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Welfare Reform & Beyond

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Tax Reform for Families: An Earned Income Child Credit

BY ADAM CARASSO, JEFFREY ROHALY, AND C. EUGENE STEUERLE

Tax legislation enacted in 2001 increased the value of the Child Tax Credit (CTC) and made it refundable, meaning that cash payments would be sent by the IRS to those without sufficient tax liability to take advantage of the credit. These provisions were to be fully phased in by 2010. In May 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) accelerated the phase-in of the value of the credit (but not the refundability provisions), thereby increasing the CTC from $600 to $1,000 but for 2003 and 2004 only; the credit reverts back to its prior law value of $700 in 2005. More legislation is likely on this front. This brief argues that the time is ripe for an integrated credit that combines the Earned Income Tax Credit (EITC) and the CTC into an Earned Income Child Credit (EICC). The proposed EICC simplifies and standardizes the definition of qualifying children and those who may claim them, and indexes the new credit for inflation so that it retains its purchasing power over time. The EICC also provides enhanced benefits to low-income working families and reduces marginal tax rates. One version would cost $6 billion relative to current law (JGTRRA) in calendar year 2003.

In recent years, the expansion of family tax credits has provided substantial new, work-dependent benefits for low- and middle-income families. In 2002, the U.S. government spent about $32 billion on families via the Earned Income Tax Credit (EITC), and $26 billion via the Child Tax Credit (CTC), compared to $21 billion on cash welfare. Although this expansion has been valuable to families, the proliferation of credits has created a bewildering array of provisions including the following:

- **Earned Income Tax Credit**—The EITC is a refundable credit intended to reward work among low-income families, especially those with children. Families receive the credit as a cash benefit when there is no tax liability to offset. The value of the credit increases with earnings up to a maximum of about

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$4,000 for a family with two children and then begins to phase out at incomes above approximately $14,000. To encourage marriage, the 2001 tax law allows married parents to qualify at a somewhat higher level of income than single parents. The EITC can be claimed for children under age nineteen, or under age twenty-four if they are still in college.

- **Child Tax Credit**—The 2001 tax law called for a gradual doubling of this credit, which can only be claimed for children under age seventeen, from $500 to $1,000 by 2010. The 2001 legislation also made the credit partly refundable, like the EITC, for families earning over $10,500 in 2003. JGTRRA accelerated this increase in the CTC, providing the $1,000 credit in 2003 rather than 2010, but with a catch: the child credit increase, as written, sunsets after 2004, so at that point the CTC reverts back to levels of less than $1,000 for all years leading up to 2010. Furthermore, JGTRRA does not accelerate the refundable portion of the credit—although Congress is currently debating on the subject—and does not index the $1,000 credit for inflation.

- **Dependent Exemption**—The personal exemption, applied to dependents, is $3,050 per child in 2003 and is indexed to inflation. At a 15 percent tax rate, the dependent exemption is worth $458 per child in reduced taxes, but is phased out for families above a certain income level. However, current law calls for the gradual elimination of this phase-out after 2005. The definition of an eligible child is the same as for the EITC.

- **Single Head of Household (HOH) Status**—Single filers with children enjoy brackets and standard deductions that are more beneficial than single filers without children. This benefit for having children is not available on joint returns, although joint returns (with and without children) do have a lower rate schedule.

WHY AN INTEGRATED CHILD CREDIT?

Because the rules governing the four tax measures described above are so confusing, errors are common. Some families entitled to benefits do not file for them; others that are not entitled receive benefits anyway. The costs of compliance are a burden on families and also on the Treasury Department, which must administer, award, and audit these benefits. Moreover, the public is hard-pressed to understand fully who gets which benefits under what circumstances. The complexity, time and compliance issues associated with this patchwork of children's tax benefits have been documented by the IRS Taxpayer Advocate; both the Treasury Department and the Joint Committee on Taxation have suggested ways to harmonize definitions of qualifying children (and pending child credit legislation contains Treasury's definition). Further evidence of complexity is revealed by the reliance of many families on paid tax preparers. Low-income households that file for the EITC are about 9 to 17 percent more likely to use a preparer than those who do not file for this credit.

