For more than two decades, free-market economists and policymakers have championed an agenda of comprehensive tax reform. Modeled on President Ronald Reagan’s 1981 tax cuts, their plans have sought to combine further cuts in marginal income-tax rates with relief for corporations and investors, along with a profound simplification of the entire federal tax code. But unlike Reagan’s immensely popular initiative, the reformers’ campaign has gained little traction with the public—and has not been enacted even in times of Republican dominance in Washington.

At the core of this failure has been a misreading of Reagan’s success. Too often, advocates of comprehensive tax reform have focused on the particular means of Reagan’s plan—the lowering of marginal income-tax rates—rather than on its more general ends: correcting economic distortions caused by government policy, lightening the tax burden on American families, and encouraging more work and investment.

Lowering tax rates today could still enhance the incentives to invest, particularly in the corporate sector. But the distortions caused by marginal tax rates are not nearly as great as they were in 1980. And attempts to solve other problems caused by the tax code itself—like the biases in favor of consumption over saving, or home building over business investment—could never in themselves garner the public support necessary for a major overhaul.

Instead, tax reformers should understand that the workplace is not the only venue in which incentives matter—and that taxpayers are not simply workers, employers, and investors. Economic man is also a family man, and the next generation of tax reform should address the distortions and burdens our fiscal policy imposes on American families.

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In particular, it is time to rethink how the tax code treats parents. Too many free-market economists still consider families an afterthought—arguing that the tax code should be “neutral” about raising children, as if parenting were merely one hobby among many. But raising children is hardly just another pastime: It is one of the most important services any American can perform for our country.

Even if we ignore the societal and cultural implications of parenting and consider economic factors alone, no government—not a government committed to an entitlement system like ours—can be neutral toward the very existence of future generations of taxpayers. Our nation’s long-term economic prospects are threatened by a declining fertility rate that, if it remains constant, will only barely manage to replace our current population. And even as Social Security and Medicare depend on large numbers of future workers, they have created an enormous fiscal bias against procreation, undermining an important motive for raising children: to safeguard against poverty in old age.

By targeting tax reforms to address these problems, policymakers would both offer meaningful relief to American families and create political opportunities to enact other pro-growth policies. Such reforms could eventually yield a much simpler tax code with lower top marginal rates on work and investment, as well as more favorable treatment for families with children. The result would be a tax-reform agenda with the right attitude toward families—and one with a chance to break the political logjam that has prevented serious change for a generation.

THE REAGAN TAX REVOLUTION

Ever since the imposition of the federal income tax in 1913, the United States has had a system of marginal tax rates. Taxpayers are grouped into brackets based on income; those who earn more are taxed at higher rates. But the bracket into which each person falls describes only the rate at which the last dollar he earns is taxed. A person in the 28% tax bracket does not pay 28% of his entire income; rather, he pays 28% only on the money he earns above the income cutoff that separates him from the previous tax bracket.

For example, let’s suppose that there are three tax brackets: Income up to $100 is taxed at 10%, income between $100 and $1,000 is taxed at 20%, and income above $1,000 is taxed at 50%. If a worker earns $100, he pays an income tax of $10. If a worker makes $1,000, his first $100 is...
taxed at 10%, while his next $900 in income is taxed at 20%. He pays a $10 tax on the first $100 of income, and $180 in taxes on the next $900 of income, for a total income-tax bill of $190. But if a worker earns $2,000, he would pay $190 on the first thousand and then a 50% tax (or $500) on the second thousand, yielding a total tax bill of $690. The nature of the marginal tax-rate system means that although his income is double that of the worker earning $1,000, his tax bill is actually more than three times larger — and the disproportion would grow with every dollar earned in the highest bracket.

At a certain point, rates can rise so high that workers already living comfortably with substantial income may decide that it is simply not worth working for more. The key insight of conservative economic thinking in the 1970s was that marginal tax rates were so high that they significantly undermined the incentives to work, save, and invest. Conservatives therefore argued that significant tax-rate cuts would not only put more money in taxpayers’ pockets, but also encourage more economic activity, and thus greater prosperity, growth, and even government revenue.

