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CBPP BRIEFING TAX ANALYSES AND BLOG

Americans for Tax Fairness and the FACT Coalition tax reform briefing

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"Blank Slate" Approach to Tax Reform Leaves Biggest Question Unanswered

June 28, 2013 at 11:54 am

Yesterday's call from Senate Finance Committee Chairman Max Baucus and ranking Republican Orrin Hatch to initiate tax reform with a "blank slate" that doesn't include any of the deductions, credits, exclusions, and other tax breaks collectively known as "tax expenditures" leaves a critical question unresolved: what will policymakers do with the proceeds from narrowing or eliminating tax expenditures?

Will they use a substantial share of the savings to help put together an alternative to sequestration or otherwise devote such savings (presumably in conjunction with spending reductions) to the long-term deficit reduction that the nation needs? Or will the savings go entirely to cutting tax rates?

Using some of the savings as part of a responsible, balanced alternative to sequestration —thereby averting harsh cuts in areas ranging from national security to education, medical research, and Head Start — and to help put the nation on a firmer long-term fiscal footing ought to be a higher priority than the pursuit of ever-lower tax rates.

Tax reform that curbs unproductive tax expenditures surely has merit. Yet revenue-neutral tax reform would be highly problematic, as it would likely take revenues off the table for deficit reduction for years to come by using up virtually all politically achievable reductions in tax expenditures. That, in turn, would likely take mandatory programs off the table for deficit reduction as well, because many policymakers would justifiably reject large mandatory cuts in the absence of new revenues.

In addition, policymakers face an immediate need to replace the harmful sequestration budget cuts, which are affecting defense and non-defense programs alike, with a mix of savings from tax expenditures and mandatory programs. But revenue-neutral tax reform could foreclose that option by using up all of the politically achievable tax expenditure savings to pay for tax-rate reductions.

An essential ingredient of tax reform — and the one target for policymakers to specify in advance — is therefore a *revenue target:* one that contributes to a balanced deficit-reduction package that includes replacing sequestration. Revenues raised through tax reform — including through a "blank slate" approach — should go to lower rates only after this target has been met, as most budget agreements under discussion over the past few years would have done.

This means that while policymakers may have useful exploratory discussions on tax reform now, they should defer actual legislative action until there is a larger fiscal policy agreement that includes a revenue target under which tax reform will contribute meaningfully to deficit reduction.

Deficit-Neutral Tax Reform Would Be a Mistake

July 12, 2013 at 9:33 am

Given the nation's long-term fiscal pressures, revenue increases need to make a significant contribution to deficit reduction, alongside cuts in spending for mandatory programs. Deficit-neutral tax reform would, as a result, be highly problematic, as we explain in a new paper. Here's an excerpt:

Tax reform generally refers to a process through which policymakers would scale back the vast collection of tax deductions, credits, and other preferences, known collectively as "tax expenditures." … If tax reform were revenue neutral, it would use up the politically achievable savings from tax expenditures to lower rates without producing any deficit reduction, and it would effectively take revenue off the table for deficit reduction for years to come. It likely would take major mandatory programs off the table as well, because many policymakers would justifiably resist changes in those programs — which could significantly affect millions of people with relatively modest incomes — if they were not accompanied by revenue increases from reforming inefficient tax expenditures that disproportionately benefit the most affluent households.

Aggravating these risks, some prominent proponents of deficit-neutral tax reform have set, as a key tax-reform goal, a sharp cut in the top income tax rates. The House-passed budget resolution of this spring, for example, calls for setting a goal of cutting the top individual and corporate rates to 25 percent and offsetting that cost through unspecified tax-expenditure savings. The House rate-cut goals would dig a $5.7 trillion revenue hole over the next ten years, the Urban Institute-Brookings Institution Tax Policy Center (TPC) has estimated, with the tax benefits heavily skewed to people at the top. The task of finding anything close to that amount in tax expenditure savings would be politically herculean, given the popularity of such major and expensive tax expenditures as the mortgage interest deduction, the charitable deduction, and many others.

Consequently, policymakers would have strong incentive to use budget gimmicks and optimistic revenue forecasts (including the dubious tactic of "dynamic scoring") to reach the stated goal of deficit-neutral tax reform. Thus, a purportedly revenue-neutral tax reform bill might be revenue neutral only cosmetically (or might be revenue-neutral only over the first ten years and lose revenue after that due to the use of "timing-shift" gimmicks). If so, tax reform could wind up raising less revenue than current law over the long term, making long-term deficits worse.

Revenue-neutral tax reform also could lengthen the amount of time that policymakers leave the "sequestration" budget cuts in effect by making it harder to craft a balanced, long-term budget agreement to replace them. Sequestration, with its equal defense and nondefense cuts, was designed to bring bipartisan negotiators to the table in search of a broader agreement that would include both mandatory spending cuts and revenue increases. Revenue-neutral tax reform could doom that prospect as well.

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July 2, 2013

Working-Family Tax Credits Help Over 1 Million Military Families

Credits Keep More Than 140,000 Veteran and Active-Duty Families Out of Poverty

By Arloc Sherman

About one in four current or former armed forces families with children, or 1.5 million military families, receive either the Earned Income Tax Credit (EITC) or the low-income component of the Child Tax Credit (CTC), two tax credits for low- and moderate-income working families, according to an analysis of Census and IRS data. In about 280,000 of these families, a parent is currently serving in the armed forces; in the rest, a parent is a veteran.

The 1.5 million families contain about 3 million children under age 18 and received, on average, about $1,000 per household from the low-income portion of the Child Tax Credit in 2011 and $2,650 from the EITC. Studies have found that children whose families receive more income support from the EITC tend to do better in school and are more likely to attend college and to earn more as adults.[1]

Table 1 provides state-by-state estimates. The number of military families receiving the credits ranges from roughly 3,000 in Wyoming, Rhode Island, and Vermont to more than 100,000 in Texas, California, and Florida. In five states (Alaska, Hawaii, Montana, Virginia, and Wyoming), military families made up more than 10 percent of families with children receiving either the EITC or the low-income component of the CTC. Military families make up 6.1 percent of the families receiving these tax credits nationwide.

In 2013, a married couple with two children may qualify for the EITC if it makes less than $48,378; it may qualify for the low-income portion of the CTC if it makes less than about $47,000. The income thresholds are lower for smaller families. For many active duty and veteran families, these credits make a major difference to their economic security:

- The EITC and CTC together keep more than 140,000 military families — with nearly 300,000 children and 600,000 total family members — from falling below the poverty line, based on the

[1] Chuck Marr, Jimmy Charite, and Chye-Ching Huang, "Earned Income Tax Credit Promotes Work, Encourages Children's Success at School, Research Finds," Center on Budget and Policy Priorities, revised April 9, 2013, www.cbpp.org/files/6-26-12tax.pdf.

federal government's Supplemental Poverty Measure (SPM).[2] (The SPM, unlike the official poverty measure, counts tax credits as income.)

- These credits reduce the severity of poverty for about another 800,000 members of military families.

