progressively increasing the standard deduction and broadening the width of the 15 percent tax bracket for couples until they both reach double that for single taxpayers. This measure, however, was vetoed by the President, who publically stated that the overall tax package was too expensive.

Recent congressional legislative proposals to address the marriage penalty, including the just-vetoed measure, have essentially involved one of the following three basic approaches.

Marital Deductions for Second Earners

The Income Security and Enhancement Act of 1999 (S. 8, Daschel) is an example of this approach. Under this proposal, married couples with combined annual incomes of $70,000 or less would be permitted a deduction of up to 20 percent of such combined income from the lower-earning spouse's income. This proposal would have resulted in the elimination of the marriage penalty for some couples, a reduction in the marriage penalty for other couples, and creation (or increases in) marriage bonuses for yet other couples. In the aggregate, the proposal would result in an overall reduction in the marriage penalty, but also would conflict with the aim of taxing married couples with equal incomes equally.

Separate Filing for Married Couples

Although no legislation allowing this option was pending this year before Congress, the Marriage Tax Elimination Act (H.R. 2456, Weller), introduced in the 105th Congress, is an example of

THE CASE OF CALIFORNIA

Two questions are of particular interest regarding the PIT marriage penalty as it relates to California:

- ***First,*** what are the impacts of the *federal* PIT marriage penalty on Californians?
- ***Second,*** does California impose its *own* state PIT marriage penalty on taxpayers, and if so, what are its characteristics?

Federal Reform Proposals (continued)

this approach. Under this alternative, tax deductions would be allocated to spouses based on either (1) which one was responsible for generating the income, or (2) a pro-rata basis according to the percentage of the couple's total income earned by each spouse. Couples currently paying a marriage penalty could avoid the penalty by filing separately, and couples currently paying no marriage penalty (or receiving a bonus) could continue to file jointly so that they would be no worse off. Although it would eliminate marriage penalties, this approach would not satisfy the marriage neutrality principal (since marriage bonuses would still exist), and also would conflict with the notion of taxing married couples with equal incomes equally.

Income-Splitting by Married Couples

Income-splitting involves dividing a couple's total income (as well as tax exemptions, credits, and deductions) equally between the two spouses, with each then filing for tax purposes as a single individual. This alternative is the practical equivalent of increasing the standard deduction for joint returns to twice the single standard deduction amount, and increasing the width of the tax brackets for married couples to equal twice that for single-return taxpayers (such as California currently does).

This approach was embodied in the Marriage Tax Elimination Act of 1999 (H.R. 6, Weller, et al.) and the Marriage Tax Penalty Act of 1999 (S. 12, Hutchison), and in part was incorporated in the Tax Reform Act of 1999—the tax relief measure which Congress recently passed, but was vetoed. Under this approach, all married couples would realize an income tax cut. Married couples who currently receive a marriage bonus would realize an additional bonus. Alternatively, those currently paying a marriage penalty would have it eliminated, and some would receive a bonus. While this approach would again deal with the marriage penalty itself, the downside is that it would create a tax penalty for single taxpayers, and thus move the tax system away from marriage neutrality.

The Effect on Californians of the Federal Marriage Penalty

The effect on Californians of the federal income tax treatment of married couples is of interest not only in its own right, but from a state policy making perspective as well. For example, to the extent that Californians in the aggregate are more versus less favorably treated under tax federal law than are couples in other states, state policy makers may or may not find that specific federal marriage-related reform proposals merit their support.

Given that the way in which a couple's income is split between the two spouses is the key to how the couple fares under the federal government's marriage-related tax provisions, the income characteristics of California couples is the key determinant of how they score in this regard. Generally, the smaller the differential in spousal incomes, the more likely are marriage penalties, and the less likely are marriage bonuses, to occur.

Effects Assuming California's Joint-Return Income Distribution

An approximation of the effect of federal marriage-related tax provisions on Californians can be made. Assuming that the distribution of penalties and bonuses *within* each income category is the *same* for California as for the nation, Figure 6 shows that a slightly *lower* percentage of California's joint filers would pay a *penalty* and a slightly *higher* proportion would receive a *bonus* relative to the nation. This reflects the fact that California's income distribution diverges slightly from the nation's, with somewhat higher representations in the lowest and the highest income categories.

