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Statement of

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The Future of Individual Tax Rates: Effects on Economic Growth and Distribution

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Chairman Baucus, Ranking Member Grassley, Members of the Committee: Thank you for inviting me to share my views on whether and how to extend the 2001 and 2003 tax cuts. I am speaking for myself alone. My views should not be attributed to any of the organizations with which I am affiliated.

The expiration of the "Bush tax cuts" at the end of 2010 creates a number of decision points for the Congress: Should all or some of the tax cuts be extended? If so, should they be made permanent? If not, how long should they be extended for? And, if only some of the tax cuts are to be extended, which ones?

In short, I believe it would be a serious mistake to make any of the tax cuts permanent now. The income tax is a mess and is badly in need of an overhaul. It doesn't raise close to enough revenue to pay for current governmental expenditures and is needlessly complex, unfair, and inefficient. A system-wide reform along the lines of the Tax Reform Act of 1986, but with the goal of eventually raising enough revenue get the national debt out of the red zone should be a top priority for the Congress. Permanent extension of the tax cuts would make such a reform far more difficult and would signal to markets that our budget problems are only going to get worse.

However, I also think it would be a mistake to allow all of the tax cuts to expire as scheduled in 2011. The economy is in a very precarious state and a major tax increase would slow the economic recovery. With credit still in very short supply, low- and middle-income households are facing serious cash flow constraints. A tax increase would result in less spending, which would ripple through the economy, costing jobs and threatening the nascent recovery.

This is not true for the tax cuts affecting high-income households. As the CBO noted in a recent report on stimulus options, the "consumption [of higher-income households] is unlikely to be constrained by their income in a given year."[1] Some have argued that lower income tax rates are necessary to encourage "pass through entities" whose owners pay individual income taxes to hire, but the CBO also was skeptical of that claim: "increasing the after-tax income of businesses typically does not create much incentive for them to hire more workers in order to produce more, because production depends principally on their ability to sell their products."

Allowing the high-income tax cuts to expire will save $125 billion through FY 2013 compared with a full extension. Those savings could make a small dent in our ballooning debt, or they could fund more effective fiscal stimulus measures such as extending unemployment benefits or aiding the states.

The duration for the temporary tax cut extension should match a commitment to produce and vote on a major tax reform. As President Reagan did in his 1984 State of the Union Address, the Congress should instruct the Treasury Department to produce a tax reform blueprint to be released after the presidential election in 2012. The tax reform should aim to simplify the tax system enough so that ordinary Americans understand it and perceive it as fair. A major goal should be to broaden the base and lower tax rates while raising enough revenue to pay for government by a set date. With luck, the President's Bipartisan Debt Reduction Task Force will come up with a plan that could serve as a useful starting point. Other good models also exist, including the Wyden-Gregg Bipartisan Tax Fairness and Simplification Act of 2010 and the proposals of President Bush's tax reform panel, although both of those plans would need significant adjustment to produce adequate revenues. Congress should commit to producing its own plan and bringing it up for a vote before the expiration of the temporary tax cut extension in 2013.

The Bush Tax Cuts

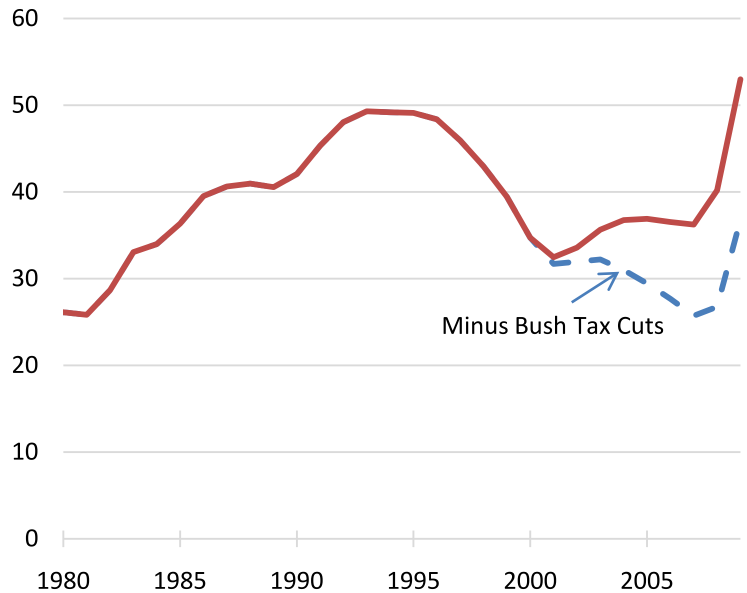
The large deficit-financed tax cuts enacted between 2001 and 2006 had many unfortunate consequences. While they had some good elements, including cuts in marginal tax rates, a phaseout of the complicated tax surcharges known to tax geeks as PEP and Pease, and important support for low-income working families through expansion of the child and earned income tax credits, they added enormously to the public debt while failing to address the major shortcomings of the income tax. Notably, the tax cuts actually exacerbated the problem of the ultra-complicated AMT by cutting regular income tax rates with no permanent change to the design of the AMT. As a result, a series of costly temporary stopgaps have been required to prevent tens of millions of middle class households from facing that incomprehensible levy.