Consider that in 1979, there were more than a dozen tax brackets — and in the top one, workers paid an income tax of 70%. Of every dollar earned beyond $108,300, a worker would keep only 30 cents. Moreover, the tax code was not indexed for inflation. So during the high-inflation 1970s, workers had additional reasons to resent the federal tax structure. First, inflation compounded the existing problems of a marginal-rate system; as salaries grew to keep pace, workers — especially those in the highest bracket — saw a greater share of their income taxed at the highest rate. And many other workers found themselves dragged into higher and higher tax brackets while the actual purchasing power of their income rose much more slowly — a process that came to be known as “bracket creep.” The tax code thus further depressed the incentive for high earners to increase their productivity, and therefore depressed economic activity, investment, and growth.

In 1980, Ronald Reagan made the Kemp-Roth tax plan — including a 30% cut in all federal income-tax rates — the centerpiece of his economic agenda. Reagan’s political success that year, and the strength and length of the economic expansions of the 1980s and ‘90s, were due largely to this one decision. Once in office, President Reagan cut tax rates across the board and indexed the tax code for inflation. Marginal income-tax
rates that had ranged from 14 to 70% were cut to a range of 11 to 50%. The positive impact on work incentives for high-income households was enormous, as the workers with the most control over their work hours, output, and pay structures had a strong reason to be more productive.

In addition, the Reagan program increased the after-tax return on investment by cutting tax rates on dividends and capital gains. By encouraging greater participation in the stock market, and therefore increasing sources of capital for businesses, these improvements helped generate the great economic expansions of the 1980s and ’90s. The reduction in tax rates on the highest-income households also paid for itself: As the economic boom increased individuals’ wealth, the total income taxes paid by top earners increased as a share of gross domestic product following the Reagan tax cuts.

It is worth noting, however, that the Reagan tax cuts improved work incentives much more for higher-income households than for the middle class and the poor. While the highest-income households experienced a 67% increase in the after-tax return on additional work, a more typical middle-class household saw only an 8% increase.

This was neither class warfare nor a peculiar artifact of the Reagan tax cuts. It was the straightforward result of having a highly progressive structure of tax rates with a very high top rate. A strategy of reducing tax rates simply cannot enhance work incentives as much for those workers who already keep most of what they earn. (And in any case, those workers generally have less control over how much they can work than the rich do.)

But regardless of how they stacked up against wealthier families, there is little doubt that middle-class households liked paying less in taxes as a result of the 1981 cut. They also appreciated, and made popular, the president who put an end to inflation-related bracket creep. But it is difficult to make the case that the middle class cared very much how the tax cut was delivered; it wasn’t all that meaningful to middle-income workers that they kept more money in their pockets because their marginal rate was lower, rather than through other mechanisms such as tax credits or adjustments to corporate taxes. The incentives guiding their economic decisions would not have been all that different had their tax bills been reduced in other ways.

It is also important to recognize that repeating Reagan’s feat — using the tax code to boost incentives for the highest-earning workers to the
same degree—would be simply impossible today. Even starting from a top income-tax rate of nearly 40% (which we can expect once President Bush’s tax cuts expire in 2011), income taxes would have to go to zero—and not be replaced by any other tax system, like a sales tax—to generate the kind of positive work incentives the original Reagan cuts produced.

There is, of course, far more room to improve the incentives for corporate investment, the profits from which currently face two layers of taxation. And policymakers should look to cut tax rates on inherited income, which—because it has been taxed once already at the time it was earned—is also subject to double taxation. But such reforms by themselves could hardly gain the political backing or produce the economic effects of a broad-based income-tax cut.

Repeating something like Reagan’s feat today would therefore require not simply imitating the particulars of his tax reform, but rather advancing its underlying aim: eliminating gross distortions that stifle economic growth and punish workers across the income scale. One such distortion does exist today, though not in the arena of marginal tax rates. A move to correct it could build the kind of political momentum ultimately needed for a broad and productive reform of the tax code.