Assuming further that California's profile tracks the nation with respect to the *size* of the respective bonuses and penalties—again *within* each

Figure 6

Effects of the Federal Marriage Penalty in California

(Dollars in Millions)

	Level of Adjusted Gross Income				All Income Levels	
Variable and Taxpayer Category[a]	Less than $20,000	$20,000 to $50,000	$50,000 to $100,000	More than $100,000	U.S.	California
Share of Married Taxpayers *(Percent)*						
With penalty	12.0%	44.1%	53.9%	54.0%	42.4%	41.1%
With bonus	63.0	54.3	43.1	46.0	51.3	51.8
Unaffected	25.0	1.6	3.0	—	6.3	7.2
Totals	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Aggregate California Penalties and Bonuses						
Penalties (increased liabilities)	$111	$958	$1,051	$846	—	$2,965
Bonuses (decreased liabilities)	-512	-862	-1,274	-811	—	-3,459
Net Effect on Tax Liability	-$401	$96	-$223	$35	—	-$494
Aggregate Penalties As a Percent of Bonuses						
California	21.6%	111.1%	82.5%	104.3%	—	85.6%
United States	23.1	110.3	82.2	105.9	87.5%	—

[a] Assumes California and nation have similar percent distributions of penalties and bonuses, and average dollar penalties and bonuses, within individual income groupings.

income category—it is possible to get a general idea as to the aggregate federal marriage penalties paid and bonuses received by individuals in the state. California's married couples are seen to fare *slightly better* than those for the nation as a whole. For example, aggregate California federal marriage penalties as a percent of bonuses are 85.7 percent, versus 87.5 percent nationally.

Effects Assuming California's Own Spousal Income Differentials

To the extent that California's married couples exhibit not only a different income distribution from nationally, but also different spousal income differentials *within* income categories, their estimated federal marriage penalties and bonuses will differ from those identified in Figure 6. To the extent that California is different from the nation with respect to spousal income differentials, this can be traced to such factors as variations in the proportion of both spouses being in the labor force full time, and differences in the earnings capabilities of second spouses.

What do we know about spousal income differentials in California, both in an absolute sense and relative to those nationally? One measure of particular interest in this regard is the proportion of married couples where each spouse earns a significant share of the couple's total taxable income, since this is the range where the greatest potential for a marriage penalty exists because of the relative similarity of the spousal incomes.

Recent data from the U.S. Department of Commerce's Current Population Survey (CPS) compiled by the California Department of Finance shows that, when *all* married couples are considered, a *smaller* percentage of the state's married couples than nationally (34.1 percent versus 36.4 percent) have each spouse earning at least 30 percent of the couple's income. This suggests that, in percentage terms, Californian's are *less* vulnerable to incurring marriage penalties than nationally. However, the share of couples where each spouse earns at least 30 percent of the couple's total income differs significantly by income level, and is especially high in California for high-income taxpayers. For example, the share is 48.9 percent (versus 46.9 percent nationally) for annual incomes between $100,000 and $149,000, and 42.2 percent (versus only 24.2 percent nationally) for earnings in excess of $149,000 annually. Thus, although the state has proportionally fewer couples in a potential penalty situation, the state may represent a disproportionately large share of the total *dollar amount* of marriage penalties (given the larger dollar tax liabilities and penalty amounts for high-income taxpayers).

Is There a Marriage Penalty Under The California PIT?

Although there are situations where California married couples face higher state PIT liabilities than comparable single persons, the state's PIT does not have its own marriage penalty per se as regards either its basic progressive tax bracket structure or allowable standard deduction. Rather, the tax is basically structured in such a way as to eliminate the possibility that a marriage penalty will arise, and generally generates bonuses for taxpayers unless their individual incomes are equal. This is demonstrated in Figure 7, which compares the state tax liabilities of several individuals and couples with income characteristics similar to the federal income tax example used earlier in Figure 1 and Figure 4.

