the budget lab

How Would Reforms Affect Employment And Children's Economic Outcomes?

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Key Takeaways

1. We estimate that Full and Partial Extension would induce an additional 100,000 adults to work. Under Clausing-Sarin, an estimated 200,000 workers would drop out of the labor force.
2. The Sarin-Clausing reform would boost wages for children in adulthood by an average of almost 0.4 percent, with smaller boosts from the Full and Partial Extension scenarios; these results, however, are speculative.

As described in the summary of revenue estimates, conventional revenue estimates account for only a limited set of behavioral feedback responses, such as re-timing realizations of capital gains or shifting income into tax-preferred legal structures. In this subsection, we expand our scope to allow for other types of behavioral feedback – first-order microeconomic responses to changes in incentives and incomes. Specifically, we allow for two different kinds of microeconomic feedback: (1) employment changes in response to changes in work incentives, and (2) later-life productivity gains in response to cash assistance in childhood. These changes would not be included in a conventional score, which assumes that overall economic income is unchanged by policy reforms.

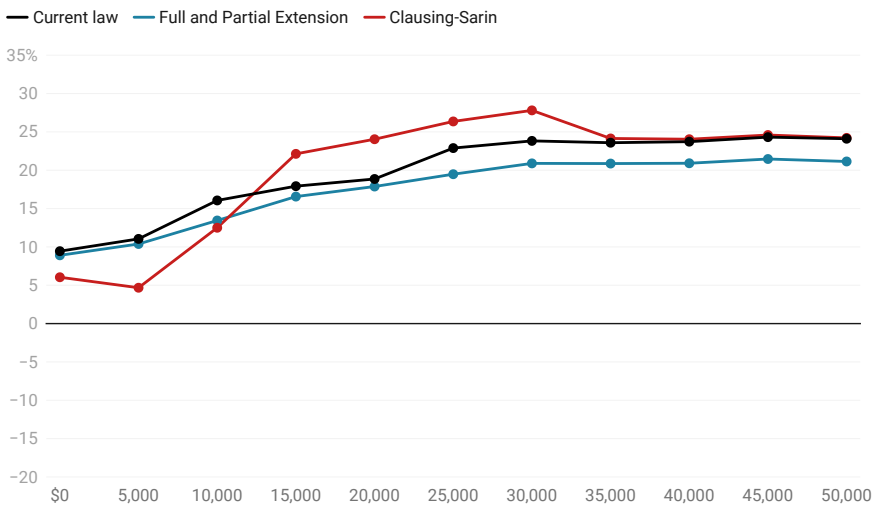
Effects on employment

Changes in tax policy can impact work incentives through two channels.[1] One is the income effect, wherein people may decide to work less in response to tax cuts because they can maintain the same standard of living despite working fewer hours. Economists generally believe income effects are small for the range of policy reforms considered in this analysis.

The other is the substitution effect: people may work less or quit working entirely if the return to working more falls due to an increase in marginal tax rates. In other words, taxes affect the cost-benefit calculation of working versus not working. The precise degree to which workers respond to changes in the return to work – the "participation elasticity" – is a matter of academic contention, but there is consensus that certain subgroups of workers are meaningfully sensitive. Parents and lower-income earners are generally thought to be more responsive than workers who are childless and/or high-income.

By changing statutory tax rates, deductions, and – most importantly for the lower end of the income distribution – refundable tax credits, each reform would affect effective marginal tax rates and thus the return to work. The figure below plots projected average effective marginal tax rates on labor income, including employment taxes, by wage income and parental status under each reform. Full and Partial Extension have identical effects for the income groups charted.

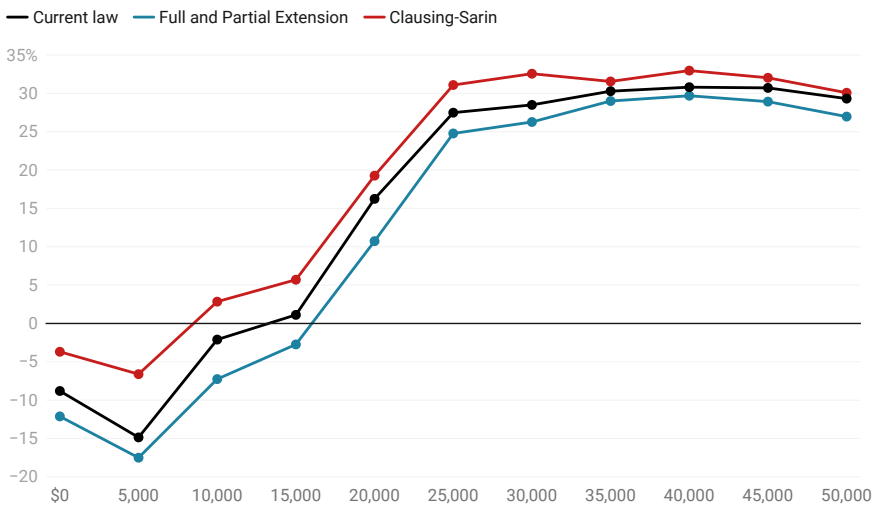
Non-parents: Average Effective Marginal Tax Rates on Wage Earnings, 2026



EMTRs include individual income taxes and employee-side payroll taxes are are calculated by adding $1 to W-2 wages. Calculations are with respect to individual earners, not tax units.