If the Bush tax cuts had never been enacted, debt held by the public at the end of 2009 would have been reduced by 30 percent, to about $5.2 trillion or 37 percent of GDP. (See Figure 1.) This was less than the level of the debt at the end of 1999. With the tax cuts, however, the debt ballooned to $7.5 trillion (53 percent of GDP) and is now over 60 percent of GDP. While the

[1] Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2010 and 2011," working paper, January 2010. http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf

cost of two wars, enhanced homeland security, the TARP, several rounds of economic stimulus and an expensive new prescription drug benefit under Medicare have clearly also contributed to the run-up in debt, the fact remains that the debt would likely be at relatively manageable levels had it not been for the tax cuts.

Figure 1. Debt as a Share of GDP, With and Without Bush-Era Tax Cuts, 1980-2009



Source: Kathy A. Ruffing and James R. Horney (http://www.cbpp.org/files/12-16-09bud.pdf) and author's

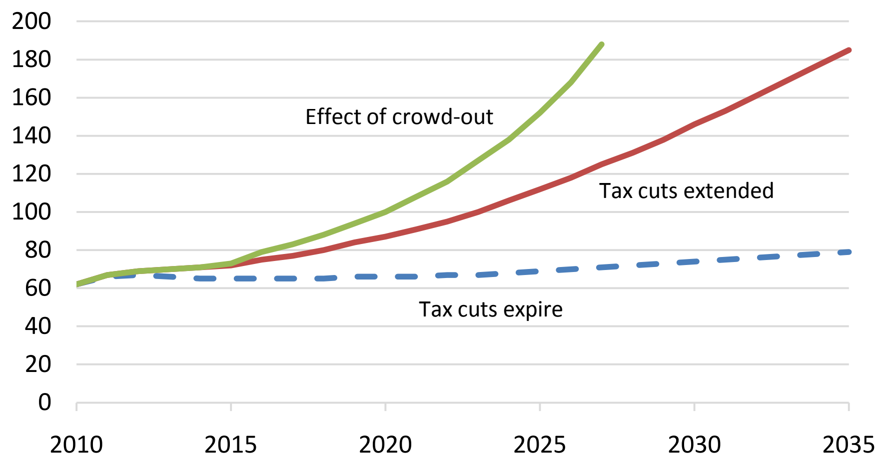
Will Rogers said, "If you find yourself in a hole, the first thing to do is stop digging." Permanently extending the tax cuts would dig the hole much, much deeper. The CBO projects that if the tax cuts are allowed to expire and the cost containment measures in the new healthcare bill are allowed to take effect, the debt will actually decline over the next decade, although it will trend up after that. (See Figure 2.) If the tax cuts are extended and the healthcare cost containment measures in the new health reform bill prove unsustainable, however, the debt explodes, reaching 100 percent of GDP by 2023. Even this grim scenario is optimistic because it assumes no response of interest rates to the higher debt levels. If interest rates increase as the government's demand for capital grows, public borrowing will crowd out private investment and the economy will suffer. The CBO estimates that, under that scenario, debt could reach 188 percent of GDP by the year 2027.