- ***Case A—Similar Individual Incomes.*** This case involves two individuals with identical earnings. It can be seen that the California income tax liability for the couple when filing jointly is exactly twice that of the liability of each of the two individuals filing single. It also can be seen that the state's personal exemption credit reduces the tax liability for each filing status, but since the credit for couples is exactly twice that for single filers, it does not affect the married tax penalty/bonus calculation. As a result, no state marriage penalty arises in this situation.

- ***Case B—Different Individual Incomes.*** Here, one individual earns substantially more than the other.

Figure 7 indicates that in this situation, the married couple receives a substantial marriage bonus at the state level in comparison with the aggregate amount of taxes that it would have paid as two single filers.

Figure 7

How Different Income Splits Can Affect California Tax Liabilities

Scenario	State Income Tax Liabilities for Two Persons With Combined Income of $70,000			
	Individual Situations		Combined Situation	
	Person 1	Person 2	If Unmarried	If Married
Case A—Equal Individual Incomes				
Gross income	$35,000	$35,000	$70,000	$70,000
Less: standard deduction	2,642	2,642	5,284	5,284
Equals: taxable income	$32,358	$32,358	$64,716	$64,716
Tax liability prior to credits	$1,377	$1,377	$2,754	$2,754
Less: personal exemption credits	70	70	140	140
Equals: tax liability after credits	$1,307	$1,307	$2,614	$2,614
No State Marriage Penalty or Bonus				—
Case B—Unequal Individual Incomes				
Gross income	$60,000	$10,000	$70,000	$70,000
Less: standard deduction	2,642	2,642	5,284	5,284
Equals: taxable income	$57,358	$7,358	$64,716	$64,716
Tax liability prior to credits	$3,685	$96	$3,781	$2,754
Less: personal exemption credits	70	70	140	140
Equals: tax liability after credits	$3,615	$26	$3,641	$2,614
State Marriage Bonus				**$1,027**

The Bottom Line—State Marriage Bonuses Result

Unlike with the federal system—where similar incomes produce penalties and divergent incomes produce bonuses—California's tax produces *no* penalty when incomes are equal and *bonuses* when they are divergent. As with the federal tax system, then, California's PIT retains the principles of *progressive taxation* and *equal treatment* of married taxpayers with different income splits, but sacrifices the principle of *marriage neutrality*. Namely, the tax-rate structure for single and joint filers is configured such that the tax liability for a married couple is never more than twice that of a similarly situated single couple, but is usually considerably *less*. Thus, marriage bonuses are the general rule in California, with the amount of the bonus positively related to the income differential between the two individuals involved.

Net State-Federal Impact

California's state marriage bonuses have the effect of either increasing the marriage bonuses that taxpayers with federal bonuses receive, or reducing or turning into bonuses the federal penalties that other taxpayers experience. The only exception is in the case of equal spousal incomes, since in this event the state's system produces neither a penalty nor bonus, and thus has no impact. Given the above, the state's tax system generally serves to mitigate federal marriage penalties, and usually makes married taxpayers better off relative to nonmarried taxpayers than if only their federal liabilities were considered. Specifically, regarding the illustrative taxpayer examples in Figure 7:

- ***Similar Incomes.*** The net penalty equals the federal penalty in dollar terms shown earlier in Figure 1, or $1,470, since the state imposes neither a penalty nor bonus on equal incomes.
- ***Disparate Incomes.*** The total bonus under Case B in Figure 7 would rise from the federal bonus of $1,425 (shown earlier in Figure 4 for this couple), to a total of $2,452, due to the state's bonus of $1,027.

It should be noted that, because these examples assume that taxpayers claim a standard deduction, they *overstate* the extent to which the state's tax system offsets federal marriage penalties or enhances federal marriage bonuses for taxpayers who itemize their deductions. This is because such taxpayers can claim federal itemized deductions for their state income taxes paid. Thus, the California marriage bonus a married couple realizes will make its state income taxes lower than otherwise, its federal itemized deductions lower than otherwise, and its federal taxable income and tax liability higher than otherwise.