**Parents and the Tax Code**

Today, most of the middle class finds itself in a 15% income-tax bracket that adjusts annually for inflation—and so proposals that focus on cutting marginal rates simply will not resonate as they did in 1981, when most middle-class families had been watching their marginal tax rates steadily increase for years. But federal fiscal policy still imposes a significant burden on the middle class, and especially on middle-class families. Indeed, our system of taxes and entitlements not only fails to reward parents—it actively discourages Americans from having children.

In more primitive economies, children are the primary vehicle for saving for old age. Parents provide their children with food, clothing, and shelter; eventually, the grown children take care of their elderly parents—often in the context of cultural or religious practices that serve as cross-generational enforcement devices. It all adds up to a natural incentive for fertility. Of course, parents may not explicitly have their advanced years in mind when deciding to have more children. But it is well demonstrated that this consideration—channeled through a
wide variety of social and cultural institutions and signals—in fact plays an important role in such decisions.

Advanced economies, meanwhile, tend to have lower fertility rates—in part because adults can save for retirement using financial instruments, which are a partial substitute for raising children. The prevalence of public retirement systems suppresses fertility even further. Across advanced countries, those with larger public retirement systems tend to have lower fertility rates, even when controlling for a wide range of other social and economic variables (such as income levels or the education and labor-force participation of women).

In fact, a growing body of economic literature shows that in the United States, Social Security and Medicare have “crowded out” the traditional incentive to raise children as a protection against poverty in old age. Most workers 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. Recent studies (especially work by Michele Boldrin, Mariacristina De Nardi, and Larry Jones and by Isaac Ehrlich and Jinyoung Kim) show that Social Security and Medicare actually reduce the fertility rate by about 0.5 children per woman. 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 fertility rates of about 2.5 children per woman—safely above the population-replacement rate—rather than their actual rates of about 2.1 and 1.5, respectively.

Compounding the problem is the fact that even as these systems depend upon a population of productive young workers at the national level, they diminish the economic need for children at the individual level—and so undermine their own sustainability. By having the economic benefits of children accrue only to society in the aggregate—and thereby distorting those benefits from the individual mothers and fathers who make the decisions about how many (if any) children to have—federal policy distorts incentives in ways harmful to the country’s future.

Unfortunately, these negative effects on fertility cannot be cured simply by converting old-age entitlement programs into mandatory savings programs, as the Bush administration proposed for Social Security in 2005. After all, requiring workers to save for retirement through private financial instruments would also crowd out the traditional motive to raise kids.
Instead, those seeking to restore the incentives for producing new generations of Americans should push to reduce taxes on families with children. Such a reform would offset the negative bias imposed by the public retirement system. It would also communicate to Americans that people living in societies with public retirement systems must meet two obligations in order to sustain those systems: first, work and pay taxes to support the previous generation; second, raise children to support today’s workers when they retire. Those who do not raise children are, in effect, enjoying a partial free ride at the expense of those who do. The next great tax reform should thus begin by cutting taxes for parents.

**A New Child Credit**

There are, of course, already some modest tax benefits attached to having children. Combining the impact of the $1,000 per-child tax credit with 15% of this year’s dependent exemption of $3,650 (15% being the income-tax rate paid by most middle-class parents), it turns out that having a child today reduces the typical household’s annual tax burden by a total of about $1,550. But considering both the cost and the value of raising children, $1,550 is much too low.

The exact cost of raising a child is notoriously difficult to estimate, given disparities in spending at different income levels—not to mention the countless unquantifiable factors involved. But if we take the commonly cited Department of Agriculture figure of $13,000 per child per year through age 17 (a figure that does not even account for college-education costs)—and the fact that Social Security and Medicare will absorb about 25% of the labor income of a child born today—we would find that sharing the direct financial costs of raising children to the same extent that the benefits of their future labor income will be shared would require reducing the annual tax bill of parents by $3,250 per child (25% of $13,000).