Furthermore, the IRS is about to require many families filing for the EITC to "precertify" by presenting tax authorities with marriage and birth certificates and affidavits from landlords and doctors to prove eligibility. These requirements could add huge delays to credit receipt and further discourage many families from applying for the credit.

HOW THE EARNED INCOME CHILD CREDIT WOULD WORK

An ideal reform would integrate all four of the tax provisions discussed above. Although this does not seem feasible in the short run, since the focus now is mainly on accelerating the phase-in of the 2001 legislation, an initial set of steps could be taken toward making these credits simpler, more generous, and less discouraging of work.

Our proposed Earned Income Child Credit (EICC) would impose a single definition for qualifying children, those who may claim the credit, and the income used to determine the amount of the credit. This proposal would not change the basic structure of the EITC and CTC—only blend the two into a seamless, more generous credit from the tax filer's standpoint.

The specific parameters we suggest for the EICC appear in table 1, alongside pre-JGTRRA law and the child credit provisions of JGTRRA. The EICC has an EITC

TABLE 1. PARAMETERS OF PROPOSED EARNED INCOME CHILD CREDIT COMPARED TO PRIOR LAW AND CURRENT LAW (JGTRRA)

Parameter	Prior Law (EITC & CTC)	JGTRRA (Current Law)	Earned Income Child Credit
EITC Phase-in rates	34% for 1 child; 40% for 2 or more	Same as prior law	38% for 1 child; 50% for 2 or more
EITC Phase-in range of income	$0 to $7,500 for 1 child; $0 to $10,540 for 2 or more	Same as prior law	$0 to $6,750 for 1 child; $0 to $8,470 for 2 or more
EITC Phase-out rates	15.98% for 1 child; 21.06% for 2 or more	Same as prior law	14% for 1 child; 19% for 2 or more
EITC Phase-out range of income	$13,760 to $33,780 (HOH); $14,760 to $34,780 (MFJ)	Same as prior law	$13,760 to $36,050 (HOH); $14,760 to $37,050 (MFJ)
Child credit refundability rate	10% in 2003-4; 15% thereafter	Same as prior law	15% in all years
Child credit refundability threshold	$10,500; indexed for inflation	Same as prior law	Same as prior law
Child credit value (2003 dollars)	$600 in 2003; $841 in 2010	$1,000 in 2003; $666 in 2005; $841 in 2010	$1,000 in 2003, 2005, and 2010
Child credit indexation	Credit not indexed for inflation	Same as prior law	Credit indexed for inflation
Child credit phase-out threshold	$75,000 for singles; $110,000 for joint; not indexed for inflation	Same as prior law	$60,000 for singles; $90,000 for joint; not indexed for inflation
Method of child credit phase-out	$50 reduction for every $1,000 of added AGI	Same as prior law	$0.05 reduction for every $1.00 of added AGI
Cost in 2003	—	—	$6.3 billion (one version)
Cost in 2010	—	No additional cost	$9.3 billion

Note: Costs are in 2003 dollars and measured relative to JGTRRA
HOH = Head of Household; MFJ = Married Filing Jointly; EITC = Earned Income Tax Credit; CTC = Child Tax Credit.

"*Note that because JGTRRA only increases the child tax credit from $600 to $1,000, it only benefits those families that currently receive the maximum $600 child tax credit.*"

portion and a child credit portion. The EITC portion would phase in at more generous rates than prior law and JGTRRA, providing a larger refund to those on the bottom rung of the income ladder. It would also phase out more slowly, leaving families with slightly lower marginal tax rates. Beginning in 2003, the EICC would raise the child credit from $600 to $1,000, increase the refundability rate from 10 to 15 percent, and index the credit for inflation after 2003. JGTRRA, by contrast, increases the CTC to $1,000 in 2003, but would not increase the refundability rate from 10 percent and would not index the child credit for inflation.

For most families, the total EICC would be at least as high as the combined EITC and CTC they receive under current law. The EICC would give families with qualifying seventeen- and eighteen-year-olds a $1,000 child tax credit they do not receive under current law. The EICC would exclude families with children aged nineteen through twenty-three (and in college) that receive the EITC under current law. Lastly, the child credit would phase out starting at $90,000 for joint returns and $60,000 for other returns, as opposed to $110,000 and $75,000 respectively under both prior law and JGTRRA.