Limited Circumstances Where Marriage Penalties Can Occur in California

As noted earlier, California does not impose a general marriage penalty based on either filing status, the basic tax-rate schedule used, or the standard deduction. Nevertheless, there are certain provisions under which married couples do not benefit to the same extent as single filers. As a result, a greater tax liability can occur for married persons than if they were not married. In this sense, some marriage penalties do exist under the California PIT. Such penalties generally involve tax provisions that are not proportionate in terms of how they affect joint-return taxpayers as compared to single taxpayers.

An Illustrative Example—Capital Losses. As an example, Figure 8 indicates how California's tax treatment of capital losses can result in a marriage penalty. In the situation assumed, each of the two single individual filers shown has no capital gains but experiences and reports a capital loss of $5,000, while as a married couple they would report the combined loss of $10,000. Under California law, however, the amount of the loss deductible from regular income is limited to $3,000, *regardless* of filing status. Thus, the two single individual filers are able to deduct twice the amount deducted by the couple—$6,000 versus $3,000. As a consequence, taxable income for the married couple is disproportionately higher than for the two single filers in combination. The result is a marriage penalty of $239, or about 9 percent.

Another case where a marriage penalty can occur involves other types of tax-related losses, where California law limits the ability of married couples filing jointly to benefit from such losses to the degree that single filers can. So-called "passive activity losses," for instance, are limited to $25,000, regardless of whether one is a single or joint filer. If a married individual chooses to file separately as a married-filing-single filer, on the other hand, the allowable amount is only $12,500. This means that an unmarried couple can claim an aggregate amount of $50,000 between them—versus only half the amount for the married couple, or $25,000, regardless of whether they file jointly or separately.

The PIT alternative minimum tax (AMT) also can result in marriage penalties. The amount of income excluded in the AMT calculation is $42,945 for single filers and $57,260 for married couples filing jointly. However, a marriage-neutral system would have a married exclusion equal to double the single-filer exclusion. Because under California's system, two single individuals would be able to exclude $85,890 for AMT purposes while they would be limited to only a $57,260 exclusion if married, the married couple's tax would be higher, all else constant.

It should be noted that certain of the state's tax provisions also exacerbate the marriage *bonuses*

Figure 8

How Capital Losses Can Produce a California Marriage Penalty

	Income Tax Liabilities for Two Persons With Combined Income of $70,000			
	Individual Situations		Combined Situation	
	Person 1	Person 2	If Unmarried	If Married
Taxable income prior to capital losses	$35,000	$35,000	$70,000	$70,000
Capital losses incurred	-5,000	-5,000	-10,000	-10,000
Allowed deductible capital losses	-3,000	-3,000	-6,000	-3,000
Taxable income adjusted for losses	$32,000	$32,000	$64,000	$67,000
State tax liability prior to credits	$1,349	$1,349	$2,698	$2,937
Less: personal exemption credits	70	70	140	140
State tax liability after credits	$1,279	$1,279	$2,558	$2,797
Marriage Penalty				**$239**

that inherently result from California's tax-bracket structures and standard deductions for married versus single taxpayers. For example:

- ***Business Losses.*** Reported business losses can be deducted under California's PIT if there is offsetting business income. Thus, should an individual with losses that are not otherwise deductible marry an individual with business gains, this would result in a marriage bonus. Otherwise, these losses would not be fully deductible.

- ***Capital Gains.*** Another example of where marriage bonuses can be augmented under California law involves capital gains. In contrast to the situation depicted in Figure 8, where marriage penalties result when capital losses are deducted from regular income, marriage bonuses can result where capital losses can be fully deducted from capital gains.

California Versus Other States

Figure 9 summarizes how California compares to other states (and the District of Columbia) in terms of its treatment of married taxpayers and the issue of marriage penalties and bonuses. It indicates that:

- California is one of eight states that generally eliminates marriage penalties by

Figure 9

Interstate Differences In Marriage Penalties

- ✔ Marriage penalties eliminated for most taxpayers, because joint-return tax brackets are twice as wide as those for single filers. Most couples receive marriage bonuses.

  States Involved: Alabama, Arizona, California, Hawaii, Idaho, Louisiana, Oregon, and Utah.

- ✔ Married couples can file either separately or jointly, thereby avoiding any marriage penalty. However, bonuses can result.

  States Involved: Arkansas, Delaware, District of Columbia, Iowa, Kentucky, Mississippi, Missouri, Montana, Tennessee, and Virginia.