Another way of looking at the issue is to consider that the present value of future Social Security and Medicare contributions for a typical worker born today is about $150,000. Rewarding parents for creating these future contributions suggests annual tax relief of about $8,500 per child.

To correct for this inadequate treatment of households with children, the existing dependent exemption for children, the child credit, the child-care credit, and the adoption credit should be replaced with one new $4,000 credit per child that can be used to offset both income and
payroll taxes. (This amount is set much closer to the $3,250 figure than the $8,500 one mostly to reduce the plan’s negative impact on federal revenue.)

The new child credit would accomplish several significant policy goals. First, it would offset the anti-parenting bias created by Social Security and Medicare. Second, the credit would help simplify the tax code by getting rid of other exemptions and credits that apply to children. Third, and very important for many families, it would end the bias against families with a stay-at-home parent now caused by the child-care credit (which applies only if both parents are working for pay). And finally, it would reduce effective marginal tax rates for many middle-class families.

Such an approach would also be very popular with a vital political constituency—middle-class parents—thereby opening the way to further tax reforms that would both help to pay for the new credit and correct other important deficiencies in the tax code. It could stand as the centerpiece of a new tax-cutting agenda.

THE NEXT TAX REFORM

Reducing the fiscal burden on parents is very important, but it should not be the only prominent goal of the next wave of tax reform. Reformers should also reduce the worst distortions in the income-tax code itself, including the multiple layers of tax on corporate profits and the highest regular income-tax rate. As they do so, their other key aim should be simplification—to help clean up the mess the tax code has become since the last major overhaul in 1986.

All of these goals can be accomplished by making limited changes to the existing tax code, rather than pushing for a utopian “big bang” tax-reform plan (like a flat tax or retail sales tax).

First, to remove impediments to capital investment, we should adopt Columbia Business School dean Glenn Hubbard’s proposal to let companies take the profits on which they pay taxes—plus interest earned from tax-free municipal bonds—and distribute them to shareholders tax-free. Corporate profits would therefore no longer face two layers of taxation, just one. Additionally, capital investment should be promoted by letting companies count 25% of plant and equipment spending as business expenses in the year the purchases are made, rather than using the current slower depreciation schedules. Cutting the effective tax rate on capital investment would encourage equity financing of new
investment, raise workers’ wages, create new jobs, and improve the competitiveness of American firms.

Second, to simplify the tax code, we should scrap the individual Alternative Minimum Tax and all itemized deductions except for two that are very popular with the voting public: those for mortgage interest and charitable donations. These two deductions would then be made available to all taxpayers, not only itemizers. The goal, however, would be to make the revenue losses associated with the two deductions the same as they are under current law—which means the principal amount on which mortgage interest could be deducted would have to be reduced, and the maximum size of the charitable deduction would have to be decreased.

After taking these deductions, but before receiving any tax credits, individuals should face only two income-tax rates (compared to the current six). The rates should be set at 15% and 35%, and the width of the 15% bracket should be twice the size for married couples as for singles. In addition, these tax rates should be halved to 7.5% and 17.5% for inherited income (above generous exemptions) and capital gains (other than on corporate shares, which would get the more favorable treatment of the Hubbard proposal). For reference, the top official income-tax rate is likely to be at least 39.6% once the Bush tax cuts expire in 2011—and high-earning Americans could see even more of their money go to the IRS, given the way that some exemptions and deductions phase out at higher incomes. Depending on the outcome of legislative efforts to further socialize the health-care system, these rates—and Americans’ tax bills—could go far higher still.

Next, whatever taxes filers owe would be reduced by two new tax credits. The standard deduction and personal exemption for each filer would be replaced by a tax credit of $2,000 that could be used to reduce income taxes only. Each year, the $2,000 figure would be adjusted for inflation. This credit would take the benefits of the standard deduction, the personal exemption for filers, and the tax relief associated with today’s 10% bracket and compress them into one simple calculation. A married couple with no children, for example, would reduce their income-tax payment by up to $4,000. (Though if they owed, for instance, $3,000 in income taxes before applying the filer credit, their income-tax bill would only go down to zero; they would not get a rebate in excess of income taxes paid.)
After the filer credit, the new $4,000 per-child credit comes into play, offsetting both income and payroll taxes. Moreover, with each passing year, the size of the credit would grow at the same rate as the taxable wage base for Social Security, which means it would generally grow faster than inflation.

