TAX REFORM

TO STRENGTHEN THE ECONOMY AND LIGHTEN THE BURDENS FAMILIES BEAR

ROBERT STEIN

Cutting marginal tax rates has been the Holy Grail of conservative efforts to reform the tax code for the past generation. And it certainly should be—for the highest earners and investors who respond the most to lower rates. Cutting marginal tax rates is not, however, an effective tool for delivering tax relief to the middle class. It does very little to lower their tax bills or improve their work incentives.

Instead, tax cuts for the middle class should be designed to offset the greatest fiscal-policy distortion that affects middle-class Americans: the disincentive to raise children caused by Social Security and Medicare. Tax cuts should reduce the cost of raising children, making it easier for parents (and potential parents) to pursue the family size they would desire in the absence of federal interference. Such a tax plan would also noticeably increase after-tax earnings for families just when their costs of living are greatest. It would offer meaningful relief to millions of middle-class Americans and could create a political opportunity to enact other pro-growth policies.

The Marginal Rate Mystique

The primary reason many conservatives still heavily emphasize the idea of cutting marginal tax rates is the success of President Reagan's tax cut in 1981. Before Reagan, there were more than a dozen tax brackets—and in the top one, workers paid an income tax rate of 70 percent. For every dollar earned beyond $108,300, a worker would keep only 30 cents. Tax rates that high obviously undermine the incentive to work, save, and invest. Conservatives therefore argued that large tax-rate cuts would encourage more economic activity and greater prosperity.

Upon taking office, President Reagan cut rates across the board; marginal income-tax rates that had spanned from 14 to 70 percent were cut to a range of 11 to 50 percent. The positive impact on work incentives for high-income households was enormous, as the workers with the most control over their hours, output, and pay structures had a strong reason to increase their earnings.

These tax cuts improved work incentives much more for higher-income households than for the middle class. Cutting the income tax rate from 70 percent to 50 percent meant the highest earners could keep 50 cents instead of 30 cents on every dollar of extra earnings. Marginal after-tax earnings rose 67 percent. By contrast, a more typical middle-class household saw an 8 percent increase in marginal after-tax pay.

The much smaller improvement in incentives for the middle class was not class warfare. It was the result of having a progressive tax code with a very high top rate. A strategy of reducing tax rates simply cannot enhance work incentives as much for those who already keep most of what they earn.

Let's say we cut the 15 percent federal income-tax rate faced by much of the middle class to 10 percent. Instead of keeping 85 cents for a dollar of extra effort, a worker would get 90 cents—an improvement of only 5.9 percent.

Meanwhile, the tax cut would make a real dent in revenues—and we could not count on its having any major effect on behavior to make up for it. Cutting the 15 percent rate to 10 percent would reduce government revenue by about $100 billion per year over the next decade.

Even worse, IRS data show that only about one-third of the tax relief would go to taxpayers who would see even a slight improvement in incentives. The other two-thirds of the tax cut would go to workers who earned some money in the 15 percent tax bracket on their way to higher tax brackets. For these workers, cutting the 15 percent rate to 10 percent would make absolutely no difference in work incentives. For them it would be a lump-sum Keynesian-style tax cut, putting money in their pockets while leaving incentives unchanged.

A Better Pro-Growth Tax Cut

In their emphasis on marginal tax-rate cuts, some conservative tax reformers have made two silent assumptions. First, they assume incentives start and stop at the workplace door, as if people are only workers, employers, entrepreneurs, or investors and incentives have no influence outside our roles as accumulators of material wealth. Second, they assume the only goal of tax reform should be to reduce economic distortions caused by the tax code itself, even if the tax code is the best place to address other distortions to human activity caused by fiscal policy.

One of those distortions, and a crucial one, is the way Social Security and Medicare have "crowded out" the traditional incentive to raise children as a protection against poverty in old age. Today, most workers can reasonably foresee getting enough support from the public retirement system to stay out of poverty when they get older, making it less likely that they will have to call on direct aid—either in cash or in kind—from their own children.

Studies (including work by Michele Boldrin, Mariacristina De Nardi, and Larry Jones, and by Isaac Ehrlich and Jinyoung Kim) show Social Security and Medicare reduce the fertility rate by about 0.5 children per woman.[1] In European countries, where retirement systems are larger, the effect is closer to one child per woman. In other words, without government-run retirement systems, both the U.S. and Western Europe would have birth rates of about 2.5 children per woman: safely above the population-replacement rate.