- ✔ No marriage penalties (or bonuses) exist, because of flat-rate income taxes or no income taxes at all.

  States Involved: States without income taxes are Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington, and Wyoming. States with flat-rate income taxes are Connecticut, Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania.

- ✔ Marriage penalties exist—although at reduced levels—because the tax bracket widths for joint filers, while more than for single filers, are less than twice as wide.

  States Involved: Colorado, Maine, Minnesota, Nebraska, New York, North Carolina, and Wisconsin.

- ✔ Marriage penalties (and bonuses) can occur, because taxes are computed as a percent of federal liabilities, or joint-return schedules are similar to single-return schedules.

  States Involved: Georgia, Kansas, Maryland, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, Vermont, and West Virginia.

doubling the width of the rate brackets used for single filers—an approach that creates marriage bonuses for virtually all couples.

- Another nine states permit couples the choice of filing either two single returns (based on their own individual incomes) or one joint return (reflecting their combined income), such as was allowed at the federal level prior to 1948. Thus, they incur no marriage penalty, but can, as in California, receive bonuses.

- In 15 states, neither marriage penalties nor bonuses are at issue. This is because six states levy flat-rate income taxes (thus, single and married taxpayers pay the same rate) and eight states have no income tax at all.

- Seven states impose marriage penalties, but in reduced frequency and dollar amount than if couples had to use single-filer tax tables. This occurs in these states because, although they have separate joint-return tax tables that are wider than those for single filers, their width is less than twice as wide (like the federal joint brackets, which are about two-thirds as wide as the single ones).

- Twelve states impose marriage penalties (and bonuses) similar to those at the federal level, either because their state taxes are computed as a percentage of the federal liability, or because married couples use tax schedules similar or identical to single-filer schedules.

Thus, 32 states (including California) generally impose no marriage penalties at all, 7 levy reduced penalties, and 12 impose penalties. Regarding marriage bonuses, they can occur in 36 states (including California).

BEHAVIORAL EFFECTS AND THE MARRIAGE PENALTY

The behavioral responses resulting from tax laws are often difficult to measure and frequently have been the subject of considerable debate. However, it also is generally acknowledged by economists and public finance experts that tax provisions *can* and *do* affect taxpayer behavior, especially if they are of significant magnitude. For example, a number of studies have confirmed that tax incentive provisions can lead to increases in the specific activities being targeted, whereas tax disincentives can reduce the affected activities. Given this, it is only natural to ask what the behavioral responses are relating to the income tax laws discussed above pertaining to marriage.

The primary types of behavioral effects involved in this area are of the following two sorts:

- Decisions about marriage and divorce, including whether to do so and, if so, their timing.

- Decisions by spouses regarding whether or not to enter the labor force and, if so, how many hours per week to work.

Marriage and Divorce Decisions

Many economists have hypothesized that existing tax laws may affect certain couples' decisions regarding marriage and divorce, to the extent that such laws make them better or worse off financially depending on whether or not they are married. The empirical economic research previously conducted on this issue provides mixed evidence.

Marriage Decisions. Regarding the decision of whether or not *to* marry, some studies have found no effect. Other research has isolated an effect, reporting that the larger the tax penalty on marriage, the less likely is marriage and the more likely is divorce to occur (with the opposite being true in the case of marriage bonuses). However, economists have found that the magnitude of these effects is relatively *small*, and thus the overall rate of marriage has been generally unaffected by existing marriage-related tax provisions.

Marriage Timing. Some evidence exists that decisions regarding the *timing* of marriage may be more sensitive to the marriage penalty than the decision to marry *per se*. In particular, researchers have noted that short marriage postponements are not uncommon when law changes significantly increasing the penalty are imposed. Generally, however, such delays tend to be for only limited periods of time—say, one or two tax years. Thus, the concerns sometimes voiced that the tax system is undermining the fundamental institution of marriage have not been confirmed empirically. Of course, the opposite argument can be made, at least in theory, regarding marriage *bonuses*—namely, that they encourage marriage and accelerate its timing.