These figures come from a Center analysis of IRS and Census Bureau data. IRS data show that, in total, about 25 million families with children received either the EITC or the low-income portion of the CTC in 2010.[3] Census data for 2009, 2010, and 2011 indicate that, nationally, 6.1 percent of such families have a parent who is a military veteran or on active duty.[4] (Multiplying the 25 million total from IRS data by this percentage yields the number of military families assisted.[5])

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[2] The SPM poverty line for a couple with two children renting a home in an average-cost community was $25,222 in 2011. The poverty reduction figures cited here include the entire CTC, both its low-income (that is, refundable) and non-refundable portions. Refundable credits like the EITC and the low-income portion of the CTC help families whose incomes are so low that they owe little or no federal income tax.

[3] Published IRS figures show that 20.7 million tax filers with one or more qualifying children claimed the EITC in tax year 2010. In addition, according to unpublished IRS data compiled by the Brookings Institution's Metropolitan Policy Program, approximately another 3.9 million tax filers claimed the low-income (refundable) portion of the CTC in 2010, not counting those who also claimed the EITC, for a total of about 24.6 million families with children who claimed either credit.

[4] The 6.1 percent estimate is from a Center on Budget and Policy Priorities analysis of the latest three years of data (for 2009, 2010, and 2011) from the Census Bureau's Current Population Survey (CPS). We use three years of data to improve the reliability of the estimates. Data on taxes and tax credits in the CPS are estimates that the Census Bureau calculates based on income and other information provided by CPS respondents.

For the state figures in the table, we follow a similar procedure but estimate percentages of military families using the Census Bureau's American Community Survey (ACS), rather than the CPS, because the ACS is larger and more reliable at the state level. We again use three years of ACS data (for 2009, 2010, and 2011) to increase the reliability of the state estimates. Because the Census Bureau does not provide tax estimates for the ACS, we have calculated families' taxes and tax credits. (We assume all of these tax filers claim the standard deduction.) As in the CPS, the ACS calculations show that, nationwide, 6.1 percent of EITC and low-income CTC filers with children are military families. The percentage ranges by state from 3.1 percent in New Jersey to 15.1 percent in Alaska.

[5] The Census data undercount the total number of families receiving the EITC and CTC. For this reason, we start with the actual number of families receiving the credit in IRS records and use Census data to estimate the portion of the participating families that are military families. If we used only the Census data, the results would be similar but a bit lower.

In some respects, our estimates are low. They leave out some military families that we could not reliably identify from the Census data, such as families with a member of the armed forces who is serving overseas or stationed in barracks — and therefore is not covered in the survey. Moreover, because we focus on parents, we do not count families receiving the EITC or CTC that contain current or former service members who are dependent children living at home, such as a recently discharged veteran with a service-related disability.

Table 1

Estimated Number of Veteran and Armed Forces Families with Children That Receive the EITC or Low-income Component of the Child Tax Credit

U.S. Total	**1,510,000**
Alabama	38,000
Alaska	6,000
Arizona	32,000
Arkansas	24,000
California	110,000
Colorado	24,000
Connecticut	6,000
Delaware	5,000
Florida	104,000
Georgia	80,000
Hawaii	13,000
Idaho	11,000
Illinois	43,000
Indiana	34,000
Iowa	12,000
Kansas	16,000
Kentucky	28,000
Louisiana	33,000
Maine	7,000
Maryland	24,000
Massachusetts	12,000
Michigan	40,000
Minnesota	15,000
Mississippi	25,000
Missouri	37,000
Montana	7,000
Nebraska	9,000
Nevada	14,000
New Hampshire	5,000
New Jersey	17,000
New Mexico	14,000
New York	51,000
North Carolina	79,000
North Dakota	3,000
Ohio	55,000
Oklahoma	28,000
Oregon	17,000
Pennsylvania	48,000
Rhode Island	3,000
South Carolina	42,000
South Dakota	5,000
Tennessee	45,000
Texas	138,000
Utah	13,000
Vermont	3,000
Virginia	56,000
Washington	37,000
West Virginia	11,000
Wisconsin	22,000
Wyoming	4,000

Source: CBPP analysis of IRS data (including state data on the overlap between the Earned Income Tax Credit and Child Tax Credit compiled by the Brookings Metropolitan Policy Program) on the total number of EITC and Child Tax Credit tax filers with children in tax year 2010; and CBPP analysis of Census Bureau data to determine the share of such tax filers in each state that were military families. The Census figures use three years of data from the American Community Survey (2009 to 2011) to improve reliability.

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Earned Income Tax Credit Promotes Work, Encourages Children's Success at School, Research Finds

For Children, Research Indicates that Work, Income, and Health Benefits Extend Into Adulthood

By Chuck Marr, Jimmy Charite, and Chye-Ching Huang[1]

The Earned Income Tax Credit (EITC), which went to 27.5 million low- and moderate-income working families in 2010, provides work, income, educational, and health benefits to its recipients and their children, a substantial body of research shows. In addition, recent ground-breaking research suggests, the EITC's benefits extend well beyond the limited time during which families typically claim the credit. The research indicates that children of EITC recipients, for instance, do better in school, are likelier to attend college, and earn more as adults. The Child Tax Credit (CTC), a related credit that's designed to help offset the cost of child-rearing, also plays a major role in helping low-income working families.

Specifically, the EITC significantly increases the work effort of its recipients. The EITC expansions of the 1990s have contributed as much to the increases in work among single mothers and female heads of households that have occurred since that time as the welfare reforms enacted in that period, extensive research has found. Women who benefited from those EITC expansions also experienced higher wage growth in subsequent years than did otherwise similarly-situated women. And, by boosting the employment and earnings of working-age women, the EITC boosts the size of the Social Security retirement benefits they ultimately will receive. In addition, the research shows that by boosting the employment of single mothers, the EITC reduces the number of female-headed households receiving cash welfare assistance.

The EITC may also improve the health of infants, research indicates. Infants born to mothers who could receive the largest EITC increases in the 1990s had the greatest improvements in such birth indicators as low-weight births and premature births.

[1] Indivar Dutta-Gupta co-authored the original version of this paper.

Moreover, income-boosting measures such as the EITC improve educational outcomes for young children in low-income households, recent research finds. Each $1,000 increase (in 2001 dollars) in annual income for two to five years improves the school performance of children on a variety of measures, including test scores. Similarly, a credit that's worth about $3,000 (in 2005 dollars) during a child's early years may boost his or her achievement by the equivalent of about two extra months of schooling.

The EITC's success in boosting work effort and earnings extends into the next generation, the new research indicates. The children of families with more income from refundable tax credits will do better in school, and they are likelier to attend college and also likely to earn more as adults. Those same children are also likelier to avoid the early onset of disabilities and other illnesses associated with child poverty, further enhancing their ability to earn more as adults.

Finally, the EITC reduces poverty and provides a short-term safety net for most of its recipients. To reduce poverty, it encourages work and supplements the wages of poor or near-poor workers — which is particularly important at a time when large numbers of Americans work for low wages, the purchasing power of the minimum wage is substantially lower than it was in the 1960s and 1970s, and job growth thus far in the economic recovery has been disproportionately concentrated in low-wage occupations. Most EITC recipients claim the credit for short periods (a year or two) and mostly to offset the temporary costs of a child's birth or a spouse's loss of income. Most EITC recipients pay more in federal taxes over the long run than they receive in the EITC benefits they tend to claim for short periods.

