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## *policy brief*

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## Withholdings, Saliency and Tax Policy

*By Damon Jones*

On November 1, 2009, California introduced a 10 percent increase in wage withholdings. Curiously, this withholdings change was not accompanied by an increase in actual tax liability. In other words, taxpayers would see a larger amount taken out of each paycheck, only to receive that money back as a refund during the next tax-filing season. Under this plan, there is no significant gain in revenue for the state, just a change in the timing of tax payments. The aim of the policy is to cover short falls in the current budget by drawing on tax payments earlier than normal — a “payday” loan of sorts for the state government. The only difference is that this payday loan carries an interest rate of zero, with taxpayers fronting the cash.

The state government estimates an increase of \$2.5 billion in withholdings over the next two years (not to be confused with increased revenues). These projections hinge on the assumption that most taxpayers will not respond by readjusting their income tax withholdings to offset the increase. If your initial response is “wait a minute, I did not know that I could change my withholdings,” then you are not alone. News coverage suggests that many taxpayers view the withholdings change as unavoidable, when in fact taxpayers can override the policy by submitting paper work to their employers.

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### About The Author

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interests include public finance, household finance and behavioral economics. His recent papers cover topics such as the Earned Income Tax Credit, Income Tax Overwithholding and 401(k) savings behavior. He received his B.A. in Public Policy from Stanford University in 2003 and a Ph.D. in Economics from the University of California, Berkeley in 2009. Starting in July of 2010, he will join the faculty at the University of Chicago, Harris School of Public Policy.

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The example from California highlights more general observations about tax withholdings: (1) income tax withholdings are not very salient to a significant share of taxpayers; (2) lawmakers can sometimes use this fact to reach certain policy goals; and (3) the effect of these policies can vary dramatically depending on an individual's knowledge and awareness of the tax withholding system.

## **The U.S. Income Tax Withholding System**

The relatively low salience of automated income tax withholdings has long been recognized by policymakers. The modern withholding system dates back to the Current Tax Payment Act of 1943. Prior to that time, income taxes were generally paid retroactively, once a year for income earned in the pervious year. The law instituted a "pay-as-you-go" system in which tax payments on current earnings are collected in real time. A major motivation for this tax change was the need to raise additional revenues to support wartime spending. It was thought that withholding at the source, the taking of taxes from each paycheck, would soften the blow of higher wartime tax rates and additionally lower

the likelihood of default on tax payments.

Under the current withholding system, employees choose their level of withholdings. This is accomplished by submitting a W-4 form to one's employer. This form is required at the beginning of employment and essentially specifies the number of exemptions one expects to receive. The employer then uses the W-4 form to calculate withholdings. A new W-4 form can be submitted at anytime, if one wishes to change the level of withholding. If no W-4 is collected, the employer is instructed to withhold a default amount assuming no exemptions for the worker, which typically results in a refund. Choosing a level of withholdings is a tricky balancing act: Paying too little may result in an IRS penalty while paying too much will result in an unnecessary, interest-free loan to the government and a future income tax refund.

## **Empirical Facts About Withholding**

A majority of U.S. taxpayers, nearly 80 percent, overwithhold and receive refunds. In 2004, the average amount of overwithholding was \$1,000. For the average taxpayer, the amount refunded comprised about

7 percent of total income.

Taxpayers with lower income levels turn out to be the most likely to overwithhold. For this group, the average income tax refund comprises 13 percent of total income.

From a financial standpoint, one's goal should be to withhold just enough to avoid any penalty from the IRS and not a penny more. Overwithheld money could be freed up to pay off debt, saved in order to avoid the need to borrow or invested until the tax return is filed. That is, a major cost of overwithholding is the lost interest on one's loan to the government. An additional cost accrues to individuals who live paycheck to paycheck and may face an emergency need for cash. Their money is unnecessarily tied up in the withholding system.

What is also apparent from recent research is that people do not frequently readjust their withholdings. Consider a taxpayer who gains a new child dependent. When this happens, one's tax liability can be expected to be lower by about \$600 because another exemption can now be claimed. In this case, submitting a new W-4 with one more predicted exemption will lower withholdings by a similar amount. Taxpayers



are very slow to make such adjustments. My research (Jones, 2009) shows that for every dollar in reduced tax liability, average withholdings only decrease by about \$0.30 in the first year and \$0.50 after three years. What this means is that if withholdings are changed by some government policy, as is the case in California, we can expect only a small amount, less than a third, to be undone by taxpayer readjustment of withholdings in the first year and only about half after three years.

### **Withholding-Based Policies**

Aside from the introduction of withholdings in 1943 and the most recent California State withholdings reduction, there are other examples of policies that are designed with an eye toward the low salience of withholdings. In 1992 a Presidential Executive Order reduced the default amount of federal withholdings for taxpayers on average by \$240. The policy was targeted to households with income below a certain threshold. The aim was to stimulate a sluggish economy. Similar to the 2009 change in California withholdings, the policy was not accompanied by a change in tax liability. In other words, taxpayers

would have to pay back the reduction in withholding at the end of the year when filing their taxes. Policymakers hoped that households would nonetheless spend most of the withholdings reduction, perhaps because taxpayers would not notice the change. Survey evidence in Shapiro and Slemrod (1995) suggests that indeed many households were not aware of the change, and overall 42 percent indicated that they would spend most of the withholdings reduction. My empirical analysis of tax returns in Jones (2009) confirms this; only about 30 percent of the withholdings changes were undone by readjustments on the part of taxpayers.

