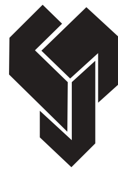

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Using the Tax Code to Subsidize Families with Children: The earned Income Tax Credit and Child Tax Credit

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Children are future workers and taxpayers so investments in children provide benefits to society as a whole, as well as to parents directly.

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In recent years, the U.S. federal government has considerably expanded assistance to families with children via the U.S. individual income tax code, including changes signed into law by President George W. Bush in Spring 2001.[1] Government's role in helping families, whether through the tax system, direct subsidy, or other means, can be justified on several economic grounds. One economic argument is that there are positive externalities associated with bearing and raising children. For instance, children are future workers and taxpayers so investments in children provide benefits to society as a whole, as well as to parents directly. Equity and redistribution are other economic rationales. Governmental assistance provides children in lower-income families with a more equal start in life. Additionally, since families with children have greater financial burdens, subsidies to them place them on more equal footing with families without children. This policy brief focuses on two specific credits that apply to families with children — the Earned Income Tax Credit (EITC) and the Child Tax Credit[2] — and analyzes their impact on poverty alleviation, work incentives, and family structure.

Tax credits work differently than tax deductions. Tax credits operate by reducing taxes owed while tax deductions reduce taxable income. Tax credits have the potential to considerably redistribute income but their effectiveness in doing so depends on whether the credit is refundable or not. When a tax credit is *refundable*, families can receive the credit even if they owe no federal income tax liability. Thus, this type of credit is able to reach poor families. If a credit is *nonrefundable*, then families with no income tax liability — principally those that are poor — receive no benefit from it. The EITC is a refundable credit while the Child Tax Credit has largely been a nonrefundable credit. Legislative changes in 2001 made the latter credit partly to fully refundable for some families, as will be discussed shortly. The following example illustrates the difference between refundable and nonrefundable credits. Consider a single-parent family in which the adult works full-time, full-year and earns the minimum wage. In 2000, this family would have had $10,300 ($5.15 x 2000 hours) in annual income. After taking into account personal exemptions and the standard deduction, they would have owed no federal income tax (but they still would have owed payroll taxes on earnings). Because they have no federal income tax liability, they would have received no Child Tax Credit (maximum value of $1,000 for families with two children). However, because the EITC is refundable, they would have received a check for $3,888 (maximum value for families with two children).

[1] This brief discusses some major changes. For greater detail, see Greenstein (2001).

[2] Other provisions of the tax code also benefit families, though they are not the focus of this Brief. These provisions include the personal exemption, which can be taken for each dependent child, and the Dependent Care Credit, which provides benefits to families that purchase child care.

The EITC was initially established in 1975 as an offset for payroll taxes owed by low-income households. In 1992, the EITC was considerably expanded under then-President Clinton, making it the *single largest cash transfer program for lower-income families* in the United States today. From 1991 to 2000 alone, the inflation-adjusted value of the credit more than doubled. The credit is structured to automatically increase with inflation.

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The amount of the EITC received by a family depends on family earnings and the presence of children. The largest benefits are provided to low-income working families with children, though a nominal benefit is available to some very poor working single adults. In tax year 2000, benefits for a family with two or more children were as follows: Families with earnings of up to $9,720 had their earnings subsidized at a rate of 40 percent. So, if earnings were $7000, the credit received was $2,800. Those with earnings between $9,720 and $12,690, such as the single-parent family described above, would have received $3,888, the maximum credit available. Beyond $12,690, the maximum credit was reduced by 21 cents for every additional dollar earned. And for those with earnings of $31,152 or more, no credit was available.

In 2000, the EITC raised the wages of a minimum wage worker employed full-time, full-year from $10,300 to $14,188, just above the poverty threshold for a family of three. So, the minimum wage and the EITC together operate as an effective anti-poverty tool, though even such income is likely to be inadequate to meet annual expenses for a family of this size.

By subsidizing the earnings of very poor families, the EITC encourages individuals to seek employment.[3] As just one piece of evidence, a recent study finds that nearly 60 percent of the increase in single mothers' employment from 1984 to 1996 was due to the expansion of the EITC alone (Meyer and Rosenbaum, 1999). On the other hand, for those workers with family earnings in excess of $9,720, the design of the EITC may cause some workers to somewhat reduce the number of hours worked[4] or in the case of married-couple families, it may discourage the secondary earner, typically the wife, from working altogether (Eissa and Hoynes, 1999). This is in large part because the amount of the credit gradually falls to zero as earnings rise.