As my Tax Policy Center colleagues and I have explained, the debt explosion could have far worse consequences than a gradual erosion of the economy.[2] It is possible that interest rates will remain low for years, creating a kind of debt bubble: our ballooning debt appears affordable to

[2] Leonard E. Burman, Jeff Rohaly, Joseph Rosenberg, and Katherine C. Lim, "Catastrophic Budget Failure," *National Tax Journal*, 63(3): 561–584, September 2010.

us and our lenders as long as interest rates stay low. At some point, investors perceive a risk of default on the debt (or inflation, which would devalue it). This pushes up interest rates, which in turn raises the risk of default, creating a vicious cycle. When the bubble bursts, the United States is an insolvent, heavily indebted superpower, with disastrous consequences for ourselves and the rest of the world. The possibility of such a "catastrophic budget failure" should be avoided at all costs.

Figure 2. CBO Projection of Debt Held by the Public Under Alternate Fiscal Scenarios, 2010-2035



Source: CBO Long-Term Budget Outlook, June 2010

<u>Rationales for permanent tax cuts</u>

Advocates of permanent tax cuts make at least three arguments for them: (1) limiting federal revenues is the only way to restrain government spending, (2) permanent tax cuts are much more effective than temporary ones at boosting the economy, and (3) tax cuts pay for themselves because they lead to higher growth and thus boost future tax revenues.

The first argument is sometimes known as the "starve the beast" theory. Under this theory, figure 1 is naïve because it assumes that spending would have been the same even if the government had collected trillions in additional revenues. Instead, it is argued, more revenues just enable more (wasteful) government spending. If the Bush tax cuts had not been enacted, policymakers would have spent more.

On its face, this argument appears plausible, but it is hard to imagine that spending could have been higher as revenues were slashed by the Bush tax cuts. Government grew much faster from 2001-2009 than during the Clinton Administration. While some of that was war-related, nondefense discretionary spending also sped up and, as noted, a major expansion in Medicare was enacted.

It appears that instead of constraining spending, deficit financing was contagious. If deficits don't matter when considering tax cuts, why should they be considered when evaluating a new drug benefit or a "bridge to nowhere?"

William Niskanen, president of the libertarian Cato Institute, posited a public choice critique of "starve the beast."[3] If deficits finance 20 percent of government spending, then citizens perceive government services as being available at a discount. Services that are popular at 20 percent off the listed price would garner less support at full price.

He found statistical support for his theory in a time series regression of revenues against changes in spending. He hypothesized that higher revenues could constrain spending, and found strong support for that conjecture based on data from 1981 to 2005. Another Cato researcher, Michael New, tested Niskanen's model in different time periods and using a more restrictive definition of spending (non-defense discretionary spending) and found the earlier results to be robust.[4]

I think that Niskanen and New might have understated the effect of deficits on spending. The message during the last decade seems to have been not that spending and tax cuts were available at a discount, but that they were free. Spending for wars, Medicare expansion, and "no child left behind" happened at the same time that taxes were falling. Citizens could be forgiven for forgetting that there is *any* connection between spending and taxes.

My guess is that if President Bush had announced a new war surtax to pay for Iraq or an increase in the Medicare payroll tax rate to pay for the prescription drug benefit, both initiatives would have been less popular. Given that the prescription drug benefit only passed Congress by one vote after an extraordinary amount of arm-twisting, it seems unlikely that it would have passed at all if accompanied by a tax increase.

Starve the beast doesn't work. Conservative Bruce Bartlett called it "the most pernicious fiscal doctrine in history."[5]

The notion that permanent tax cuts are more effective than temporary ones has a stronger pedigree, dating back to Milton Friedman's "permanent income hypothesis." The basic notion is that prudent consumers will spend only part of a temporary windfall and will save the rest, whereas a permanent increase in income will translate immediately into permanently higher spending. Ample empirical evidence supports the hypothesis.

Nonetheless, this insight is not a very useful guide to tax policy. While permanent tax cuts may be more effective as anti-recession tools than temporary cuts, an endless series of permanent tax cuts would bankrupt the nation and is thus infeasible as policy.

Deficits are simply deferred tax increases or spending cuts. The Bush tax cuts will have to be paid back (with interest) and given the retirement of the baby boomers and the continued growth in health care costs, they will surely be offset with higher taxes rather than lower spending.

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[3] William A. Niskanen, "Limiting Government: The Failure of 'Starve the Beast'," *Cato Journal*, 26(3):553-558, Fall 2006.

[4] Michael J. New, "Starve the Beast: A Further Examination," *Cato Journal*, 29(3): 487-495, Fall 2009.

