FIRST FOCUS

MAKING CHILDREN & FAMILIES THE PRIORITY

An Improved Child Tax Credit:

Good for the Economy, Good for Kids

The "R" Word

Unemployment hit a two-year high last month[1]. Retailers experienced their worst December sales in five years.[2] The stock market began 2008 with a week of steady declines. Consumer Confidence is at a six year low.[3] Federal Reserve Chairman Ben Bernanke recently admitted, "The outlook for real activity in 2008 has worsened," and all but promised to make further interest rate cuts.[4] Dozens of state budgets are set to go into the red in the coming years, and of course, the housing crisis continues unabated with both rising foreclosure rates and slumping housing sales.[5]

With all of these ominous signs, many economists and policy-makers have begun to think seriously about what kind of action the federal government can take to avoid a recession, or, if an economic downturn is inevitable, to at least blunt its impact. There are a wide variety of policy changes the federal government could consider as part of am "Economic Stimulus Package," some of which would be more effective and efficient than others. This policy brief will highlight one of these policy options: improving the Child Tax Credit.

How Do Economic Stimuli Work?

Economies slow down for a variety of reasons. In the current case, a variety of factors, including the mortgage crisis, rising national debt and worsening state budgets, have combined to produce those dark clouds that we see on the economic horizon. Slowdowns turn into recessions when slackening demand causes employers to trim their payrolls, pushing unemployment up, and further dampening economic activity. The federal government can head off this spiral if it can quickly increase demand for goods and services.[6]

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[1] Neil Irwin. "Job Woes Deepen Economic Anxiety." