

The Liberty Bullhorn

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Publisher and Editor: Sven R Larson

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Tax Reform and the EITC

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Short Take

State expenditure report 2011

The annual National Association of State Budget Officers (NASBO) will publish its State Expenditure Report in December. As a teaser of what it will say, NASBO published a fiscal survey of the states in May. [That report gives some hints](#) of what we might see in the State Expenditure Report in December:

Increased spending. There are some reasons to expect that state spending will have gone up over the past year. Tax revenues are up in every state, and when tax revenues go up experience tells us that state legislators are quick to spend more;

Weaker consolidation. Most states report a positive end-year balance, but it looks like the balances reported for 2011 will on average be smaller than for 2010. Since tax collections are up, this hints of substantial spending increases;

Medicaid turmoil. Federal Medicaid funds have grown excessively due to the “Stimulus bill”. Those funds are going away already, but the extra enrollment will not. States can beg for more federal funds, raise in-state revenue or terminate enrollment. Regardless of which alternative the state legislators choose, 2011 and 2012 will be tough years for them.

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Republican tax reform and the Earned Income Tax Credit

Sven R Larson

The Republican presidential candidates have produced several tax reform plans. Best known is probably [Herman Cain's flat rate 9-9-9 plan](#). Newt Gingrich proposes [a flat federal income tax](#) as an option to the current system. [Michele Bachmann](#), [Jon Huntsman](#) and [Rick Santorum](#) want fewer brackets and lower rates than today's system. Mitt Romney wants to [keep the current system but with lower rates](#) while Ron Paul wants to [throw out the income tax altogether](#).

Most of the tax debate between the GOP candidates focuses on what their plans will do for mid-to-high income earners. This focus is understandable since the main job creators are small businesses.

At the same time, it is essential for proponents of tax reform to keep in mind what will happen at the other end of the income scale as a result of their reform proposals. In 2009, 27.4 million families received [a total of \\$55.1 billion in Earned Income Tax Credit](#), averaging \$2,206 per family. This makes the EITC the largest entitlement program for working families.

None of the Republican presidential candidates mention the EITC in their tax reform proposals. It is reasonable to assume that Romney, who wants to keep the current system with lower rates, also wants to keep the EITC. It is also reasonable to assume that Huntsman and Santorum, who both want three tax brackets, are in favor of keeping the EITC.

Bachmann's take on the EITC is less clear. She has said that she wants everyone to pay taxes so that they feel that they are contributing to the government services they benefit from. It remains an open question whether or not this means she wants to do away with the EITC; she appears to want everyone to be a net taxpayer, which would imply that she wants to eliminate the EITC.

Cain's flat tax proposal is, in theory, compatible with keeping the EITC. However, in practice it would aggravate a major problem with the EITC, namely the steep marginal income tax effect that it imposes on low-income earners. As this newsletter demonstrates below (page 3), a combination of scaled reduction in benefits and the marginal effect of actual tax rates in the current system can force EITC beneficiaries to pay a higher marginal income tax than families who make ten times more. With a reduction in the top- income tax rates but no reform to the EITC, the discrepancy between the effective marginal tax rate on a \$30,000 income and a \$300,000 income will grow even wider.

There are moral questions associated with this kind of discrepancy, but at least as pressing are the economic questions. Established economic theory says that steep marginal income taxes discourage increases in labor supply and labor effort. A move from the current six-tiered income tax system to a flat tax will undoubtedly encourage more effort from those who make or are within reach of high incomes. But our economy also needs more labor supply at the lower end of the scale. Low-income earners also need encouragement to work more and earn more.

Given the marginal effects that the EITC creates, what are the Republican presidential candidates planning to do to encourage more work at the lower end of the income scale?

Calculating marginal tax rates under the EITC

To calculate the effects of the Earned Income Tax Credit on the marginal income tax rate of eligible families, we perform the following experiment. A married couple is assumed to file jointly, with no children and no other deductibles. The EITC benefits are calculated using the EITC eligibility calculator provided by the Internal Revenue Service. Federal income tax amounts are taken directly out of the IRS 1040 tax table.

When we deduct the EITC from the couple's federal income taxes, we get a net that is negative for couples making \$10,000 and \$20,000. This means that they receive more in earned income credit than they pay in taxes. The net between the federal income tax and the EITC gives us the net average tax rate:

EITC and the Effective Tax Rate

<u>Taxable income</u>	<u>Federal Income Tax</u>	<u>EITC</u>	<u>Net</u>	<u>Effective rate</u>
\$ 10,000	\$ 1,003	\$ 5,030	\$ (4,024)	-40.2%
\$ 20,000	\$ 2,166	\$ 5,030	\$ (2,865)	-14.3%
\$ 30,000	\$ 3,666	\$ 3,230	\$ 430	1.5%
\$ 40,000	\$ 5,166	\$ 1,120	\$ 4,040	10.1%

Due to the tax-EITC net effect, there is a significant increase in the net taxation of low-income families. This effect is further highlighted in calculations of the effective marginal tax effects.

Suppose Jack and Jill make a combined \$30,000 per year. Jack is offered a better job which would increase his income by \$5,000. Their combined federal income taxes would increase by \$750, indicating a 15-percent marginal tax on the new income. But their higher income also reduces their EITC eligibility from \$2,700 to \$1,640. The effective tax on their \$5,000 income increase is therefore \$1,810. This corresponds to a 36-percent effective marginal tax rate.

This effective marginal rate prevails through a wide income bracket: from \$22,500 to \$40,000. These numbers are, again, calculated under the assumptions outlined above, which makes them somewhat artificial. Nevertheless, they do highlight the fact that taxpayers who qualify for the EITC are taxed more heavily on the margin than high-income earners.

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