[5] Bruce Bartlett, "Tax Cuts And 'Starving The Beast'," *Forbes.com*, May 7, 2010. http://www.forbes.com/2010/05/06/tax-cuts-republicans-starve-the-beast-columnists-bruce-bartlett.html.

This means that anti-recession tax cuts will be temporary—whether advertised as such or not—and thus will have diminished effectiveness.[6] Thus, to produce a given level of stimulus, any temporary tax cut has to be bigger. Alternatively, the money might be spent on direct expenditures—such as investment in infrastructure—which guarantees that all of it will be spent and produce income for the recipients.

Finally, some supply-side theorists have contended that cuts in marginal tax rates could pay for themselves because the economy would grow faster and generate more tax revenues. Serious analyses of supply-side tax cuts, even by those very sympathetic to the premise that tax cuts can boost economic growth, have all concluded that deficit-financed tax cuts do not pay for themselves over the long run.[7] In fact, if the resulting deficits are ultimately offset by higher tax rates, the ultimate effect is likely to be lower GDP.

This occurs because the cost of taxation grows disproportionately with the tax rate. Thus, if top tax rates are cut from 40 percent to 35 percent for a while, but then raised to 45 percent to pay back the resulting debt, the 5 percentage point increase in rates reduces growth by much more than the temporary 5 percentage point rate cut boosted it.

As a general rule, stable tax rates impose less economic cost than volatile ones. For that reason, it would be far better to raise taxes soon to reduce the deficit than to postpone action for many years. The longer we wait, the higher tax rates would have to be to restore balance. And income tax rates of 50 or 60 or 70 percent would entail huge economic costs compared with a 40 percent rate.

A Strategy for the Short- and the Long-Term

I suggest three goals for tax and budget policy over the next few years:

- Do not stifle the nascent economic recovery.
- Implement a credible plan to get the debt down to a sustainable level within the next decade.
- Reform the tax system to make it simpler, fairer, and more conducive to economic growth.

[6] There are exceptions. Temporary investment credits or deductions can be very effective at shifting the timing of expenditures. If taxpayers know that they have to spend money this year to get a tax credit or deduction, they will be inclined to accelerate spending. The home buyers' credit and bonus depreciation are both in the category of timing tax incentives; however, experience with the home credit suggests that proper timing can be a challenge. While the credit sped up home purchases among those who qualified, its expiration appears to be creating a significant dip in home sales while the housing market is still very weak.

[7] The Congressional Budget Office, Joint Committee on Taxation, and the Treasury all conducted studies in the early 2000s. They concluded that tax rate cuts could boost the economy in the short-run, but not by nearly enough to offset the direct revenue loss. The long-run effect depended on how the deficits were closed. If the deficits ultimately led to higher tax rates, GDP would be lower than without the tax cuts. If the deficits ultimately led to spending cuts, GDP would increase permanently. In all cases, the effects were small. See Jane Gravelle, "Issues in Dynamic Revenue Estimating," CRS Report for Congress RL31949, U.S. Congressional Research Service, 2007, for an excellent survey.

Temporarily Extending the Middle-Class Tax Cuts

The goals of addressing the debt crisis without retarding the economic recovery are directly in conflict. The traditional fiscal policy recipe for addressing a severe economic downturn calls for spending increases and/or tax cuts with resulting deficits in the near term to boost aggregate demand and stimulate economic activity. The other avenue for boosting the economy is expansionary monetary policy, but the Federal Reserve's traditional toolkit is unlikely to provide much additional support with interest rates barely above zero.[8] Thus, the Fed's ability to offset the effect of contractionary fiscal policy with monetary easing may be especially limited.

For that reason, traditional fiscal policy would call for continuing all or most of the tax cuts, but, as noted, that path will eventually lead to ruinous deficits. The balance between the two objectives can be reached by extending the most expansionary of the tax cuts, but only temporarily. This would limit the increase in the debt.

The most effective way to boost aggregate demand (and thus the economy) is to raise the incomes of those whose spending is constrained—that is, those with low incomes. Lower-income households spend virtually all of their income while those with high incomes are able to save. During normal times, middle-income households can smooth their consumption by borrowing—for example, by using a credit card or tapping a home equity line of credit—but the financial market meltdown has sharply curtailed access to credit. This increases the likelihood that targeted tax cuts would boost spending (rather than simply reducing debt or increasing saving).