How the EITC and CTC Work

The EITC, a federal tax credit for low- and moderate-income working families and individuals, is designed to encourage and reward work as well as to offset federal payroll and income taxes. To claim the credit, a taxpayer must have earnings from a job. The EITC is "refundable," meaning that if it exceeds a low-wage worker's federal income tax liability, the Internal Revenue Service refunds the balance to the taxpayer.

The EITC's primary recipients are working parents with children, though a small EITC is available to working adults without dependent children. The credit rises with earned income until it reaches a maximum (which varies by the number of qualified children) and then phases out as income rises further.[2] For 2013, the phase-outs begin at $17,530 for single filers and $22,870 for married filers, and the average size of the credit is expected to be $2,828 for a family with children and $280 for a family without children.[3]

The CTC, which provides taxpayers up to $1,000 for each of their dependent children under age 17, is designed to help families offset the costs of raising children.[4] Unlike the EITC, the CTC is not

[2] For more on how the EITC operates, see "Policy Basics: The Earned Income Tax Credit," Center on Budget and Policy Priorities, updated February 1, 2013, http://www.cbpp.org/cms/index.cfm?fa=view&id=2505.

[3] Tax Policy Center Table T13-0117.

[4] For more on how the CTC operates, see "Policy Basics: Child Tax Credit," Center on Budget and Policy Priorities,

targeted on low- and moderate-income families but extends to middle-income and most upper-middle-income families.[5]

The CTC is partially refundable: a family whose credit exceeds its federal income tax liability can receive a refund for the rest of the credit — but the refund cannot exceed 15 percent of the amount by which the family's earnings exceed a minimum earnings threshold, which is now $3,000. The low-income (i.e., partially refundable) part of the CTC is particularly beneficial to lower-wage workers.

Encouraging Work

The EITC significantly increases the work effort of its recipients, according to substantial research over the past 15 years.[6]

EITC expansions between 1984 and 1996 accounted for more than half of the large increase in employment among single mothers during that period, researchers found.[7] The most significant gains in employment attributable to the EITC occurred among mothers with young children and mothers with low education.[8]

The EITC is particularly effective at encouraging work among single mothers working for low wages,[9] and is considered among the most effective policies for increasing the work and earnings of female-headed families. The EITC expansions of the 1990s "appear to be the most important single

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updated February 1, 2013, http://www.cbpp.org/cms/index.cfm?fa=view&id=2989.

5 The CTC begins to phase out at incomes of $75,000 for single parents filing as heads of household, $110,000 for married couples filing jointly, and $55,000 for married couples filing separately. The income level at which the credit phases out completely depends on the number of qualifying children. For example, the credit phases out at $150,000 for married couples filing jointly with two children.

6 For a summary of research on the EITC, see V. Joseph Hotz and John Karl Scholz, "The Earned Income Tax Credit," in Robert A. Moffitt, ed., *Means-Tested Transfer Programs in the United States* (Chicago: The University of Chicago Press, 2003) and Bruce Meyer, "The Effects of the Earned Income Tax Credit and Recent Reforms," in Jeffrey R. Brown, ed., *NBER Book Series Tax Policy and the Economy* (National Bureau of Economic Research, 2010), http://www.nber.org/chapters/c11973. The refundable CTC is much newer and has not been studied as extensively.

7 See Bruce D. Meyer and Dan T. Rosenbaum, "Making Single Mothers Work: Recent Tax and Welfare Policy and its Effects," in Bruce D. Meyer and Douglas Holtz-Eakin, eds., *Making Work Pay: The Earned Income Tax Credit and Its Impact on America's Families* (New York: Russell Sage Foundation, 2001) and Bruce D. Meyer and Dan T. Rosenbaum, "Welfare, The Earned Income Tax Credit, and the Labor Supply of Single Mothers," *Quarterly Journal of Economics* 116(3): 1063-2014.

8 Economists Nada Eissa and Jeffrey B. Liebman of the Kennedy School of Government also found that the EITC was particularly effective at encouraging work among mothers with low education. Nada Eissa and Jeffrey B. Liebman, "Labor Supply Response to the Earned Income Tax Credit," *Quarterly Journal of Economics* (May 1996).

9 Chris M. Herbst, "The labor supply effects of child care costs and wages in the presence of subsidies and the earned income tax credit," November 17, 2009, http://www.chrisherbst.net/files/Download/C._Herbst_Labor_Supply_Effects.pdf.

factor in explaining why female family heads increased their employment over 1993-1999,"[10] University of Chicago economist Jeffrey Grogger has concluded. Those expansions, he found, actually had a larger effect in increasing employment among single mothers than the 1996 welfare law. (See Figure 1.) In addition, women who were eligible to benefit the most from those EITC expansions apparently had higher wage growth in later years than other similarly-situated women.[11]

Moreover, by boosting the employment and earnings of working-age women, the EITC also boosts their Social Security retirement benefits, which should result in lower poverty among them in old age.[12] (Social Security eligibility and benefit levels are based on how much one works and earns.)

By boosting employment among single mothers, the EITC also produces large declines in the numbers of families that receive cash welfare assistance. The EITC expansions of the 1990s induced more than a half a million families to move from cash welfare assistance to work, research shows.[13] In fact, the research found, those EITC expansions likely contributed about as much to the fall in the numbers of female-headed households receiving cash welfare assistance from 1993 to 1999 as the time limits on cash assistance and other changes under welfare reform.[14]

Nor is there much evidence that when EITC benefits phase down as a family's income rises above certain levels, workers substantially reduce their work hours.[15] Instead, research shows, the EITC

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[10] Grogger, 2003.

[11] Molly Dahl, Thomas DeLeire, and Jonathan A. Schwabish, "Stepping Stone or Dead End? The Effect of the EITC on Earnings Growth," Institute for the Study of Labor, revised April 2009, http://ftp.iza.org/dp4146.pdf.

[12] Molly Dahl, Jonathan Schwabish, Thomas DeLeire, and Timothy Smeeding, "The Earned Income Tax Credit and Expected Social Security Retirement Benefits Among Low-Income Women," Congressional Budget Office, revised March 5, 2012, http://www.cbo.gov/publication/43033.

[13] Stacy Dickert, Scott Houser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," *Tax Policy and the Economy,* Vol. 9, MIT Press, 1995. V. Joseph Holt, Charles H. Mullin, and John Karl Scholz also showed that the EITC was an important tool encouraging welfare recipients to enter the labor force. V. Joseph Holt, 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 No. 11968, January 2006, http://www.nber.org/papers/w11968.

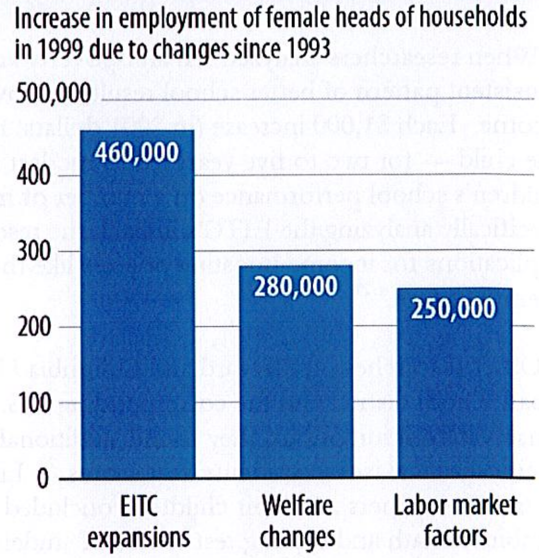
[14] Jeffrey Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income among Female-Head Families," *Review of Economics and Statistics*, May 2003. Using different data, in another study, Grogger reaches similar conclusions. Jeffrey Grogger, "Welfare Transitions in the 1990s: the Economy, Welfare Policy, and the EITC," NBER Working Paper No. 9472, January 2003, http://www.nber.org/papers/w9472.pdf.