Source: The Budget Lab • Created with Datawrapper

Parents: Average Effective Marginal Tax Rates on Wage Earnings, 2026



EMTRs include individual income taxes and employee-side payroll taxes are are calculated by adding $1 to W-2 wages. Calculations are with respect to individual earners, not tax units.

Source: The Budget Lab • Created with Datawrapper

- Under current law, the phase-in structures of the EITC and CTC generate negative effective marginal tax rates (EMTRs) for low-wage workers. That is, for each dollar of additional earnings, a worker will bring home more than one dollar. Then, as these credits plateau or phase out, EMTRs rise steeply to more than 30 percent. Non-parents, who generally do not qualify for large refundable credits, always face positive EMTRs.
- The Full and Partial Extension scenarios would slightly reduce EMTRs for both parents and non-parents, strengthening their incentive to work. This change is attributable to a larger standard deduction, lower tax rates, and a more generous CTC.
- Clausing-Sarin would affect parents' and non-parents' work incentives differently. By eliminating the CTC phase-in, the proposal would increase EMTRs at the low end of the distribution, disincentivizing work relative to current law. Put differently, this CTC design does not actively discourage work in isolation – rather, the proposal would remove an existing subsidy. For non-parents, however, the effects are mixed. The EITC would (1) phase in at a faster rate, which decreases EMTRs for those making below $10,000, and (2) phase out at a faster rate, which increases EMTRs for those in the $15,000 to $30,000 earnings range.

How would these changes in incentives translate to employment gains or losses? We answer this question by following the approach taken in Bastian (2023), wherein the author calculates the return to work under current law and the policy reform, and then applies participation

elasticities ranging from 0 to 0.4 depending on economic and demographic attributes. We adapt and extend this approach in our tax microsimulation model; please refer to this companion piece for further details.

- We estimate that Full and Partial Extension would induce an additional 100,000 adults to work.
- Under Clausing-Sarin, an estimated 200,000 workers would drop out of the labor force.

For context, from December 2011 to December 2019 an average of around 110,000 people joined the labor force each month.

Effects on child outcomes

To what extent does additional income for families with children – particularly low-income families with children – improve economic outcomes for those children when they grow up? Additional income in childhood might impact later-life outcomes through various channels including improved nutrition and health, better education, the ability to move to higher-opportunity geographic areas, and more. This question is the subject of recent attention, from both academics and policymakers. The answer has important budgetary implications: if policy interventions today can increase the productivity and wages of the next generation, some fraction of the up-front costs will be offset by higher income and payroll tax revenues in the future.

A body of high-quality descriptive research measures intergenerational mobility, quantifying the extent to which parental income can predict children's income. Data on the distribution of later-life economic outcomes for children at each point in the parent income distribution forms the basis of our approach to modeling these effects:

1. First, we measure the impact of a reform in terms of parent income percentile. For example, imagine a CTC reform which delivers a $1,000 tax cut to a 20th percentile family. Because the distance between the 20th and 21st percentile is about $1,000, this reform is worth 1 rank unit.
2. Then, we adjust future labor market outcomes of affected children to reflect those of children in the counterfactual parent rank.