In contrast, high-income households spend only a fraction of their incomes. In 2003, households with incomes over $200,000 spent less than 40 percent of their incomes.[9] The rest goes to saving and taxes. Tax cuts for such households are likely to have little effect on spending.

Temporarily extending only the provisions affecting low- and middle-income households would dramatically reduce the cost of extending the tax cuts. Excluding the high-income provisions, as proposed by the Obama Administration, would reduce the 10-year cost of full extension by about 25 percent—nearly $1 trillion—based on Treasury estimates. Further limiting the tax law extension to three years (through 2013) would reduce the revenue cost of extension by roughly 80 percent—or about $3 trillion. Including savings in interest payments, the national debt could be reduced by close to $4 trillion by 2020 under a temporary targeted extension of the middle-class tax cuts.

In addition, a smaller budgetary commitment to tax cuts could make more resources available for other possibly more effective economic stimulus measures, such as an extension of unemployment benefits—which ranks at the top of CBO's list in terms of bang for the buck—or

[8] The Fed can also print money (technically, using its currency reserves to buy Treasury bonds and other assets, increasing the stock of cash in circulation). Until the economic meltdown, the Fed primarily relied on its control of interest rates to expand or tighten access to credit because it is easier to quickly open or close the spigot at the discount window.

[9] Leonard E. Burman, Jane G. Gravelle, and Jefffrey Rohaly, "Towards a More Consistent Distributional Analysis." *National Tax Association Proceedings of the 98th Annual Conference*, 2005.

aid to states to forestall some of the spending cuts and tax increases they are undertaking under tremendous budgetary pressure.

Tax Reform

The other part of the program would be a commitment to comprehensive tax reform that would stabilize the debt at about 60 percent of GDP by the end of the decade.[10] A good place to start this effort could be the recommendations of the bipartisan National Commission on Fiscal Responsibility and Reform if it produces a recommendation for tax and budget reform. Alternatively, the Treasury might take the lead as it did in producing the first draft of what became the Tax Reform Act of 1986 in the Fall of 1984, after the presidential election. Following that precedent, the Treasury report would be completed by the end of 2012. A three-year extension of the middle-class tax cuts would give Congress until the end of 2013 to craft and pass a tax reform bill.

The ideal reform would broaden the tax base and lower tax rates. Both the Wyden-Gregg Bipartisan Tax Fairness and Simplification Act of 2010 and the proposals of President Bush's tax reform panel took this approach and would significantly reduce top income tax rates. The problem with both proposals, however, is that they would substantially add to the public debt. The Wyden-Gregg plan is designed to be revenue neutral compared with a full extension of the expiring tax provisions, including the AMT patch. The Bush proposals would raise more revenue because they did not assume an AMT fix in the baseline. But both options would fall far short of revenues needed to get deficits under control.

To meet revenue targets, a new more efficient tax such as a carbon tax or value-added tax could be enacted to complement the income tax and facilitate lower individual and corporate income tax rates while maintaining a suitable degree of progressivity.[11]

This would be far better than simply raising top income tax rates under the current flawed system. Tax rate increases harm the economy and cannot, by themselves, close the budget gap.[12] In contrast, base broadening can boost tax revenues and make the income tax more efficient, fair,

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[10] Two careful bipartisan plans for debt reduction chose the 60 percent target. See National Research Council and National Academy of Public Administration, *Choosing the Nation's Fiscal Future,* Washington, DC: National Academies Press, 2010; and Peterson-Pew Commission on Budget Reform, "Red Ink Rising: A Call to Action to Stem the Mounting Federal Debt," Washington, DC: Peterson-Pew Commission, 2009. Economists Carmen Reinhardt and Kenneth Rogoff provide one rationale for such a threshold: Half the nations that experience debt crises had debt-to-GDP levels below 60 percent of GDP. See Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Foll*y. Princeton: Princeton University Press, 2009.

[11] For example, I have suggested enacting a VAT dedicated to paying for health care, which would allow a major reform and simplification of the individual and corporate income taxes at much lower rates than the current system. See Leonard E. Burman, "A Blueprint for Tax Reform and Health Reform," *Virginia Tax Review* 28: 287-323, 2009.