[15] Once EITC recipients reach the phase-out range, recipients with no children have their EITC reduced by 8 cents for each additional dollar earned, recipients with one child have their EITC reduced by 16 cents, and recipients with two or more children have their EITC reduced by 21 cents. In theory, the phase-out could discourage additional hours of work among those with incomes in the phase-out range. The only studies to find a reduction in work hours, however, have found such effects to be small. Moreover, those studies generally found such effects only among *married* EITC recipients, and many analysts believe this effect is likely due largely to the fact that the additional income the EITC provides allows the second earner in some married families to choose to spend more time raising children and less time working out of the home. Analysts across the political spectrum have observed that the fact that the EITC may lead some married parents to make such a choice should *not* be regarded as an adverse policy outcome. See David T. Ellwood, "The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage, and Living Arrangements," June 2010, http://www.ipr.northwestern.edu/jcpr/workingpapers/wpfiles/ellwood_eitc99_update.PDF.

has a powerful effect in inducing many more workers to enter the labor force and go to work.

Figure 1

Earned Income Tax Credit the Biggest Factor in Boosting Employment Among Single Mothers



Note: Categories from the Grogger study were combined for simplicity. The categories "time limits," "other reforms," and "maximum benefits" were combined into the category "welfare changes." The categories "minimum wage" and "unemployment rate" were combined into the category "labor market factors."
Source: CBPP analysis of results from Jeffrey Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income among Female-Head Families," Review of Economics and Statistics, May 2003 and data from March 1999 Current Population Survey.

Improving Infants' Health

The EITC may improve the health of infants.

Researchers at the University of California at Davis compared changes in birth outcomes for mothers who likely received the *largest* increases in their EITCs under the expansions of the 1990s and mothers who likely received the *smallest* increases.[16] They found that (1) infants born to mothers who likely received the largest increases had the greatest improvements in a number of birth indicators, such as fewer incidences of low weight births and premature births;[17] (2) mothers who likely received the largest increases were likelier to receive prenatal care, including care before the critical third trimester, and to smoke and drink less during pregnancy; and (3) changes in health insurance coverage did *not* seem to be a primary explanation for these improved health outcomes.[18]

These results mirror a small but promising body of research on the EITC's impact on the health of newly born infants. Previous studies also found strong associations between EITC expansions and improvements in birth weight. Those studies also indicated that mothers who received the EITC were less likely to smoke during pregnancy than similarly-situated mothers who did not receive the EITC.[19]

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[16] The authors controlled for welfare reform, changes in Medicaid or CHIP income eligibility thresholds, the unemployment rate, and the unique impact that belonging to a particular demographic or socio-economic group, living in a particular state, having a particular number of children, and idiosyncrasies of a particular year might have on the incidence of low birth weights for each group of women in their analysis.

[17] Hilary W. Hoynes, Douglas L. Miller, and David Simon, "The EITC: Linking Income to Real Health Outcomes," University of California Davis Center for Poverty Research, Policy Brief, 2013, http://poverty.ucdavis.edu/research-paper/policy-brief-linking-eitc-income-real-health-outcomes.

[18] Hilary W. Hoynes, Douglas L. Miller, and David Simon, "Income, The Earned Income Tax Credit, and Infant Health," NBER Working Paper No. 18206, July 2012, http://www.nber.org/papers/w18206.

[19] See studies cited in footnote 4.

Boosting Children's School Achievement

The EITC and other income-enhancing measures improve the educational outcomes of young children in low-income families, recent research indicates.[20]

When researchers analyzed ten anti-poverty and welfare-to-work experiments, they found a consistent pattern of better school results for low-income children in programs that provided more income. Each $1,000 increase (in 2001 dollars) in annual income — the equivalent of a full CTC for one child — for two to five years led to modest but statistically significant increases in young children's school performance on a number of measures, including test scores. While not specifically analyzing the EITC's impact, the researchers noted that their results have important implications for income-boosting policies like the EITC "that link increases in income to increases in employment."[21]

Other researchers at Harvard and Columbia University analyzed data for grades 3-8 from a large urban school district and the corresponding U.S. tax records for families in the district. Even under conservative assumptions, they found, additional income from the EITC and CTC leads to significant increases in students' test scores.[22] Likewise, researchers who studied nearly two decades of data on mothers and their children concluded that additional income from the EITC raises the combined math and reading test scores of students by similarly-large magnitudes.[23]

All of the studies cited in the previous two paragraphs used different datasets and analytical techniques. Nevertheless, they found similarly-sized effects for a given increase in income — a fact that bolsters the findings of all three analyses. In a review of the evidence, Greg Duncan (University of California Irvine) and Katherine Magnuson (University of Wisconsin) conclude that a credit worth about $3,000 (in 2005 dollars) to a working parent during a child's early years may boost that child's achievement by the equivalent of about two extra months of schooling.[24]

Gordon Berlin, the president of MDRC — one of the nation's leading research organizations that

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[20] For a discussion of the research on the impact of early childhood poverty, see Greg J. Duncan and Katherine Magnuson, "The Long Reach of Early Childhood Poverty," *Pathways*, Winter 2011, pp. 22-27, http://www.stanford.edu/group/scspi/_media/pdf/pathways/winter_2011/PathwaysWinter11_Duncan.pdf. For a more technical discussion of the evidence, see Greg J. Duncan, Pamela A. Morris, and Chris Rodrigues, "Does Money Really Matter? Estimating Impacts of Family Income on Young Children's Achievement with Data from Random-Assignment Experiments," *Developmental Psychology* (June 2011), pp. 1263–1279.

[21] Duncan, Morris, and Rodrigues, 2011.

[22] Raj Chetty, John N. Friedman, and Jonah Rockoff, "New Evidence on the Long-Term Impacts of Tax Credits," Statistics of Income Paper Series, November 2011, http://www.irs.gov/pub/irs-soi/11rpchettyfriedmanrockoff.pdf.

[23] Gordon Dahl and Lance Lochner, "The Impact Of Family Income On Child Achievement: Evidence From The Earned Income Tax Credit," *American Economic Review* (2012), pp. 1927-1956, http://www.aeaweb.org/articles.php?doi=10.1257/aer.102.5.1927.

[24] Duncan and Magnuson, "The Long Reach of Early Childhood Poverty," Winter 2011, which is based on an analysis of studies, including those cited here, of the impact of early-childhood poverty.

is known for its rigorous evaluation of anti-poverty and welfare-to-work programs — summarized the results this way:

> [There is] a remarkably strong body of research — much of it based on large-scale, well-implemented, experimental research designs — showing that supplementing the earnings of parents helps raise families out of poverty and improves the school performance of young children. This point is so important — and to many so surprising — that I want to state it again: We have reliable evidence involving thousands of families in multiple studies demonstrating that "making work pay" causes improvements in young children's school performance.[25]

Boosting Work Effort and Earnings When Children Reach Adulthood

The EITC not only boosts the work effort of parents, particularly single mothers. It extends those benefits to the next generation, recent research suggests.