Why adjust the filer credit by inflation but the child credit by wage growth? The purpose of the filer credit is to ensure that all taxpayers can earn the basic costs of living — food, clothing, and shelter — without having to pay any income taxes. Over time, the basic cost of living should rise with inflation. The purpose of the child credit, however, is not only to let parents deduct the costs of creating the next generation of taxpayers, but also to reward parents for raising the future workers who will support the public retirement system. The amount of that future support will, naturally, be tied to overall wage growth. And if the child credit grew only with inflation, each year would gradually erode the incentive parents have to raise children relative to those children’s future payroll contributions — thereby undermining a key rationale for offering the credit in the first place.

Under this new tax system, most singles would get a tax cut of $175 while most married couples without children would get a tax cut of $350. But the biggest impact would be felt by parents. Take a married couple with two children, earning $70,000 a year: Under current law, this family generates income taxes of about $5,800 and payroll taxes of $10,710 (combining the employee and employer sides of Social Security and Medicare taxes). But under the tax structure outlined above, their income taxes would be completely eliminated and they would also receive a $1,500 credit against their payroll taxes. They would thus enjoy a tax cut of more than $7,000 per year compared to what they currently pay.

Notice how the child credit enhances this family’s work incentives at the same time that it acknowledges the immense benefits their decision to raise children will confer on the country. If the family generates an additional $5,000 in income, their income taxes do not go up at all. In effect, they face a marginal income-tax rate of zero.

From the standpoint of federal revenue, the child credit and the filer credit are the most “expensive” items, with the child-credit expansion likely reducing revenue by about $200 billion per year and the filer credit costing another $100 billion per year (after accounting for the elimination of the standard deduction and personal exemptions). Some of these costs would
be offset by eliminating itemized deductions (other than mortgage interest and charitable contributions). The rest would have to be offset by allowing the top rate of 35% to touch more taxpayers than it currently affects.

Overall, the plan is designed to be revenue neutral — and yet most taxpayers without children will pay a little bit less in taxes, while middle-class families with children under 18 years of age will pay substantially less. So who pays more? Primarily high-income workers, but also upper-middle-class taxpayers who do not have children in the home (either because they have decided not to raise children at all, or because their children have already turned 18).

To be blunt, the plan is a tax hike on the rich and makes the tax code even more progressive than it is today. Given the loss of the state and local tax deduction, the tax hike will be particularly acute for high earners from high-tax states. And although the top income-tax rate would be capped at 35%, that rate would kick in at lower income levels than it does today. The result would be a marginal tax-rate hike — and a corresponding weakening of work incentives — for many workers who today find themselves in the 25%, 28%, and 33% brackets.

But the effect of this change on the overall economy is likely to be small. Most of the income taxed at those rates actually comes from wealthier people, passing through the upper-middle brackets on their way to earning their last dollars in the top bracket. Applying a higher rate of 35% to more of their income will not make them happy, but it should not dramatically change their incentive to work. Meanwhile, with the top rate set at 35%, rather than the 39.6% or more now scheduled for 2011, the very highest earners will have greater incentive to work harder and more productively.

ANSWERING CRITICS

This agenda would no doubt face resistance from some anti-tax purists. For instance, many conservatives over the years have developed an allergy to any mention of tax credits, and for good reason. Often tax credits phase out over the upper income brackets, which means that earning more money can end up costing a worker his credit — effectively resulting in higher marginal tax rates. Another problem is that checks for tax credits are often mailed out regardless of how much a worker has paid in taxes (or whether he has paid taxes at all); this can convert a tax credit into a de facto welfare payment.
Some may argue that the plan outlined here is much the same thing: a large welfare-style transfer payment. But the child credit is not a welfare check sent to unemployed adults just because they have more kids. If one has no labor income, one simply does not receive the credit. And once a household has no more income or payroll tax to offset, having more children gets the family nothing. Nor does the child credit turn raising children into a money machine: Anyone who has children knows that $4,000 per year is only a fraction of the actual cost of raising them. Moreover, given the generosity the tax code already shows low-wage parents, the new credit would not be available to those taking the Earned Income Tax Credit. It’s either-or, not both.