In order to keep going, Social Security and Medicare requires each working-age generation to accomplish two tasks: first, work and pay taxes to pay benefits to the older generation; second, raise enough productive children so current workers can get benefits when they retire. But the entitlement programs allow those without children to get similar benefits to those with children, without having spent the time, money, and effort that parents do raising their children. So, even as the old-age pension system collectively depends on a population of productive young workers, it diminishes the economic need for adults to raise them—and so undermines its own sustainability.

By making so much of the economic benefit of children accrue to society collectively—and thereby reducing that benefit for the individual mothers and fathers who make the decisions about how many (if any) children to raise—federal policy distorts family formation.

Unfortunately, these negative effects cannot be fixed by converting old-age entitlement programs into mandatory savings programs, as the Bush administration suggested for Social Security in 2005. Requiring workers to save for retirement by accumulating financial instruments would also crowd out the traditional motive to raise kids.

In theory, changes could be made directly to the Social Security system to offset the bias against raising children. Charles Blahous and Jason Fichtner have proposed raising the general Social Security tax rate to 14.4 percent from the current 12.4 percent (6.2 percent on employer and worker, each). Then, parents would have the basic rate reduced by 2.5 percentage points for each child, so that parents of two children under age 18 would pay 9.4 percent, parents of three children would pay 6.9 percent, and so on.

Enacting this proposal would, however, be extremely difficult. Under current budget and procedural rules in the Senate, the Blahous-Fichtner reforms would require a supermajority of 60 votes, even if the plan had zero net effect on federal revenue or the budget deficit. A "revenue-neutral" tax reform, on the other hand, could offset the government's anti-parent bias with a simple majority of both houses of Congress and a willing President.

A New Child Credit

At present, the income tax code provides very modest relief to parents for each additional child they raise. The code includes a $1,000 credit and a $3,950 personal exemption. Applying a 15 percent tax rate to that exemption generates tax relief of $593, which means the typical middle-class parent reduces her tax bill by $1,593 per child. But this is only a tiny fraction of the cost of raising a child.

The Department of Agriculture says the cost of raising the typical child is $13,600 per year through age 17—and that doesn't include the cost of saving for college. Considering that Social Security and Medicare will absorb about 25 percent of the labor income of a child born today, sharing the direct financial costs of raising children to the same extent that the benefits of their future labor income will be shared suggests reducing the annual tax bill of parents by $3,400 per child (25 percent of $13,600).

Another way of determining the appropriate amount of tax relief for parents is to consider the present value of future Social Security and Medicare contributions for a typical worker born today, which is about $160,000.

> For some families, the extra money could be just the boost they need to be able to send their kids to a better school. Coming at a time in life when many parents and potential parents are considering whether they can afford an additional child, the extra credit would directly make carrying the burden (and generating the future social benefits) of a growing family somewhat easier.

Rewarding parents for making these future contributions possible suggests annual tax relief of about $9,000 per child. (The contribution figure is what matters, because today's children will get benefits only if they as a group raise children, regardless of whether they're "promised" benefits under current law.)

A recent tax reform proposal by Senator Mike Lee (R., Utah) would take a large step in this direction. He would keep the current $1,000 child credit and the personal exemption for children, and add a new credit of $2,500 available to all taxpayers with kids, with no phase-out of the sort that applies to the current credit. The new credit could be used to reduce income-tax and payroll-tax liabilities; it couldn't be used to increase refunds for those who have already used other credits (like the earned income credit) to reduce their tax bill to zero.

To help pay for the new larger child credit, Senator Lee would greatly simplify the income tax code, getting rid of all itemized deductions except for the mortgage interest and charitable deductions. He would also limit the deduction for new mortgages to $300,000.

Senator Lee's plan would increase the tax relief associated with having each child by $2,500 per year for the typical middle-class family. So, for example, under the proposal, a married couple with two children earning $70,000 would get a tax cut of roughly $5,000 per year compared to current law.

For some families, the extra money could be just the boost they need to be able to send their kids to a better school. Coming at a time in life when many parents and potential parents are considering whether they can afford an additional child, the extra credit would directly make carrying the burden (and generating the future social benefits) of a growing family somewhat easier. In addition, because the size of the credit would temporarily wipe out tax liabilities for some middle-class parents it would also reduce their marginal tax rate on additional work to zero.

A recent "score" of Senator Lee's proposal by the Tax Policy Center suggests the concept needs to be adjusted to achieve revenue neutrality compared to the current tax code. But that can be done without disturbing the framework of the plan.