With more family income through refundable tax credits, children in the family are likelier to attend college and earn more as adults.[26] In fact, researchers found that each dollar of income through tax credits may increase the real value of the child's future earnings by more than one dollar.

For children in low-income families, a $3,000 increase in family income (in 2005 dollars)[27] between a child's prenatal year and fifth birthday is associated with an average 17 percent increase in annual earnings and an additional 135 hours of work when the children become adults, compared to similar children whose families do not receive the added income, researchers have found.[28] (See Figure 2.)

Young children who are raised in lower-income families tended to work less and earn less as adults than higher-income children raised in otherwise similar circumstances. One reason, according to an emerging field of research, may be that the low-income children are more likely to experience poor health as children and in some cases their poor health carries into adulthood. But children in

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[25] Gordon L. Berlin, remarks at National Summit on America's Children, May 22, 2007, http://www.mdrc.org/investing-parents-invest-children.

[26] Chetty, Friedman, and Rockoff 2011.

[27] The authors refer to pre-tax income here. However, they had fairly similar findings when they re-estimated their models using a measure of childhood income that subtracted federal income taxes.

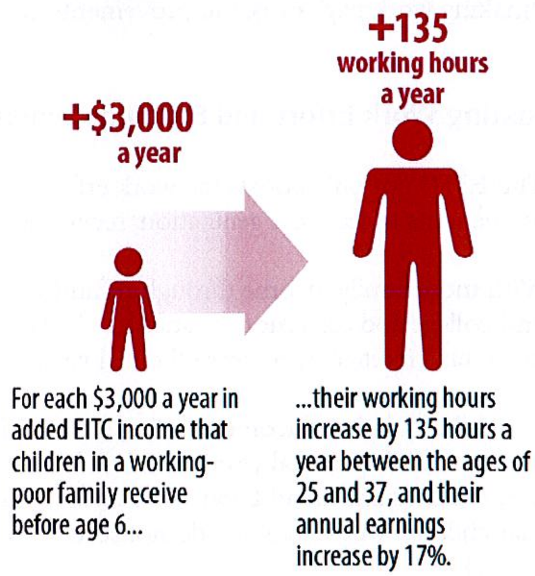
[28] The paper says 19 percent, but our calculations, confirmed by one of the authors, show that this is a typographical error and 17 percent is correct. Duncan, Ziol-Guest, and Kalil, 2010.

households that receive the EITC appear likelier to avoid the early onset of disabilities and other illnesses associated with child poverty, and that apparently increases their ability to earn more as adults.[29]

In short, studies indicate, young children in low-income families that receive the type of income support that the EITC and CTC offer perform better in school, on average, and are likelier to be born healthier and grow up to work more and earn more. "When analyzing the costs and benefits of policies such as the Earned Income or Child Tax Credit," researchers from Harvard and Columbia University advised, "policymakers should carefully consider the potential impacts of these programs on future generations."[30]

Figure 2
Earned Income Tax Credit Income for Poor Children Linked to More Work Hours and Higher Earnings Later in Life

The change in annual adult work hours associated with a sustained $3,000 increase in income to children in working-poor families before age 6.



Source: Greg J. Duncan, Kathleen M. Ziol-Guest, and Ariel Kalil, "Early-Childhood Poverty and Adult Attainment, Behavior, and Health," *Child Development*, January/February 2010, pp. 306-325

Reducing Poverty

The EITC reduces poverty in two ways: (1) by encouraging work and (2) by supplementing the wages of low-paid poor or near-poor workers.

Many Americans work for low wages. For example, the food-preparation sector (cooks, servers, dishwashers, and the like), which employs 11 million people and accounts for about one in every 11 jobs, provided a median wage of only $9.09 an hour in 2011. A full-time, year-round worker at that wage level would have annual earnings of $18,180 — or 80 percent of the poverty line for a two-adult, two-child family.[31]

For many workers, working substantial hours is not enough to lift them out of poverty.[32] The recent recession and slow recovery have aggravated the situation. The share of workers paid below-poverty wages (hourly wages too low to support a family of four at the poverty line even with full-

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[29] Kathleen M. Ziol-Guest, Greg J. Duncan, Ariel Kalil, and W. Thomas Boyce, "Early childhood poverty, immune-mediated disease processes, and adult productivity," *Proceedings of the National Academy of Sciences of the United States of America* (October 16, 2012), 17289-17293.

[30] Chetty, Friedman, and Rockoff, 2011.

[31] Bureau of Labor Statistics, Occupational Employment Statistics, http://www.bls.gov/oes/current/oes_nat.htm; U.S. Census Bureau, http://www.census.gov/hhes/www/poverty/data/threshld.

[32] For example, nearly 11 million workers lived below the official poverty line in 2011; these workers worked an average of 32 hours per week for 35 weeks of the year. CBPP analysis of March 2012 Current Population Survey.

time, year-round work) rose from 25.5 percent of employed workers in 2009 to 28 percent in 2011.[33] While 60 percent of the jobs lost during the recession were mid-wage jobs, only 22 percent of the jobs gained during the recovery were mid-wage jobs, the National Employment Law Project has found in an analysis that goes through the first quarter of 2012.[34] Lower-wage jobs, in contrast, represented 21 percent of the jobs lost during the recession but 58 percent of jobs gained during the recovery.

The share of Americans earning low wages could keep growing even when labor market conditions improve. "Good jobs are not disappearing for everyone, but . . . they are largely disappearing for less-educated workers,"[35] Urban Institute economist Harry Holzer and his coauthors from the National Science Foundation, the University of Chicago, and the Treasury Department have written.

Meanwhile, policymakers have let the minimum wage erode substantially, especially in the 1980s, and subsequent increases have not fully offset that erosion. At $7.25 an hour in 2013, the minimum wage is 21 percent below its 1968 level, after adjusting for inflation.[36]

In addition, the median or typical wage paid for four of the ten occupations that the Bureau of Labor Statistics expects to generate the most new jobs over the next decade — home health aides, food preparers, personal care aides, and retail salespersons — was below a poverty-level wage[37] in 2010.[38]

By supplementing the earnings of low-paid workers, the EITC and CTC lifted 9.4 million people, including 4.9 million children, out of poverty in 2011 under the federal government's new Supplemental Poverty Measure, which counts non-cash public benefits and refundable tax credit payments as income, as many analysts favor. Of these 4.9 million children, the EITC alone lifted 3.1 million of them out poverty.[39]

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33 Economic Policy Institute, *The State of Working America*, 12th edition, http://stateofworkingamerica.org/data/.

34 The figures here contrast job losses between the first quarter of 2008 and the first quarter of 2010 with job *gains* between the first quarter of 2010 and the first quarter of 2012. The National Employment Law Project defines lower-wage jobs as those with median hourly wages from $7.69 to $13.83 (in 2012 dollars) and mid-wage jobs as those with median hourly wages from $13.84 to $21.13. To place these figures in context, in 2012, the year-round, full-time earnings of a lower-wage job are equivalent to between 66 percent and 119 percent of a two-adult, two-child family's poverty threshold. National Employment Law Project, "The Low-Wage Recovery and Growing Inequality," August 2012, http://nelp.3cdn.net/8ee4a46a37c86939c0_qjm6bkhe0.pdf.