The EICC differs from JGTRRA in 2003 as a result of its higher EITC phase-in rates, its more immediate application of a 15 percent child credit refundability rate, and its lower EITC phase-out rates. In 2010, the key differences are again the higher phase-in rates and lower phase-out rates and the indexation of the EICC's minimum child credit to inflation.

JGTRRA spends $16.8 billion in calendar year 2003 on the CTC. This version of the EICC would spend $6.3 billion more. In 2010, the EICC would cost $9.3 billion more (in real 2003 dollars); JGTRRA has no additional cost in 2010 since it merely accelerates the child tax credit provisions already in current law without indexing them for inflation. Out of the EICC's $9.3 billion price tag in 2010, $7.5 billion would go to indexing for inflation, while the remaining $1.8 billion is the cost of its increased generosity.

Other versions of the EICC, some with lower costs, have been designed and analyzed using the Urban Institute-Brookings Institution Tax Policy Center Tax Model, which is similar to those used by the Treasury and the Congressional Budget Office. More information about these other versions, along with their costs and benefits, can be obtained from the authors upon request.

WINNERS AND LOSERS

Winners under the EICC would be families with children under age nineteen who reside with the taxpayer, particularly those families with children aged seventeen and eighteen, and those families that earn under $90,000 per year if married and $60,000 per year if single. Table 2 compares the potential impacts of the EICC and the child credit provisions in JGTRRA by income group in 2003. As shown by the figures at the top of the first column, the EICC would provide

TABLE 2. DISTRIBUTIONAL IMPLICATIONS OF THE EICC AND THE CHILD CREDIT PROVISIONS IN JGTRRA RELATIVE TO PRIOR LAW IN CALENDAR YEAR 2003, BY INCOME FIFTHS[1]

	Bottom Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Top Fifth 80%-90%	Top Fifth 90%-100%	All Fifths
Total Decrease in Income Tax Liability (Millions)							
All Filers							
JGTRRA 2003[2]	$58	$3,709	$5,732	$5,407	$1,746	$129	$16,817
EICC[3]	$1,321	$7,152	$7,673	$6,526	$374	$8	$23,158
Average Decrease in Income Tax Liability per Filer[4]							
Filers with Children							
JGTRRA 2003	$7	$289	$502	$460	$346	$28	$303
EICC	$155	$550	$672	$552	$74	$2	$418
All Filers							
JGTRRA 2003	$2	$114	$176	$166	$107	$8	$103
EICC	$42	$219	$235	$200	$23	$0	$142
Percent Increase in After-Tax Income							
Filers with Children							
JGTRRA 2003	0.1%	1.3%	1.4%	0.8%	0.4%	0.0%	0.6%
EICC	2.7%	2.6%	1.9%	1.0%	0.1%	0.0%	0.8%
All Filers							
JGTRRA 2003	0.0%	0.7%	0.7%	0.4%	0.2%	0.0%	0.3%
EICC	1.1%	1.4%	0.9%	0.5%	0.0%	0.0%	0.4%

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

[1] *Income is equivalent to adjusted gross income plus nontaxable social security benefits, nontaxable pension income, and tax-exempt interest income. Income has been adjusted for family size using the implicit adjustment factors in the federal poverty thresholds. Returns with negative income have been excluded from the lowest fifth but are included in the totals. Baseline is pre-JGTRRA law.*

[2] *JGTRRA accelerates the increases in the child tax credit scheduled in the 2001 tax cut (EGTRRA), from $600 to $1,000, but these increases are only temporary. The child credit reverts back to the amounts set forth in EGTRRA after 2004.*

[3] *The Earned Income Child Credit combines the Earned Income Tax Credit and the Child Tax Credit into a single credit, working off 2001 tax law (EGTRRA) parameters for the most part. Qualifying children must be under age 19.*

[4] *Or increase in refunded amount.*

$1.3 billion more than prior law to the poorest fifth of all families, whereas JGTRRA's child credit provisions would allocate $58 million to the same group. At the other end of the income spectrum, the EICC would provide $380 million more than current law to the richest fifth compared to JGTRRA's $1.9 billion. This result is mirrored in the average tax refund families would receive, also shown in Table 2. The EICC would provide the bottom-fifth of families an average additional tax refund of $155 compared to JGTRRA's $7. By contrast, it would provide the top fifth of families an average additional tax refund of $38 compared to JGTRRA's $187 (not shown in table).

Note that because JGTRRA only increases the child tax credit from $600 to $1,000, it only benefits those families that currently receive the maximum $600 child tax credit. Those families that currently receive a CTC under $600—such as a head of household with one child earning below $14,800 or a married couple with two children earning below $19,300—will not benefit. This has to do with the CTC's

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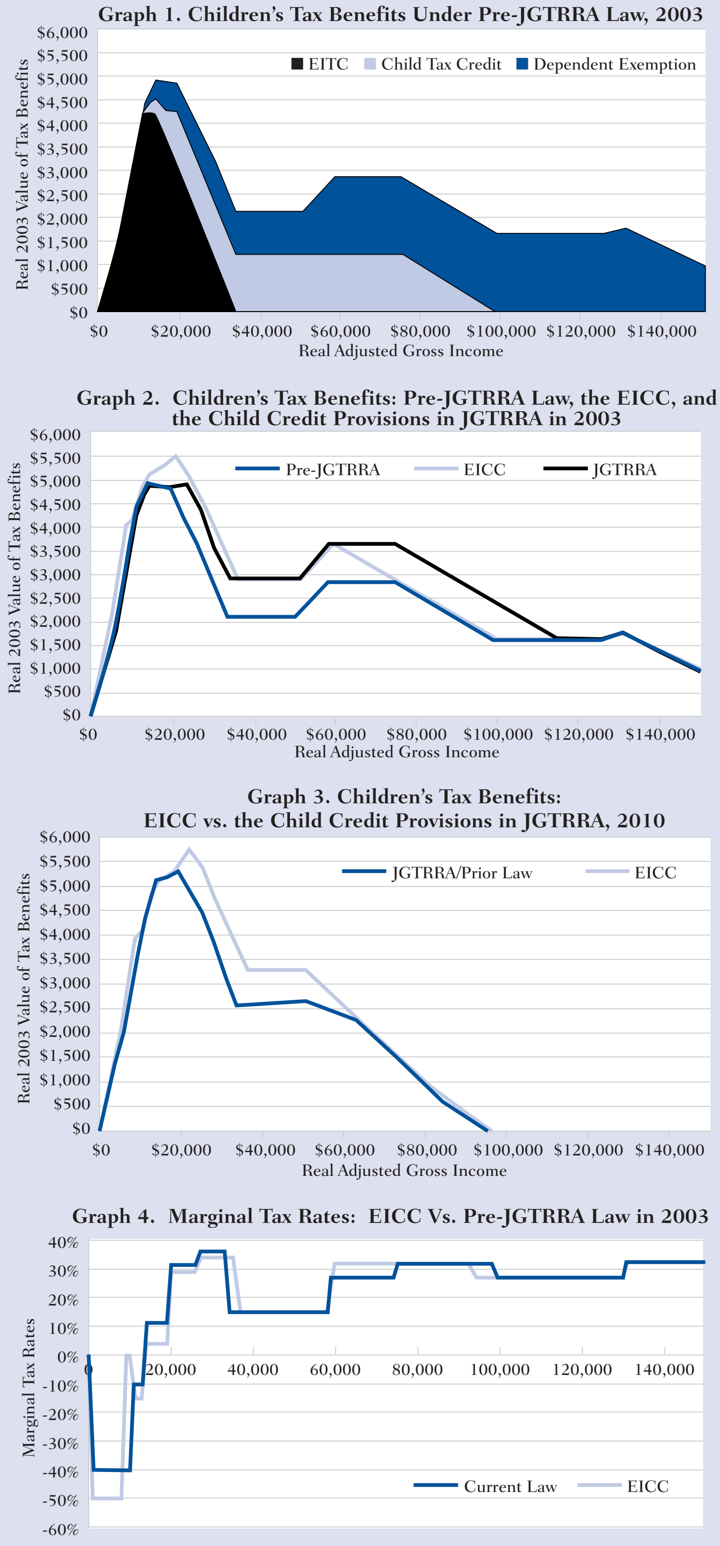
FIGURE 1. TAX BENEFITS AND MARGINAL RATES FOR A HEAD OF HOUSEHOLD WITH TWO CHILDREN