Others may object that, over time, there is actually no net government revenue gain to raising more children, because those children will grow up to draw on public retirement benefits. But in a mature public retirement system, the amount of benefits available for each generation of workers depends largely on the aggregate earning power of that generation’s children. Whether those children will get anything themselves is not a foregone conclusion; it depends on the aggregate earning power of their children. No matter how you slice it, encouraging more children will mean more government revenue to support current entitlement commitments — and, if the incentives stay on the books, will probably help pay for the next generation’s as well.

Some may also worry that having fewer workers pay taxes each year will increase the electorate’s appetite for more government, since fewer people would directly feel government’s cost. These critics point out that as things stand now, in a given year, the top 40% of earners pay about 99% of federal income taxes. Factoring in other federal taxes — like those on payrolls and corporate profits, and excise taxes — the top 40% of earners each year generate about 85% of that year’s federal tax revenue. There is no escaping the fact that the tax proposal outlined here would increase the share of annual taxes paid by the highest earners, and decrease the share of the U.S. population that pays income taxes in a given year.

But annual snapshots can be deceiving, because 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 the top brackets during the year the cuts are enacted, so too will people who drop off the tax rolls in one year likely find themselves paying taxes again in another.
Moreover, no economic analysis has actually shown a relationship between moving more citizens off the tax rolls and increased support for larger government. Indeed, there is evidence indicating the opposite. Economist Gary Becker has shown that countries with flatter tax systems tend to have larger governments, as the burden of new spending proposals can be spread across a wider tax base—which means fewer taxpayers care enough at the individual level to resist the expansion of government.

Even more important, the tax proposal outlined here does not simply reduce the tax rolls based on income. Instead, it reduces the tax rolls based on parenting. This is a crucial difference. Some low-income earners might imagine themselves earning little for the foreseeable future, based on their experience to date. As a result, voting for more government might appear to be a bargain for them. But parents know that their children are not going to be 17 or younger forever. And given the generous size of the tax credit, they will know that when their children are old enough to leave home their tax bills will spike—giving parents a good reason to restrain the growth of government. 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 resources during their parenting years is one reason they might pursue more government favors in the first place.

One final potential criticism of this plan is that it too heavily favors parents over non-parents. But the plan outlined here includes many work and investment incentives that benefit parents and non-parents equally—such as cutting the top marginal income-tax rate, eliminating the double taxation of corporate profits, and providing faster depreciation for purchases of plant and equipment.

And in the end, it is right and proper to show some favor to parents. Our country is not comprised of individuals who simply fall out of the sky as fully grown citizens—and our civilization’s continued existence hinges on the willingness and desire of adults to raise children. Our public policy can no longer fail to reward those who do.

**A Pro-family tax agenda**

Tax policy will soon be front and center again in our politics. Ongoing efforts to expand the entitlement system will inevitably generate a discussion about overhauling our tax system. Treasury Secretary Timothy
Geithner and White House economic advisor Lawrence Summers have both refused to rule out tax hikes on the middle class. Next year, at the behest of the president, former Federal Reserve chairman Paul Volcker may even deliver a proposal to impose a European-style value-added tax on Americans.

Opponents of these ideas will need to present their own version of tax reform, and it cannot be the same agenda that has failed to gain traction for decades. They will need a plan that makes the tax code simpler and more efficient, corrects unfair distortions, pulls our entitlement programs back from the brink of bankruptcy, and helps American families with tangible tax relief. For reformers serious about achieving these aims, recognizing and rewarding the vital role of parents is the best place to start.