35 Harry J. Holzer, Julia I. Lane, David B. Rosenblum, and Fredrik Andersson, *Where are All the Good Jobs Going?* (New York: Russell Sage Foundation, 2011), p. 17.

36 CBPP analysis of data from the U.S. Department of Labor, Wage and Hour Division, Bureau of Labor Statistics, http://www.dol.gov/whd/minwage/chart.htm.

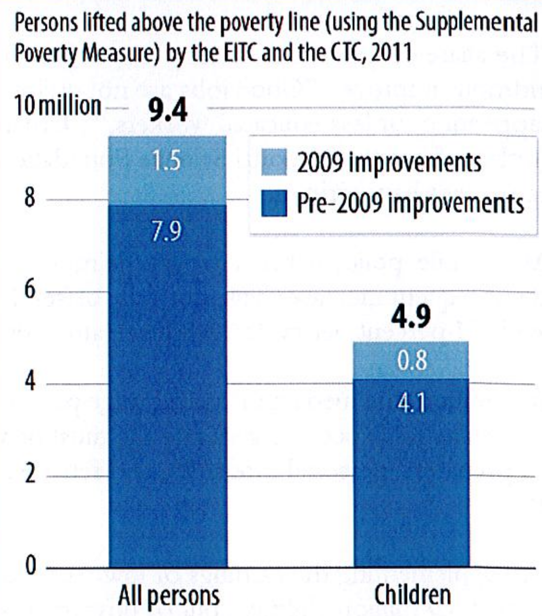
37 We define the poverty-level wage as the wage level needed to bring a family of four to the poverty line with full-time, year-round work.

38 Bureau of Labor Statistics, Occupational Outlook Handbook, 2010-2011 Edition, http://www.bls.gov/oco/oco2003.htm#occupation.

39 CBPP analysis of the Census Bureau's March 2012 Current Population Survey.

Of the 9.4 million people whom the EITC and CTC lifted out of poverty, improvements in the credits under the 2009 Recovery Act were responsible for raising about 1.5 million of them above the poverty line (see Figure 3) — about 900,000 people from the CTC improvements and another 500,000 from the EITC improvements.[40]

Figure 3
Earned Income Tax Credit and Child Tax Credit Lift Millions Out of Poverty



Note: Unlike the Census Bureau's official poverty measure, the SPM poverty measure counts the effect of government benefit programs and tax credits.

Source: CBPP analysis of Census Bureau's March 2012 Current Population Survey

Providing a Short-Term Safety Net

The EITC provides ongoing income support for some low-wage workers, but it helps an even larger group of workers meet a temporary need. "The EITC," researchers found, "acts as a short-term safety net to many taxpayers who claim the EITC for short periods during shocks to income or family structure" — a child's birth, for instance, or one spouse's loss of income — after which their earnings grow again.[41]

Some 61 percent of those who received the EITC between 1989 and 2006 did so for only a year or two at a time (see Figure 4).[42] About *half* of all taxpayers with children used the EITC at least once during that 18-year period. With its broad but temporary reach, the EITC provides critical income insurance for working families that face hardship or must care for newborns or very young children.[43]

In addition, EITC recipients pay significant federal income taxes over time, even though they may receive more in EITC benefits in a given year than they pay in federal income taxes in that year. In a forthcoming study, researchers report that taxpayers who claimed the EITC at least once from 1989

[40] The figures do not add to the total because more people are lifted above the poverty line by the joint impact of the CTC and EITC (1.5 million) than by the sum of the two credits counted separately.

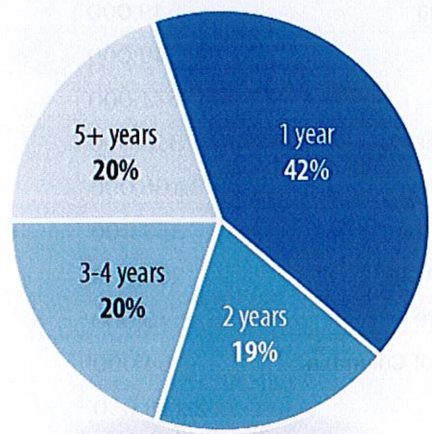
[41] Dowd and Horowitz, 2011.

[42] These findings do not imply that EITC recipients only use the EITC once or twice over their entire working career. Rather, they suggest that the majority of EITC recipients use the credit for short periods at a time.

[43] Dowd and Horowitz, 2011.

through 2006 paid *a few hundred billion dollars more* in federal income taxes over that period than they received in EITC benefits.[44]

Figure 4
Majority of Earned Income Tax Credit Families Receive Credit for Only One or Two Years at a Time



Note: Data from 18-year period, 1989-2006.
Source: Tim Dowd and John B. Horowitz. "Income Mobility and the Earned Income Tax Credit: Short-Term Safety Net or Long-Term Income Support".

Moreover, low-income households also pay substantial state and local taxes. Most state and local tax systems are regressive, meaning that low-income families pay a larger share of their incomes in these taxes than more affluent households do.[45] The bottom-fifth of households paid an average of 12.3 percent of their incomes in state and local taxes in 2011, according to the Institute on Taxation and Economic Policy, compared to 11.3 percent for the middle-fifth of households and 7.9 percent for the top 1 percent of households. (ITEP also found that for most states, families in the bottom income fifth paid a larger share of their incomes in state and local income, property, sales, and excise taxes than families in the top end of the distribution.[46])

Conclusion

The recent research on the EITC and similar income-boosting measures is noteworthy and important. It shows that the credit does much more than reduce poverty and provide a short-term safety net for the low-income working families that receive it. The EITC, which goes to between 25 and 30 million low- and moderate-income families, also provides income, employment, educational, and health benefits that, for children, can extend into adulthood.

[44] Authors' communications with Tim Dowd of the Joint Committee on Taxation and John B. Horowitz of Ball State University, October 18, 2011.

[45] Carl Davis *et al.,* "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," 4th Edition, Institute on Taxation and Economic Policy, January 2013, http://itep.org/itep_reports/2013/01/who-pays-4th-edition.php.

[46] Citizens for Tax Justice, "Who Pays Taxes in America?" April 4, 2012, http://www.ctj.org/pdf/taxday2012.pdf.

Table 1

Average Annual Effects of the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC) from 2009-2011

State	Households Benefiting from the EITC	Households Benefiting from the CTC	People Lifted Out of Poverty by the EITC and CTC	Children in Families Lifted Out of Poverty by the EITC and CTC
Alabama	549,000	404,000	129,000	75,000
Alaska	49,000	34,000	17,000	10,000
Arizona	571,000	509,000	234,000	131,000
Arkansas	318,000	232,000	102,000	57,000
California	3,166,000	2,898,000	1,274,000	629,000
Colorado	363,000	307,000	152,000	82,000
Connecticut	209,000	150,000	67,000	33,000
Delaware	73,000	55,000	24,000	12,000
District of Columbia	54,000	34,000	14,000	7,000
Florida	2,113,000	1,431,000	532,000	281,000
Georgia	1,142,000	909,000	394,000	209,000
Hawaii	112,000	76,000	48,000	24,000
Idaho	139,000	114,000	69,000	36,000
Illinois	1,043,000	870,000	422,000	224,000
Indiana	553,000	425,000	212,000	119,000
Iowa	214,000	154,000	71,000	39,000
Kansas	221,000	177,000	72,000	39,000
Kentucky	412,000	295,000	149,000	83,000
Louisiana	550,000	375,000	126,000	69,000
Maine	105,000	62,000	24,000	13,000
Maryland	412,000	328,000	120,000	61,000
Massachusetts	395,000	255,000	144,000	73,000
Michigan	847,000	566,000	237,000	120,000
Minnesota	350,000	257,000	77,000	43,000
Mississippi	422,000	298,000	116,000	60,000
Missouri	534,000	370,000	179,000	97,000
Montana	87,000	54,000	28,000	15,000
Nebraska	138,000	106,000	54,000	29,000
Nevada	238,000	219,000	102,000	51,000
New Hampshire	81,000	49,000	20,000	11,000
New Jersey	581,000	466,000	211,000	106,000