Source: Carasso, Rohaly, and Steuerle, 2003

TABLE 3. TAX BENEFITS AT SELECT INCOME LEVELS BY OPTION

	Family Income Level (in 2003 Dollars)		
Option	**$9,000**	**$21,000**	**$33,000**
In 2003			
EICC	$4,062	$5,517	$3,494
JGTRRA	$3,427	$4,884	$3,079
Difference	**$635**	**$633**	**$415**
In 2010			
EICC	$4,062	$5,568	$3,485
JGTRRA	$3,427	$5,078	$2,748
Difference	**$635**	**$490**	**$737**

Note: Data points are taken from Graphs 2 and 3 of Figure 1 and apply to a head of household with two children. Baseline is pre-JGTRRA law.

refundability and has been a subject of recent intense debate in Congress. In addition, under JGTRRA, all families are scheduled for an effective tax increase, because first, the legislation does not extend past 2004, and second, JGTRRA fails to index the CTC for inflation.

Although there are few losers under the EICC, these losers are worth noting. Taxpayers who currently claim the EITC for college-age children are one group. We believe that college financing for low-income individuals is better directed through other federal education programs such as Pell Grants. Other losers would include some taxpayers earning over $90,000 per year if married and $60,000 per year if single, corresponding to the start of the phase-out of the EICC's child credit; taxpayers with children living away from home; and taxpayers who are married but who file separately.

Another way to see who would win and who would lose is to look at the four graphs in figure 1. Graph 1 shows the value of the major children's tax benefits under current law for a typical family in 2003. Graph 2 compares the tax benefits offered under the EICC to the child credit provisions in JGTRRA in 2003. Winners include those earning less than about $25,000 who benefit because of the credit's more generous phase-in rate and its use of a 15 percent refundability rate in the child credit portion, compared to JGTRRA's (and prior law's) 10 percent rate. The EICC continues to provide significantly higher tax benefits than JGTRRA—even though each has a $1,000 per child credit—up through $36,000 of family income, because of the EICC's lower phase-out rate. Graph 3 compares the EICC option and JGTRRA in 2010. Compared to current law and the Bush administration's proposal, the family would be significantly better off in 2010 than in 2003 with the EICC since the child credit portion is indexed to inflation. Finally, graph 4 shows the EICC's impact on marginal tax rates in

Additional Reading

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2003. The EICC lowers the highest marginal rates for families in the $20,000 to $35,000 income range from 31 and 36 percent to 29 and 34 percent.

Table 3 summarizes the differences in the tax benefits received at three income levels in both 2003 and 2010.

The EICC's impact on marriage penalties is mainly positive, although some couples experience tax increases (really, decreases in the amount of tax subsidies they receive from marriage). JGTRRA reduces marriage penalties for all families earning above $17,000.

CONCLUSION

In revising and combining the EITC and CTC, it is possible to improve: (1) simplicity; (2) work incentives and net income from work at the bottom of the income distribution; and (3) benefits for most families with children. At an additional $6 billion in 2003, the EICC option we describe is more costly than JGTRRA, but unlike JGTRRA it would provide a greater share of benefits to low-income families and index the value of the credit to inflation so that those gains are locked in over time. It would be possible to reduce the cost of this option—for example, by deferred indexing—and still improve simplicity, work incentives, and benefits.

Ideally, we believe that Congress should push further along the simplification path by considering the looming alternative minimum tax problem, which will affect about 33 million families by 2010. Although a potential crisis, it is also an opportunity. Congress could create an integrated credit that, in addition to the EITC and CTC, incorporates the dependent exemption and does away with the head of household rate schedule. However, such an option does not seem feasible in the short-run.

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