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On "Individual Tax Reform"

Tax Relief for Parents

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Chairman Hatch, Ranking Member Wyden, and distinguished members of the Finance Committee, thank you for convening this hearing on "Individual Tax Reform." I am a visiting fellow at the American Enterprise Institute, a senior editor at National Review, and a columnist for Bloomberg View. This testimony reflects my own views and not those of any organization with which I am affiliated. It is an honor to be testifying before you.

While tax policy has been a politically contentious issue, over the last twenty years a broad political consensus has supported tax relief for parents of dependent children. The major reforms of the tax code undertaken over this period have consistently included such tax relief. The Taxpayer Relief Act of 1997 instituted a tax credit of $500 per eligible child. The Economic Growth and Tax Relief Reconciliation Act of 2001 raised the amount of the tax credit to $1,000. The Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerated the phase-in of that expansion. And the American Tax Relief Act of 2012 made that expansion permanent.

People on different parts of the political spectrum have had varying reasons for supporting the child credit, including an appreciation of the costs of raising children and the belief that raising children is, in no merely metaphorical sense, an investment in the nation's future. The fact that the child credit lifts nearly three million people out of poverty each year has also brought it support.[1]

Yet the child credit has had critics, who believe that it represents a form of governmental favoritism or even "social engineering," and that changes to the tax code should consist of measures more directly related to increasing economic growth.

In this testimony I will lay out a case for expanding the child credit—specifically, for increasing the maximum level of the credit and for applying it to reduce payroll-tax as well as income-tax liability—as a crucial component of tax reform.

Reducing the "Parent Tax"

The main goal of tax reform is generally taken to be to move closer to a tax code that raises the desired amount of revenue while minimizing the distortions that government policy can create. One example of a distortion caused by government policy is an unjustified tax break for a particular kind of investment. This departure from neutrality between different types of economic activity has two negative effects. It unfairly transfers resources from one group of people to another, and it reduces the efficiency with which markets direct capital to its most productive uses. In that way the tax break reduces national welfare and eliminating the break would increase it. Another example of a distortion: In theory, high tax rates on income can

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[1] "Policy Basics: The Child Tax Credit," Center for Budget and Policy Priorities, October 21, 2016.

so discourage work that reducing them raises the same amount of revenue while allowing for a larger economy.

One rationale for an expanded tax credit for children is that it reduces a distortion caused by government policy: the large, though implicit, tax on parenting that the structure of our entitlement programs has inadvertently created. Social Security and Medicare, our principal government programs to take care of senior citizens, rely for their financing, in large part, on parents. All taxpayers, whether or not they have children, contribute to the program. Parents, however, contribute to the program both through the federal taxes they pay and through the financial sacrifices they make to raise children (including, in many cases, forgone income). The federal government does not recognize the extent of this contribution, which has the effect of causing parents to shoulder a larger share of the burden of government than they should.

Consider two couples with similar earnings histories, one with two children and one with none. The first couple contributes more to the future of the entitlement programs but gets no more benefits from those programs as a result. In the world before the entitlement state, many of the financial sacrifices the first couple made in raising children would redound to their direct benefit in old age, as their children took care of them. Entitlements socialize much of the financial return from child-rearing for the betterment of senior citizens as a group, regardless of whether or how many children those senior citizens have.

Society has made this choice for weighty and very widely supported reasons. But if it does not recognize parental investment in children as a contribution to the entitlement programs, it is, whether it consciously aims to do so or not, transferring resources from parents to the childless and from larger families to smaller ones. We can call this transfer the "parent tax."[2]

Two mistaken objections to this analysis may suggest themselves. The first is that it is a kind of single-entry bookkeeping, since most of those children will grow to be senior citizens one day and then benefit from Social Security and Medicare themselves. In the past, I have suggested a thought experiment to illustrate why that's a mistaken view.[3] Imagine a society with old-age programs similar to ours in which for generations each woman has had two children. Imagine next that for one

[2] Large transfers of this kind can also be expected, all else equal, to reduce by some amount the number of children that people raise. For evidence that this effect has occurred in developed countries, see Michele Boldrin, Mariacristina De Nardi, and Larry E. Jones, "Fertility and Social Security," NBER Working Paper no. 11146, February 2005; and Isaac Ehrlich and Jinyoung Kim, "Social Security, Demographic Trends, and Economic Growth: Theory and Evidence from the International Experience," NBER Working Paper no. 11121, February 2005.
[3] Ramesh Ponnuru, "The Empty Playground and the Welfare State," *National Review*, May 28, 2012.

generation each woman has three children, and then the pattern of two children re-asserts itself. That increase in the number of children would work an improvement in the finances of the programs that would never be undone. For one generation, the same tax rate would yield a higher level of benefits. Afterward that society could revert to the previous benefit level, but it would never have to go below that level. (Alternatively, that society could react to its baby boom by keeping benefits flat and for one generation reducing tax rates.)[4]

The second mistaken objection is that this analysis omits the many government benefits that accrue to families with children. Childless adults pay for schools through their taxes, after all. The difference is that all of these childless adults benefited themselves from an education financed by someone else. A system of general taxation to pay for schooling does not create free riders in the way Social Security and Medicare do, and does not represent a transfer from smaller families to larger ones.