For example, income that is today taxed at a 25 percent rate would get a 15 percent rate under Senator Lee's proposal. But if income in the current 25 percent bracket had a 35 percent rate (the same tax rate Senator Lee would apply to all regular income above the 15 percent bracket) the proposal would be revenue neutral.

Some supply-siders will reflexively cringe at this idea. Most of the extra revenue from applying the 35 percent rate to a lower income level would, however, come from workers who would already be paying a marginal rate of 35 percent. Alternatively, the 25 percent bracket could remain 25 percent and some extra revenue could be generated by more quickly limiting the mortgage interest deduction to the middle class or perhaps limiting the exemption for interest on municipal bonds.

Answering Critics

Increasing the amount of tax credits for parents would certainly result in a smaller share of workers paying taxes in any given year. Some suggest this could increase the electorate's appetite for government spending, because fewer of them would directly feel the cost. Already, the top 40 percent of earners pay about 99 percent of federal income taxes. Factoring in other federal taxes — like those on payrolls and corporate profits, and excise taxes — the top 40 percent of earners pay about 85 percent of federal tax revenue.

But annual snapshots are deceiving. Most workers move across different income groups during their lifetimes. And just as tax cuts for the highest brackets are eventually enjoyed by many more people than those who happen to be in those brackets in any one year, so too will people who drop off the tax rolls in one year because they're busy raising children likely find themselves paying taxes again in another.

Moreover, no economic analysis has actually shown a structural relationship between moving more citizens off the tax rolls and increased support for larger government. By contrast, conservative Nobel Prize–winning economist Gary Becker has shown that countries with flatter tax systems tend to have larger governments, as the burden of additional spending proposals can be spread across a wider tax base—which means fewer taxpayers have an incentive to resist the expansion of government.

Even more important, Senator Lee's proposal does not simply reduce the tax rolls based on income. Instead, it reduces the tax rolls based on parenting. This difference is crucial. Some low earners might imagine themselves earning little for the foreseeable future. As a result, voting for more government spending might appear a bargain. But parents know their children are going to eventually leave the nest. They will know that also means their tax bills will go back up—giving parents a good reason to want government spending restrained.

Moreover, reducing the high cost of raising children could make many middle-class parents less likely to support government spending, not more—since a lack of cash during their parenting years is one reason they might favor more government activism in the first place. The constituency for government-provided pre-school, for example, would be smaller if parents had more ability to finance the child-care options they chose.

The Next Conservative Tax Reform

For conservatives to move forward, we have to come to grips with both our victories and our failures. Having substantially cut top tax rates in the 1980s,

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our potential gains from fighting on the tax rate battlefield are now diminished. Not gone completely, just smaller. To gain popularity for a broader conservative agenda, we need to offer something more than just updated versions of plans that have failed to gain traction for decades.

Too many free-market economists still consider the economics of the family a sideshow. They say the tax code should be “neutral” about raising children even though fiscal policy is not. Others simply ignore the way the entitlement state has distorted family life.

Unwittingly, the federal government has set up programs that deter parenting. Using the tax code to fix that problem would not only correct a distortion but could be the key to winning back the political trust and support of the middle class.

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The Solution: A conservative governing vision to restore America's promise YUVAL LEVIN

1. So, for instance, Paul Krugman can write: "Start with the proposition that there is a legitimate left-right divide in U.S. politics, built around a real issue: how extensive should we make our social safety net, and (hence) how much do we need to raise in taxes? This is ultimately a values issue, with no right answer." Like many on the Left, he takes the essential question of our politics to be exactly how much of the Left's agenda should be adopted. ("The Closing of the Conservative Mind," *New York Times*, May 25, 2013, http://krugman.blogs.nytimes.com/2013/05/25/the-closing-of-the-conservative-mind/.)
2. As former representative Barney Frank put it at the Democratic National Convention in 2012, "There are things that a civilized society needs that we can only do when we do them together, and when we do them together that's called government." Similarly, in his second inaugural address, in 2013, President Obama sought to depict individual action as the only alternative to government action, saying: "No single person can train all the math and science teachers we'll need to equip our children for the future, or build the roads and networks and research labs that will bring new jobs and businesses to our shores. Now, more than ever, we must do these things together, as one nation and one people."
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Health-care reform to lower costs and improve access and quality JAMES C. CAPRETTA

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Tax reform to strengthen the economy and lighten the burdens families bear ROBERT STEIN

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K–12 Education reform to give the next generation a chance to thrive FREDERICK M. HESS

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Higher-education reform to make college and career training more effective and affordable ANDREW P. KELLY

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