New Mexico	224,000	164,000	65,000	36,000
New York	1,754,000	1,175,000	547,000	282,000
North Carolina	932,000	775,000	395,000	202,000
North Dakota	45,000	29,000	9,000	5,000
Ohio	979,000	665,000	270,000	136,000
Oklahoma	360,000	272,000	117,000	71,000
Oregon	287,000	218,000	117,000	60,000
Pennsylvania	930,000	616,000	230,000	118,000
Rhode Island	81,000	55,000	28,000	14,000
South Carolina	506,000	382,000	127,000	70,000
South Dakota	67,000	46,000	19,000	10,000
Tennessee	677,000	497,000	234,000	119,000
Texas	2,704,000	2,238,000	1,138,000	617,000
Utah	201,000	226,000	91,000	50,000
Vermont	47,000	26,000	14,000	7,000
Virginia	614,000	457,000	160,000	85,000
Washington	449,000	368,000	208,000	108,000
West Virginia	163,000	98,000	*	*
Wisconsin	390,000	296,000	136,000	71,000
Wyoming	40,000	29,000	*	*
United States	**27,523,965**	**21,296,537**	**9,362,000**	**4,912,000**

* Insufficient sample size

Source: IRS for households benefiting from credits. For persons and children lifted out of poverty, Brookings Institution Metropolitan Policy Program analysis of March 2010-2012 Current Population Survey data and Supplemental Poverty Measure Public Use Files at www.taxcreditsforworkingfamilies.org/working-families-poverty-eitc-ctc-state/.

Notes: "Households" refers to tax filing units. Poverty is defined in accordance with the Census Bureau's Supplemental Poverty Measure, which adjusts for regional housing cost differences, includes both cash income and in-kind benefits, and subtracts taxes, work expenses, out-of-pocket medical expenditures, and child support paid to another household. Unit of analysis for poverty figures is the related family living at the same address and includes unmarried partners. For full details on the SPM, see www.census.gov/hhes/povmeas/methodology/supplemental/research/Short_ResearchSPM2011.pdf.

Table 2
Average Annual Effects of the 2009 Improvements to the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC) from 2009-2011

State	Number of households benefiting from the 2009 improvements to the EITC and CTC	Number of children in families benefiting from the 2009 improvements to the EITC and CTC
Alabama	287,000	513,000
Alaska	21,000	42,000
Arizona	305,000	709,000
Arkansas	156,000	298,000
California	1,525,000	3,165,000
Colorado	191,000	345,000
Connecticut	75,000	147,000
Delaware	32,000	52,000
District of Columbia	17,000	38,000
Florida	977,000	1,718,000
Georgia	587,000	1,140,000
Hawaii	52,000	103,000
Idaho	74,000	150,000
Illinois	467,000	992,000
Indiana	268,000	525,000
Iowa	86,000	191,000
Kansas	98,000	201,000
Kentucky	183,000	333,000
Louisiana	231,000	406,000
Maine	35,000	65,000
Maryland	154,000	306,000
Massachusetts	165,000	299,000
Michigan	428,000	771,000
Minnesota	116,000	271,000
Mississippi	234,000	399,000
Missouri	257,000	481,000
Montana	39,000	69,000
Nebraska	63,000	120,000
Nevada	114,000	247,000
New Hampshire	22,000	36,000
New Jersey	219,000	442,000
New Mexico	115,000	215,000
New York	725,000	1,414,000

North Carolina	523,000	1,114,000
North Dakota	20,000	36,000
Ohio	499,000	997,000
Oklahoma	207,000	384,000
Oregon	134,000	258,000
Pennsylvania	388,000	773,000
Rhode Island	30,000	58,000
South Carolina	263,000	502,000
South Dakota	29,000	60,000
Tennessee	331,000	595,000
Texas	1,463,000	2,952,000
Utah	121,000	288,000
Vermont	17,000	29,000
Virginia	275,000	494,000
Washington	246,000	492,000
West Virginia	77,000	129,000
Wisconsin	155,000	320,000
Wyoming	18,000	31,000
United States	**13,115,000**	**25,716,000**

Source: Citizens for Tax Justice, July 2012, rounded to nearest thousand. Figures are for tax filers with children.

off the charts
Policy insight beyond the numbers.
Center on Budget and Policy Priorities

When Reforming Corporate Taxes, Don't Forget the Deficit

February 24, 2012 at 1:03 pm

We released a brief analysis of the President's corporate tax reform framework this morning. Here's the opening:

The Administration has advanced a coherent framework for corporate tax reform that could lead to a more efficient corporate tax regime. The framework's main weakness is that it seeks no deficit-reduction contribution from corporate tax reform, aiming only for revenue neutrality.

Given the nation's serious long-term budget problems and the painful sacrifices that policymakers will have to impose to put the budget on a sustainable path, it is imperative that all parts of the budget be on the table. A key test of well-designed corporate tax reform, therefore, is that it contributes to long-term deficit reduction; the Administration's framework falls short in this critical area. The framework also lacks detail on how to achieve its revenue-neutrality goal.

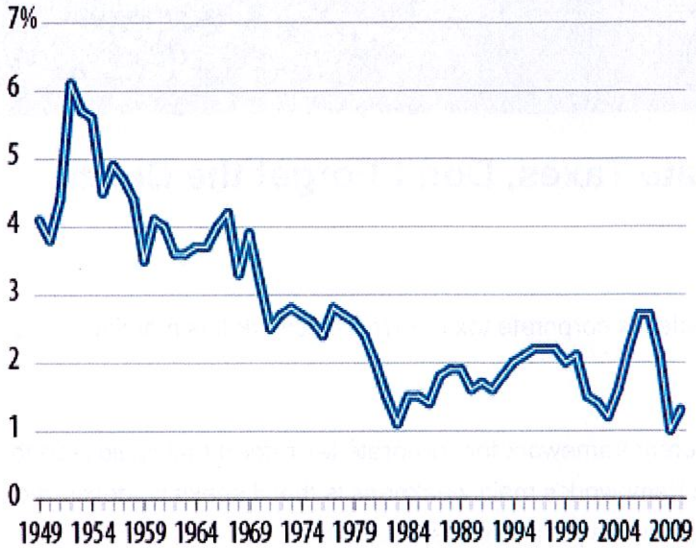
To its credit, the Administration's framework addresses the other key tests of successful corporate tax reform. It would impose a minimum tax on the overseas profits of U.S.-based firms to correct the tax code's tilt in favor of overseas investments and to reduce corporations' incentives to shift domestic profits to tax havens. It calls for reducing the tax code's bias toward debt financing of corporate investments and for achieving greater parity between the tax treatment of large businesses with different corporate structures. Finally, it calls for the elimination of certain industry-specific tax subsidies.