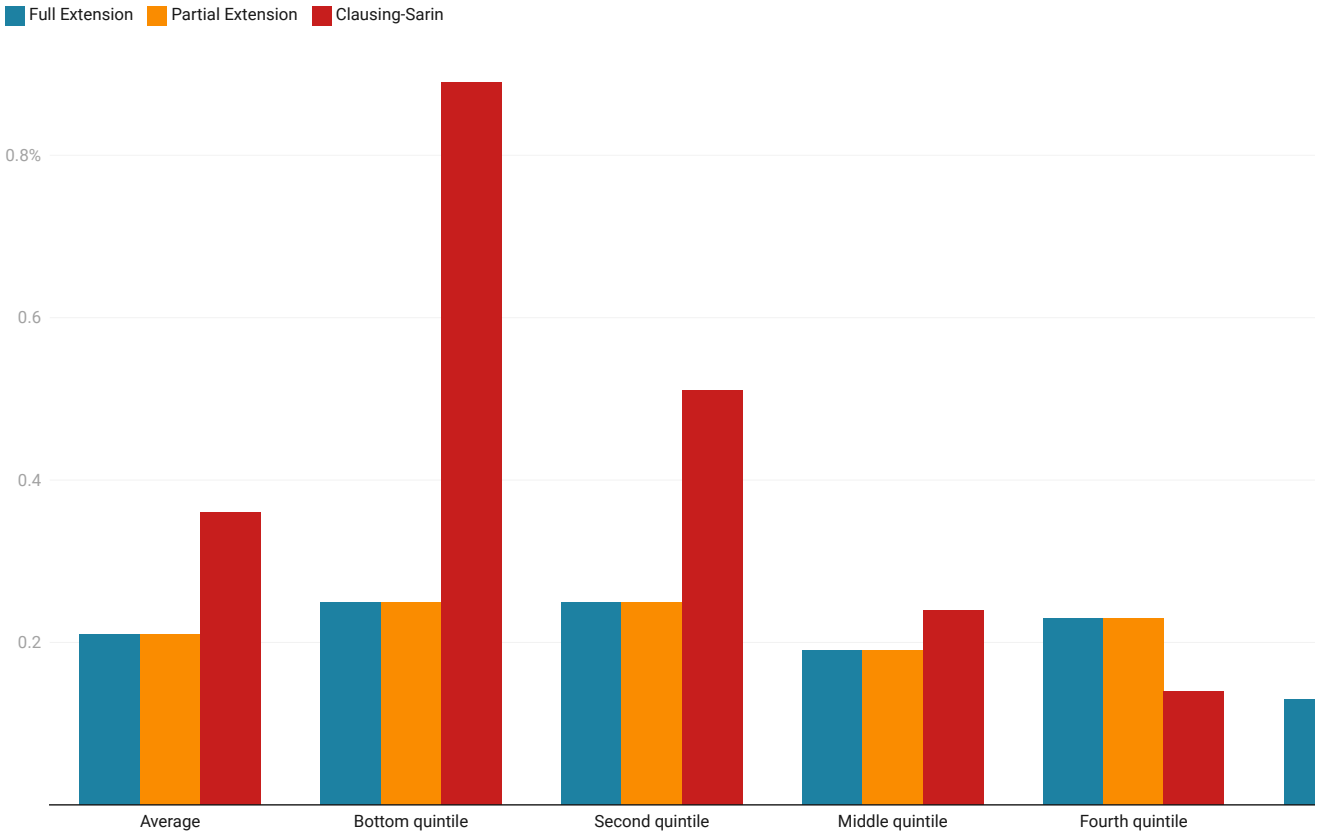
Of course, an overly literal interpretation of the correlation between parental income and child outcomes would overstate the impact of policy reforms in this setting. Differences in childhood outcomes across parent income percentiles reflect factors other than income (such as differences in human capital at birth or the effects of racism) and may also indicate zero-sum status competition (for example, the ability to outbid others for a fixed supply of housing). To this end, informed by our conversations with researchers who work on intergenerational mobility and poverty issues and our assessment of the relevant academic literature, we assume that only 20 percent of the correlation is causal; that is, only one-fifth of a reform's impact translates to later-life outcomes. For example, if a reform increases after-tax income by +5 rank units for a 10th percentile family, the labor market outcomes of children in that family will be adjusted to reflect those of the 11th percentile, not the 15th percentile. We discuss this assumption in a companion piece documenting our methodology in more detail, highlighting how our assumed effect size compares to that of other researchers. Our comparisons suggest that this is a conservative assumption.

The results in this subsection are more uncertain compared to our other estimates. This exercise involves strong assumptions and depends on multiple data imputation steps. Still, we believe it functions as a useful starting point for a discussion about plausible magnitudes.

The figure below displays estimated changes in wages for 2050 among children exposed to a full 18 years of each reform. It breaks out effects by parent income rank.

Estimated Impact on Later-Life Earnings by Parent Income Quintile, 2050

Change in Wages Relative to Baseline, Percentage Points



Universe is tax units with adults who were under age 18 during or after 2026. Parent income rank is determined with respect to parent tax units only.

Source: The Budget Lab • Created with Datawrapper

- Full Extension and Partial Extension scenarios generate nearly identical estimated outcomes.
- We estimate that the Sarin-Clausing reform, which dedicates a greater share of its gross tax cuts to families with children, would boost wages by an average of almost 0.4 percent. The effect falls with parental income, reflecting the progressive nature of the net tax changes. Children from bottom-quintile families would see increases of almost 1 percent on average.
- Note that, by construction, any deficit-financed initiative for families with children will generate positive earnings effects in the long run. In reality, this additional borrowing will eventually be financed with tax hikes, spending hikes, or faster inflation – the burden of which may fall on these same children. How to account for these costs is a topic The Budget Lab is actively exploring.

Footnotes

1. The elasticity values we use generate a probability of employment with respect to taxes. What we model is the existence or non-existence of wages. Therefore, what we see is earnings on the extensive margin, which is functionally a participation decision. We have tried to be consistent in our use of "employment" or "participation" where correct.