More recently, the withholdings system has been used to distribute stimulus payments under the American Recovery and Reinvestment Act of 2009. This law includes the Making Work Pay Credit, which is a reduction in federal withholdings ranging between \$400 and \$800. Unlike the previous two policies mentioned, this change in withholdings is accompanied by a change in tax liability, so that after-tax income is actually increased. Though similar tax cuts have been made in the past,

they have been delivered as one-time payments in the form of a rebate check. One rationale for switching to a withholdings-based payment is that the smaller and more frequent credits may be less salient to taxpayers. If this is true, then the stimulus may be more likely to be spent as opposed to the one-time rebate checks, which tend to be partially saved or used to pay off debt. In that case, the withholding policy may be more effective in stimulating consumer demand during a recession because of the low salience of withholdings.

### **Distributional Impacts of Withholding-Based Policies**

Policies that are built around the withholding system may not have same effects for all taxpayers. For one, lower-income households are the least likely to adjust. Therefore, policies that increase withholdings, such as the California withholdings change, will disproportionately reduce cash on hand for lower-income households. Conversely, policies that reduce withholdings, such as the Making Work Pay Credit, are more likely to translate into increased spending for lower-income households.

Another factor that helps determine the overall effect a withholdings change is one's level of assets and access to credit markets. Those who have sufficient savings or the ability to borrow are in a better position to compensate for short-term shifts in the timing of income between the present and the near future. This means that taxpayers with the lowest incomes will be the most affected by changes in withholdings, as they generally have low savings and limited access to credit. In addition, those low-income taxpayers that do have access to credit may face relatively high interest rates, further making withholding increases more costly for this group.

The Earned Income Tax Credit (EITC), a refundable tax credit available to low-income workers, presents the starkest example of differential effects of withholding policy. A household with three children and particularly low earnings in 2009, say \$13,000, will have income supplemented with a cash transfer of \$5,657. The catch is that the payment is delayed, typically delivered in early 2010, when taxes are filed. One way to rebalance this mistiming is by

reducing withholdings, since the EITC is effectively a reduction in tax liability. However, for many households, reducing withholdings to zero would still result in a refund.

Provisions exist that allow taxpayers to more easily undo this extreme lumping of payments. The Advance EITC allows workers to receive a portion of the EITC in smaller payments, earlier in the year with each paycheck. In effect, it allows one to reduce withholdings below zero. Interestingly, Jones (forthcoming) shows that very few make use of the Advance option and are unresponsive to efforts to encourage greater participation. As a result of the ineffectiveness, the government is set to end the Advance EITC option in 2010, cutting off one of the few means of transferring the EITC into earlier payments for lower-income taxpayers.

### **Future Policy Options**

The low salience of withholdings contributes to the effects of changes in withholding policies. In addition, withholding changes are most likely to affect lower-income taxpayers, who are least likely to readjust withholdings and also least likely to have access

to credit. The most significant example of such policies comes as a result of the timing of the EITC: Lower-income taxpayers see a large share of their income concentrated during one time of the year. Furthermore, a key means of smoothing out this lumpy pay schedule, the Advance EITC, is slated for expiration in 2010.

Should the Advance EITC be kept in place? Perhaps it should not with its current design. Efforts to expand participation have seen little success. One major turn-off of the Advance EITC is that recipients are reluctant to part with the larger, one-time payment of an income tax refund in exchange for smaller weekly or bi-weekly payments. Also, there is a threat of having to pay back ineligible payments at tax time. However, a more attractive alternative can and should be considered by policymakers.

Some lessons can be drawn from the U.K. analog, the Working Tax Credit (WTC). Similar to the EITC, this tax credit is a subsidy to low-income working families. A major difference is that it is paid on a bi-weekly or monthly basis. Thus, the payments are

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split into smaller amounts and delivered in a more frequent and timely manner. The program is not without its drawbacks. Payments are based on earnings in the previous years, and recipients often fail to update their status, especially when it would reduce payments. Thus, at the end of the year, many recipients have received overpayments. To reconcile this, the British government waives the repayment of excess credits, provided they are not too large. Overall, this makes the WTC a more expensive program.

A revamping of the Advance EITC in the United States could learn from the U.K. experience. First, we could shift to a more timely delivery of the EITC, but not necessarily as frequent as every paycheck. A quarterly EITC would offer recipients earlier delivery, while retaining relatively large payments that recipients seem to value. In addition, errant overpayments could be waived if they are below some amount. This would of course increase the costs of the EITC, and therefore require a compensating reduction in the generosity of the program. However, it seems reasonable that recipients would be willing

to forfeit at least some of the benefit in exchange for the peace of mind of not worrying about an unexpected bill at the end of the year. A pilot study of such a program would help reveal the optimal trade-off.

Another requirement of such a change to EITC policy would be additional administrative costs. Currently, information on income (and therefore eligibility) is aggregated once a year within the tax return. With quarterly EITC payments, additional effort would be needed to process and calculate payments. The U.K. experience (Brewer, 2006) indicates that using a centralized administrator is preferable to placing the burden solely on individual employers. Possible solutions include using data from unemployment insurance records, Social Security payroll records, or having the IRS assume additional responsibility. The IRS receives payments from all employers on a quarterly basis and therefore could use that opportunity to calculate EITC payments. Pushback from each of the agencies would be expected, especially during a time of widespread budget cuts. Obstacles notwithstanding, it seems that policymakers could do

better than just abandoning the Advance EITC program altogether.

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