Decisions About Working

Basic economic theory suggests that the greater the marriage penalty, the less the likelihood that spouses will enter the labor force and, if they do, the less they will choose to work (with the opposite again being the case with regard to marriage bonuses). This is because the marriage penalty diminishes the after-tax return from working.

Economists have indeed found that differentials in tax rates can result in adjustments by individuals to their decisions to work in general, and the number of hours to work in particular. Specifically, it has been found that higher marginal income tax rates result in decreased labor force participation and hours worked after controlling for all other influencing factors. Such behavioral effects can particularly apply to second, nonprimary wage earners, since their incomes are "added on to" the primary wage earner's income for tax purposes. In addition, the "opportunity costs" for second wage earners working are often quite high to begin with, since they frequently involve child-rearing issues and the expenses incurred for child care. The last of these can significantly limit the net after-tax incomes of second wage earners, potentially making their work decisions especially sensitive to the marriage penalty. The existence of marriage bonuses can have just the opposite effect.

CONSIDERATIONS FOR THE LEGISLATURE

Given the fundamental tax policy issues raised by the marriage penalty/bonus, as well as the large number of married taxpayers affected by it, the Legislature may want to examine its own views regarding the tax treatment of married couples (see Figure 10). Specifically, it may wish to focus on whether these views are consistent with the state's current tax code, as well as how they relate to the various marriage-related tax code changes proposed at the federal level. This process should include weighing the relative importance of the principles of *equal treatment*, *marriage neutrality*, and *progressive taxation*, with the "bottom line" being to determine whether the existing marriage-related penalties and bonuses are appropriate.

Once the Legislature's tax policy objectives with regard to married couples have been reviewed, it will be in a position to best determine what steps may be appropriate to take with regard to state and federal marriage-related tax laws.

The Case of California—Should Its Own Tax Code Be Modified? As noted above, most Californians receive marriage bonuses with regard to their state income taxes, while a lesser number are penalized because of such factors as capital losses and/or passive losses. Thus, the Legislature may wish to ask such questions as:

- Is it appropriate for married couples generally to be receiving California bonuses?
- Should specific state tax provisions which can produce California marriage penalties be eliminated or otherwise changed?

Figure 10

Considerations for the Legislature Regarding the Marriage Penalty Controversy

☑ What are the Legislature's own views and priorities regarding the tax treatment of married couples, including the existence of marriage penalties and bonuses?

- Does the current tax system reflect these priorities?
- How do these priorities compare with the alternative marriage-related tax code changes being debated at the federal level?

☑ Do California's own tax provisions regarding married couples merit revision?

- Does the state's general practice of providing marriage bonuses make sense?
- Should those selected provisions that create marriage penalties for state taxpayers be modified?

☑ Should the Legislature "weigh in" on the federal marriage-penalty debate?

- How would Californians fare under different federal reform proposals?
- Should the Legislature express its views regarding any of these proposals?

- Should the state's basic tax system be modified so as to more fully offset the federal marriage penalty that many Californians face?

The Federal Marriage-Penalty Debate—Should California "Weigh In?" While California does not determine federal tax laws, it *could* influence them. The Legislature may want to make its own views regarding the marriage penalty known to federal decision makers, especially if there are certain federal tax-change proposals that are either beneficial or disadvantageous to its own citizens. To assist it in this area, the Legislature may want to have a study prepared of how Californians fare under the alternative proposals being considered.

Concluding Comment. Addressing marriage penalty issues is an inherently challenging task, especially given policy makers' diverse views on the subject. The fact that unresolved debates about the tax treatment of married couples have gone on for so many years at the federal level attests to the difficulty of fully resolving the various issues involved. Policy makers must sift through a complex series of policy issues in addressing the question. For example, they must weigh the importance of equal tax treatment of married couples with identical incomes versus treating married individuals the same as similar single individuals. While taxing on an individual basis would achieve the former objective, this approach (given the progressive tax structure) would result in different tax liabilities for married couples with the identical combined incomes, but with a different distribution of incomes within the marriage. It is difficult issues and trade-offs like these that the Legislature faces in considering the tax treatment of married couples generally, and the marriage penalty/bonus issue in particular.