In analyzing this and other corporate tax reform proposals, we measure them against six tests outlined in our newly updated report. A well-designed corporate tax proposal should:

1. **Contribute to long-term deficit reduction.** Corporate tax revenues are now at historical lows as a share of the economy (see graph), at a time when the nation faces deficits and debt that are expected to grow to unsustainable levels. Although the top *statutory* corporate tax rate is high, the *average* tax rate — that is, the share of profits that companies actually pay in taxes — is substantially lower because of the tax code's many preferences (deductions, credits and other write-offs that corporations can take to reduce their taxes). Moreover, when measured as a share of the economy, U.S. corporate tax receipts are actually low compared to other developed countries. All parts of the budget and the tax code, including corporate taxes, should contribute to deficit reduction. Well-designed corporate tax reform can improve economic efficiency *and* help on the deficit-reduction front at the same time.

Corporate Tax Revenues Near Historical Lows

Corporate tax revenue as a share of GDP



Source: Office of Management and Budget

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2. **Reduce the tax code's bias toward overseas investments.** U.S. multinationals pay much lower taxes on profits from their *overseas* investments than on profits from their *domestic* investments. That gives corporations a strong incentive to shift economic activity and income from the United States to other countries. Policymakers should address the features of the corporate tax code that allow so much business activity to escape taxation and that favor foreign investments over domestic ones.

3. **Improve economic efficiency by reducing special preferences.** The corporate tax code taxes different kinds of corporate investments at very different rates. This "unlevel playing field" encourages businesses to choose among investments in substantial part based on their tax benefits, instead of making those decisions based entirely on investments' real economic value. Policymakers should level the playing field through corporate tax reform.

4. **Provide more neutral treatment of corporate and non-corporate businesses.** Over time, various policy changes have made it easier for companies to enjoy the benefits of corporate status without being subject to the corporate income tax. Reform should reflect the guiding principle that firms engaging in similar activities and enjoying similar legal benefits should be taxed at similar rates.

5. **Reduce the tax code's bias towards debt financing.** The current corporate tax code encourages corporations to finance their investments with debt (e.g., by issuing bonds) rather than equity (e.g., by selling stock). This encourages corporations to rely excessively on debt, which, as the recent financial crisis demonstrated, poses risks for both the firms and the broader economy. The tax code should be more even-handed in treating these two types of financing.

6. **Take specific steps to discourage tax sheltering.** If policymakers lower the statutory corporate tax rate to well below the top *individual* tax rate, they should also establish safeguards to prevent high-income individuals from sheltering their income in corporations in order to pay taxes at a lower rate.

Switching to "Territorial" Tax System Would Carry Serious Risks

January 31, 2013 at 1:21 pm

Adopting a so-called "territorial" tax system, as some multinational corporations are lobbying Congress to do (see today's press release from the Business Roundtable), would create greater tax incentives for multinationals to invest and move profits overseas rather than in the United States, our new report explains. As a result, it would risk hurting domestic businesses, boosting deficits over the long run, and weakening the economy.

Currently, U.S.-based multinationals owe U.S. taxes on the income they generate at home as well as overseas; they get a credit for the foreign taxes they pay so that they aren't taxed twice on the same income.

But multinationals don't owe tax on much of their foreign profits until they bring them back to the United States. So they can — and many do — defer U.S. tax indefinitely by keeping those profits overseas.

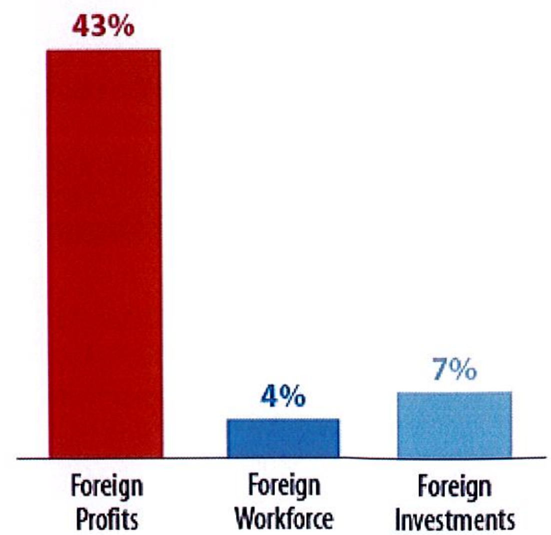
In a territorial system, a country generally taxes only the income that a corporation generates in that country. Moving the U.S. system to a territorial one would create several major problems, as our paper explains:

First, a territorial system would create greater incentives for U.S.-based multinationals to invest and book profits overseas rather than at home. Under a territorial system, U.S.-based multinationals would face a top tax rate (currently 35 percent before they lower their taxes by using deductions and credits) on their domestic income and a zero or very low tax rate on their foreign income. That would give U.S.-based multinationals a strong incentive to shift their operations from the United States to low-tax countries or so-called "tax havens," or to artificially shift their profits by using what are known as "earnings stripping" techniques.

A new Congressional Research Service (CRS) report finds that many multinationals already shift where they report profits from the United States to low-tax and tax haven countries where they have few taxes or investments in order to delay paying U.S.

U.S. Multinational Corporations Report Large Profits in Tax Havens But Have Little Activity There

Percentage of U.S. multinationals' foreign profits, hiring, and investments reported in tax haven and tax preferred countries,* 2008



* Selected countries: Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland

Source: Congressional Research Service based on Bureau of Economic Analysis data

Center on Budget and Policy Priorities | cbpp.org taxes (see graph). A territorial system would make this practice still more lucrative.

Second, by encouraging capital to flow overseas, a territorial system would risk reducing wages at home. If a lower U.S. tax rate on foreign profits encourages capital to move offshore, basic economic theory predicts that the returns to U.S. capital would *rise* but that the wages of U.S. workers would *fall*. As Jane Gravelle, a leading tax economist at the CRS, testified before Congress, "[Moving to a territorial system] would make foreign investment more attractive. That would cause investment to flow abroad, and that would reduce the capital which workers in the United States have, so it should reduce wages. A capital flow reduces wages in the United States [and] increases the wages abroad."

Third, a territorial tax system would risk higher budget deficits by draining revenues from the corporate income tax. The more a territorial system encouraged U.S.-based multinationals to shift profits overseas, the less the income of such multinationals would face any U.S. tax. That's because a territorial system would enable the United States to tax only the income that a U.S.-based multinational generated at home. The Treasury Department estimates that a simplified territorial system — one that lacked rules to mitigate these revenue losses — could cost the federal government roughly $130 billion in lost revenue over ten years.

Fourth, a territorial system would risk higher taxes on smaller businesses and domestic businesses. If policymakers sought to offset the lost revenues from a territorial system (and any cut in the U.S. corporate tax rate), they would likely do so by broadening the business tax base. Business base broadening would have to rely on reducing large tax breaks for domestic activity (since overseas activity would be largely or entirely free of U.S. tax), thereby reducing incentives for domestic investment. Thus, even if policymakers cut the top statutory tax rate as they adopted a territorial system, smaller domestic businesses could well face higher taxes.