Other government policies, however, represent genuine but very partial offsets to the parent tax: notably the tax exemption for dependents and the existing tax credit for children. The problem is the scale: These policies reduce the parent tax but leave it still quite high. One conservative estimate suggests that the child credit would need to increase to roughly $4,800 per child to eliminate it completely.[5]

While a large child credit is not the only way to reduce the parent tax, it has significant advantages over other methods. An alternative that has been proposed is to reduce payroll taxes based on the number of children a taxpayer is raising.[6] Benefit levels in retirement could also be set to vary based on the number of children a senior citizen had raised. A larger child credit would, however, be administratively simpler than either policy, since it would only change an existing provision of the tax code. Compared to a higher-benefits policy, it would also direct resources to households at the time they are most likely to be needed: that is, when they are raising children.[7]

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[4] The thought is developed in Hans-Werner Sinn, “The Value of Children in a Pay-As-You-Go Pension System: A Proposal for a Partial Transition to a Funded System,” National Bureau of Economic Research Working Paper 6229, October 1997.

[5] Robert Stein, “Taxes and the Family,” *National Affairs*, Winter 2010. I have updated his estimate using the Consumer Price Index.

[6] Charles Blahous and Jason J. Fichtner, “Limiting Social Security’s Drag On Economic Growth: Removing Disincentives to Personal Savings and Labor Force Participation,” Mercatus Research, 2012.

[7] Shrinking the entitlement programs would also reduce the parent penalty, although that proposal would of course involve important trade-offs beyond the scope of this testimony. The programs would have to be very drastically reduced, however, to eliminate the parent tax entirely. See Hans-Werner Sinn, “The Pay-As-You-Go Pension System As a Fertility Insurance and Enforcement Device,” National Bureau of Economic Research Working Paper 6610, June 1998.

A larger deduction for the cost of commercial day care, meanwhile, would reduce the parent tax for some families but exclude the many families who make different arrangements for their children.

An increased standard deduction has also been proposed as a way to deliver tax relief to middle-class Americans. Whether or not this increase would be desirable on other grounds, it would not reduce the parent tax. It appears that more of the benefits of a child-credit expansion would also accrue to relatively low-income households.[8]

Applying the Child Credit Against Payroll Taxes

The logic of this case for a large child credit does not just militate in favor of raising its maximum value from $1,000 per child to some bigger number. It also militates in favor of applying it against payroll taxes as well as income taxes: in favor, that is, of making it partially "refundable."

The parent tax arises, again, because parents are contributing to Social Security and Medicare both through their taxes—including especially their payroll taxes—and through the financial sacrifices they make to raise children. If we wish to reduce their contributions to put it on par with those of non-parents, we need to take account of the payroll taxes as well as the income taxes. Consider once more our two couples, one with children and one without, and assume both of them are paying the same amount of payroll taxes but do not make enough money to have income-tax liability. The former couple should have a lower payroll-tax liability.

Not only that: The credit should in principle be applied not just against "employee-side" payroll taxes but against "employer-side" payroll taxes as well. It is widely recognized among economists that the taxes an employer pays toward Social Security and Medicare for employees represent forgone wages.[9] Their true economic incidence, that is, falls almost entirely on the worker. They, too, are thus part of the contribution that the taxpaying employee makes to these programs.

Some observers have expressed concern about taking people off the income-tax rolls. The child credit has already kept some families from having a positive income-

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[8] The Tax Foundation estimates that a doubling of the standard deduction would reduce revenue by $1.3 trillion over ten years while raising incomes in the second-lowest-earning quintile of taxpayers by 0.15 and 1.4 percent; doubling the child credit would on the other hand reduce revenue by $640 billion over ten years while raising income in the lowest quintile by 0.5 percent and the second-lowest quintile by 2.1 percent. "Options for Reforming America's Tax Code," Tax Foundation, 2016.
[9] See, for example, Jonathan Gruber, "The Incidence of Payroll Taxation: Evidence from Chile," National Bureau of Economic Research Working Paper 5053, March 1995.

tax liability and an expanded child credit would have that effect for even more families—and, as we have seen, reduce their payroll-tax liability too. These observers worry that voters who do not pay taxes will have an unhealthful relationship to government, seeing its benefits as free. The empirical grounding for this fear is weak, however, and in any case a household's removal from the tax rolls will be temporary: Adults will lose the credit when their children grow up. And if any large group of citizens can be expected to look to the future, it should be parents.

Paying for an Enlarged Child Credit

As with any form of tax relief, a larger child credit would require the government either to tolerate larger deficits, to reduce spending, or to raise other taxes. It is possible to agree on the case for a larger child credit while disagreeing on many of these questions of fiscal and tax policy. My own top preference would be to reform Social Security and Medicare in ways that would reduce the federal government's long-term spending compared to their projected levels while also maintaining and perhaps even augmenting our current commitments to the neediest.[10] My second preference would be to scale back or eliminate tax breaks such as the deductions for mortgage interest and state and local taxes, especially for the highest earners. A third solution would be to lower the thresholds at which people move into the highest tax brackets, so that the top marginal tax rates in a reformed tax code apply to a larger number of people.

My main point in this testimony, however, is to argue that reducing the parent tax ought to be a priority for tax reform. If tax reform aims to keep revenues flat, then it should expand the child credit somewhat and make revenue-raising tax-policy changes to compensate. But the increase in the credit cannot be wholly paid for by eliminating the dependent exemption, since that would leave the parent tax unaffected.[11] If tax reform instead aims for lower revenues than currently projected, then a larger child credit should account for some of that reduction. An expanded tax credit for children should be part of any larger tax reform that Congress enacts, so that the reform is both pro-growth and pro-family.

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[10] See Andrew Biggs, "A New Vision for Social Security," *National Affairs*, Summer 2017, for an example of a proposal that seeks these goals.

[11] Eliminating the dependent exemption and raising the child credit by $600 per child, for example, may be a good idea for reasons unrelated to the parent tax. But it would do nothing to provide tax relief for the many parents in the 15 percent tax bracket—since the lost value of the exemption would cancel out the expansion of the credit—and would therefore not reduce the parent tax they pay.