The EITC may also affect decisions to marry or get divorced because the value of the credit varies with the presence of children and earnings. For instance, the EITC may discourage marriage between a low-earning single mother and a low-earning single man because the value of their EITC may be substantially reduced if they do so. Yet, it might encourage marriage for others. For instance, a low-earning single man and an unemployed single mother would benefit by marrying because the presence of children combined with low (but positive) earnings increase the size of the credit. Notably, the tax changes signed into law in spring 20001 will somewhat, though by no means completely, reduce the potential negative effects of the EITC on marriage and married women's labor supply. Specifically, the new legislation expands the income thresholds for married couples in future years (Greenstein, 2001). These changes also means that, for the first time, the EITC varies not only by presence of children and earnings as described above, but also by marital status.

Another credit aimed at families, initially introduced in 1997, is the Child Tax Credit. As of 2000, the Child Tax Credit provided a benefit of as much as $500 per child. To date, this credit has been less effective at redistributing

[3] Most discussions on incentive effects, such as the one here, assume that the EITC is received on a regular basis throughout the year. However, virtually all recipients receive it as a lump sum so they may respond to it differently as discussed in Smeeding, Philips and O'Connor (2000).

[4] In terms of economic theory, in the middle range of the credit, it has a pure income effect, which operates to reduce hours worked. In the phase-out range of the credit, at which point the credit is reduced by 21 cents for each dollar earned, both the income and substitution effects operate to reduce hours worked.

income than the EITC, principally because it has been nonrefundable. At the upper end of the income distribution, the Child Tax Credit is phased out (at $110,000 for married couples in 2000), which has nevertheless made it somewhat progressive (Gentry and Hagy, 1996).

Legislation in 2001 made two significant changes. First, the maximum credit per child was raised to $600 for 2001 and will further increase to $1,000 by 2010. Second, the credit was made partly to fully refundable for families with earnings in excess of $10,000 in 2001 (this figure is indexed to inflation, thereafter). Specifically, starting in 2001 families are able to receive the *lesser of* the potential credit or 10% of earnings in excess of $10,000. So, for those with precisely $10,000, such as the working single-parent family with two children described earlier, they still receive no Child Tax Credit (10% of zero "excess" earnings is zero). But, families with $15,000 in earnings and two children will receive a $500 refund check, and thus at least partly benefit from the credit.[5]

The tax code is an attractive means of redistributing incomes because it does not require a new government bureaucracy, just additional tax forms.

From a theoretical standpoint, the effects of the Child Tax Credit on hours worked are varied and complex, depending on earnings and the number of children. On the one hand, some middle-income parents may respond by working fewer hours since the availability of the credit makes it possible to work less and still have the same net income. On the other hand, the credit may encourage work among some lower-income parents. In terms of family structure, this policy is unambiguously pro-natalist since benefits rise with the number of children. Still, given the overall costs of raising a child to age 18, estimated by the Department of Agriculture to be as high as $160,140 per child in 2000, such effects are likely to be small.

In evaluating these credits, it also useful to briefly consider budgetary and administrative implications. The tax code is an attractive means of redistributing incomes because it does not require a new government bureaucracy, just additional tax forms to be filled out. From this standpoint, it has been relatively inexpensive. However, even tax credits have administrative costs. Among these, the EITC has been subject to fraud, though the Internal Revenue Service has taken measures to reduce this. In addition, the rules governing the EITC and the Child Tax Credit have, with few exceptions, grown increasingly complex. Additional "outreach" efforts are required to educate taxpayers and tax preparers (Greenstein, 2001). Finally, the budgetary implications of these policies are real — lower tax collections — but perhaps less obvious because these credits are negative taxes rather than direct budget outlays (Steurle, 1998).

In conclusion, tax credits are not without costs or unintended consequences, and they are not able to help all children, but there is firm evidence that they have benefited many families and children. Given the considerable bipartisan support of the past decade, they are likely to remain an important policy tool well into the new century.

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[5] This example is from Greenstein (2001). In this case, $500 is the lesser of $1,200 (maximum credit for two children in 2001) and $500 (.10*($15,000-$10,000)). Greenstein also offers more complicated examples, including those in which the family has some tax liability.

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