Appendix A

HISTORICAL BACKGROUND ON THE FEDERAL TAX TREATMENT OF MARRIED COUPLES

The most significant of the federal income tax law provisions and changes involving married couples since the income tax was established in 1913 are discussed below.

The Pre-1948 Situation

Marital Status Was Not Considered. When the federal personal income tax was first established, there was no marriage penalty. This is because the tax took no account whatsoever of one's marital status. Rather, individuals were required to file their own tax returns regardless of whether they were single or married. In one sense, then, this system was viewed as "fair" in that it treated all individuals with similar incomes the same. Thus, for example, two given individuals would pay the same combined income tax regardless of whether or not they were married to each other.

Inequities Existed Between Married Couples. At the same time, however, the then existing system's progressive tax bracket structure in effect meant that it produced inherent inequities from the viewpoint of many married couples. The fact that the existing system looked at individuals as the taxpaying unit as opposed to households meant that two married couples with the same total income could end up paying grossly different taxes. For example, due to the progressive system, a married couple for which one spouse earned $50,000 and the other earned nothing would pay considerably more in income taxes than a couple with individual incomes of $25,000 apiece, even though both couples had total income of $50,000. The larger the difference in the incomes of the individual spouses, the more significant the tax disparity became.

1948—Inter-Couple Inequities Were Eliminated

Couples Became a Tax Unit. In 1948, Congress eliminated the difference in tax liabilities that married couples with identical total incomes could face based on differences in the relative incomes of individual spouses. It did this by taxing married couples as a household, rather than as two separate individuals. Technically, married couples were allowed to file jointly and pay taxes on their total income based on tax brackets that were twice as wide as those used by single taxpayers. (As used here, the "width" of a tax bracket refers to the range of income to which a particular tax rate is applied.) This had the effect of making the tax liability of a couple twice that of a single taxpayer earning the average income of the two spouses. In practical terms, the change made a couple's tax liability depend only on its total income, not the amount of income attributable to each spouse. Thus, for example, if couple A had individual spousal incomes of $50,000 and $0, and couple B spousal incomes of $40,000 and $10,000, both paid an equivalent tax equal to twice that on their average income of $25,000.

But This Generally Led to "Marriage Bonuses." This change did eliminate the problem of different tax liabilities for couples having similar total incomes. However, in doing so, it created yet another problem. Namely, it gave an advantage to certain married couples over unmarried couples earning identical individual incomes. For example, a married couple with individual incomes of $40,000 and $10,000 would pay less tax (based on its average spousal incomes of $25,000) than the unmarried couple, given the progressive rate schedule. Put another way, the change tended to put married couples in a lower effective tax bracket than single taxpayers, thereby providing a "marriage bonus" to most couples.

1969—A Separate Tax Table for Couples Was Adopted

Marriage Penalties Emerged and Bonuses Were Reduced. To address the widespread marriage bonus situation, the Tax Reform Act of 1969 introduced the concept of separate tax tables for married couples versus single taxpayers—the system still used today. The tax brackets and rates chosen at the time were generally aimed at eliminating, in the *aggregate*, the marriage bonus problem. It did this by reducing the dollar size of marriage bonuses for most couples still receiving them, and also shifted many couples from receiving marriage bonuses to being subject to marriage penalties. Specifically, couples with similar incomes became subject to the latter, and although taxpayers with less-equal incomes generally still received bonuses compared to single taxpayers, their amounts were generally reduced and were limited to a maximum of 20 percent.

Post-1969 Changes

There also have been a variety of significant tax-law changes since 1969 that have affected the tax positions of married couples in relation to both one another and single taxpayers (see Figure 2 in text). These have included the Earned Income Tax Credit (EITC) put in place by the Tax Reform Act of 1975, the two-earner income deduction adopted as part of the Economic Recovery Tax Act of 1981, provisions in the Tax Reform Act of 1986 which had the effect of significantly reducing marriage penalties, and tax-related provisions adopted in 1990 and 1993 which affected the prevalence and amounts of both marriage penalties and marriage bonuses. A number of these provisions such as the EITC remain in place today, in either their original or a modified form.

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This report was prepared by Mark A. Ibele, under the supervision of David Vasché. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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