[12] See Rosanne Altshuler, Katherine Lim, and Roberton Williams, "Desperately Seeking Revenue," *National Tax Journal,* forthcoming. They calculate that raising only the top three tax rates would require a top rate of more than 76 percent to get the deficit down to down to an average of two percent of GDP from 2015 to 2019; and raising only the top 2 rates—the policy most consistent with the President's promise to spare the middle class—would require a top rate of almost 91 percent, a level not seen since the Kennedy Administration. In fact, the resulting tax avoidance would reduce the revenue take at these very high tax rates. Thus, rate increases alone could not possibly close the budget gap.

and comprehensible.[13] Loopholes and preferences in the income tax complicate tax preparation and create opportunities for tax avoidance and evasion. For example, long-term capital gains face a 15-percent top rate compared with a 35 percent rate for ordinary income. The capital gains preference has created a whole tax shelter industry designed to convert highly taxed ordinary income into lightly taxed capital gains. The lower rate can distort investment and occupation choices. For example, finance experts who work in the private equity arena are taxed at less than half the rate of bond traders who may work down the hall and do very similar work. Taxing capital gains at the same rate as other income would eliminate those distortions.[14]

Issues and Concerns

Several critiques have been raised with respect to extension of only the low- and middle-income tax relief. One is that high income tax rates would discourage entrepreneurship and slow employment, threatening the economic recovery. In addition, some analysts have raised concerns that the refundable tax credits, which were significantly expanded as part of the 2001 and 2003 legislation (and also by the recently enacted health reform legislation), can discourage work.

<u>Income tax rates and entrepreneurship</u>

Entrepreneurship is a key component of economic growth. Entrepreneurs take risks and, when successful, create jobs, profits for shareholders, and innovations that other firms can imitate.[15] If high individual income tax rates discouraged entrepreneurship, that would be undesirable. The conventional argument for why high tax rates might have such an effect is simply that potential entrepreneurs won't do the hard work or take the risks necessary for success unless they can keep a large share of potential returns. A somewhat more subtle argument is that progressive tax rates discourage risk taking since successful entrepreneurs end up in high tax brackets where much of their profits go to the tax collector, whereas the unsuccessful entrepreneur faces low tax rates which reduce the value of loss deductions.[16]

In fact, it is unlikely that higher income tax rates on entrepreneurs would reduce hiring in the short term. For one thing, less than 3 percent of tax returns with business income are in the top

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[13] See Emmanuel Saez, Joel B. Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," NBER Working Paper 15012, 2009. They conclude that rate increases entail significant economic costs while base broadening reduces the cost of taxation. Conservative icon Martin Feldstein made the same argument in a *Wall Street Journal* op ed, arguing that additional revenues are needed and eliminating tax breaks would be far better than raising tax rates. See Martin Feldstein, "ObamaCare's Crippling Deficits," *Wall Street Journal*, September 7, 2009.

[14] Numerous other arguments are made for a lower tax rate on capital gains. See Leonard E. Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*, Washington, DC: Brookings Institution Press, 1999, for a discussion and critique.

[15] Julie Berry Cullen and Roger H. Gordon, "Taxes and Entrepreneurial Risk-Taking: Theory and Evidence for the U.S," *Journal of Public Economics*, 91(7-8): 1479-1505, 2007.

[16] William M. Gentry and R. Glenn Hubbard, "'Success Taxes,' Entrepreneurial Entry, and Innovation," in *Innovation Policy and the Economy. Volume 5,* edited by Adam B. Jaffe, Josh Lerner and Scott Stern, 87-108, Cambridge and London: MIT Press, 2005.

two tax brackets, so the vast majority would be protected from tax rate increases by the extension of middle-class tax cuts proposed by the President.[17]

But even those who might face higher tax rates would not have an incentive to change hiring decisions. Employers will hire a new worker if they expect the value of the worker's output to exceed what he or she is paid. If the hire is profitable before tax, it doesn't matter whether the employer gets to keep 60 or 65 percent of that additional profit. The new worker will also be profitable after tax. And if the worker cannot produce enough to justify his or her costs, income tax rate cuts cannot make the new hire profitable.

As for the effect of individual income tax rates on the decision to become an entrepreneur, it is likely that higher individual income tax rates encourage entrepreneurship for several reasons. First, successful entrepreneurs can choose to incorporate to take advantage of the 15-percent tax bracket that applies to small corporations. According to economists Julie Cullen and Roger Gordon, "The option to choose the organizational form ex post based on the outcome reduces the effective tax rate on profits without affecting the tax rate on losses, thereby encouraging risk taking. *The higher are personal relative to corporate tax rates, the larger is the encouragement to risk taking arising from this option.*" (p. 1480, emphasis added)

Self-employed people may also fully deduct expenses that wage and salary workers cannot deduct. And, to the extent that self-employed people work at low wages, investing their labor into their business (that will ultimately be repaid in the form of lightly taxed capital gain if the business is successful), they save the taxes they would have paid if they had remained in a wage-paying job. The value of those tax savings grows with the individual income tax rate. Cullen and Gordon estimated the empirical effect of all of these factors on entrepreneurial activity and concluded that "contrary to conventional wisdom, … a cut in personal tax rates can substantially reduce entrepreneurial risk taking." (p. 1501)

In addition, self-employed people are notoriously non-compliant. The IRS estimates that sole proprietors misreported income by an average of 57 percent in 2001.[18] The tax sheltering aspects of self-employment become more attractive at higher income tax rates.

Thus, the evidence suggests strongly that higher marginal income tax rates on high-income entrepreneurs are unlikely to result in significantly less employment or risk-taking. There may, however, be a much more important indirect effect. If rising debt levels pushed up interest rates, that would have a very deleterious effect on investment and hiring decisions of all businesses, including entrepreneurs. By sharply curtailing the revenue loss attributable to the Bush tax cuts, a targeted, temporary extension could help keep interest rates low and boost economic activity and entrepreneurship.

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[17] William G. Gale, "Small Businesses and Marginal Income Tax Rates," *Tax Notes*, 471, April 26, 2004.
[18] See Susan C. Nelson, "Tax Policy and Sole Proprietorships: A Closer Look," *National Tax Journal*, 61(3): 421-443, September 2008.

Refundable tax credits and work incentives

The Bush-era tax cuts significantly expanded the amount of tax credits that could be claimed by households with no income tax liability. The new laws raised the maximum child tax credit from $500 to $1,000 per child and created a refundable child tax credit of 15 percent of earnings above $3,000 up to the maximum of $1,000 per child. The refundable earned income tax credit (EITC) was also increased. Prior to 2001, households with one child received a refundable credit equal to 34 percent of earnings up to a maximum level; the phase-in rate was 40 percent for households with two or more children. The credit phased out at higher income levels. Married couples and singles were subject to the same phase-in and phase-out schedule for the credits, creating potentially substantial marriage penalties. (Marriage could push family incomes into the phase-out region for the EITC, reducing or eliminating the credit.)

The American Recovery and Reinvestment Act of 2009 (ARRA) added a third tier for the EITC—a 45 percent phase-in rate for families with three or more children—and increased the EITC marriage penalty relief that was created as part the 2001 tax cut. The EITC now phases out at a higher income level for couples than for singles.

The combined credits can now be quite substantial. In addition, the making work pay tax credit, enacted in 2009, is another refundable wage subsidy, and the only substantial work incentive for households without children.[19] In total, the subsidies are designed to encourage work and help lower-income families with children.

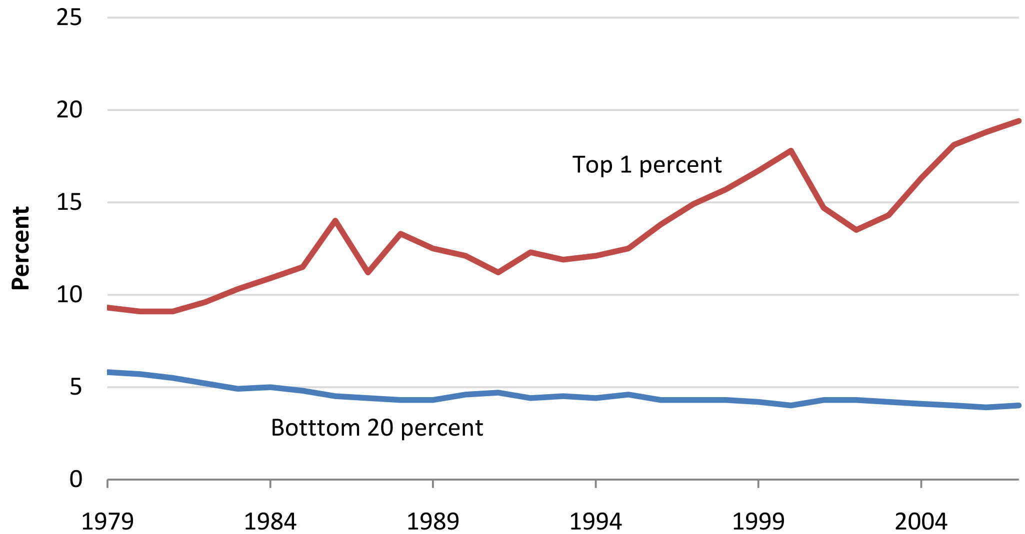
Although some conservatives are uneasy about the large refundable tax credits, sometimes calling them "welfare," well designed work subsidies would seem to epitomize conservative values. They reward work over welfare and make it possible for families in low wage entry level jobs to earn a decent after-tax income. By encouraging an attachment to the work force, the subsidies encourage the development of human capital and promote upward economic mobility.

While most economists believe that a well-functioning free market system may maximize aggregate income, there is no guarantee that the distribution of income is equitable. Indeed, between 1979 and 2007, average real incomes at the bottom of the income distribution stagnated while incomes at the top exploded. At the same time, the share of income earned by top earners more than doubled while low earners saw a dwindling share of total income. (See Figure 3.)

Refundable tax credits play an important role in mitigating rising economic inequality. I view this as a good thing in its own right, but even those who believe that it is fine for a small number of people to control more and more of society's resources might have an interest in using the tax system to diminish inequality. Growing inequality could lead to a populist revolt against factors thought to be implicated, such as free trade and relatively unfettered markets. Increasing trade barriers and increased regulation could diminish the incomes of those at the top by much more than a modestly progressive tax system (and might not help those at the bottom either). The progressive income tax might be viewed as a mechanism to buy the support of ordinary working people for a system that disproportionately benefits a few high earners.

[19] The Affordable Care Act (health reform) will include refundable credits that dwarf the existing work and child subsidies for households with low incomes when it is fully phased in.

Figure 3. Share of Pre-Tax Income Earned by Bottom 20 and Top 1 Percent of Households, 1979-2007



Source: Congressional Budget Office, *Average Federal Taxes by Income Group*, June 2010.

The other line of criticism levied at refundable tax credits is that they are poorly designed and discourage work. While it is true that the phase-out of the EITC combined with payroll taxes and income taxes can create relatively high effective marginal tax rates for low-income households, the evidence suggests that, on balance, the EITC encourages work. The credit creates conflicting incentives. For a single parent (the vast majority of EITC recipients), the credit encourages participation in the labor force because earnings are necessary to qualify for the credit. For very low-income workers whose earnings fall entirely in the phase-in range, the credit raises the after-tax (after credit) wage, which rewards working more hours. However, many workers' earnings are in the phase-out range, where each additional dollar of earnings can cost as much as 21.06 cents in lost credits (for workers with two or more children). These workers might decide to cut hours to avoid the high implicit taxes.

Empirical research suggests that the participation effect is the more important of the two conflicting incentives.[20] The EITC encourages single parents to work and has little or no effect on hours worked in that group. Among married couples with income in the EITC phase-out range, there is a small negative effect on participation and hours of second earners. On balance, the EITC encourages work.

[20] See, e.g., Eissa, Nada, and Hillary W. Hoynes, "Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply," in Poterba, James M. (ed.), *Tax Policy and the Economy, Volume 20*, 73–110, Cambridge, MA: National Bureau of Economic Research, 2006; Steve Holt, "The Earned Income Tax Credit at Age 30: What We Know," The Brookings Institution Research Brief, February 2006; V. Joseph Hotz, Charles H. Mullin, and John Karl Scholz, "Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare," NBER Working Paper 11968, January 2006.

While research on the empirical effects of the refundable child tax credit and making work pay tax credits on labor force participation and work hours is not yet available, those programs were designed to provide a positive subsidy to meager wages and they do not phase out until fairly high income levels. It is thus likely that those credits would reinforce work incentives for low-wage workers.

The credits could, of course, be improved. For example, the various tax subsidies for work and children could be consolidated and simplified. If phase-outs and the resultant high marginal tax rates are deemed undesirable, they could also be addressed as part of tax reform. However, the refundable credits mitigate some of the harshest features of the free market, encourage work and economic mobility, and provide essential aid to low-income working families with children.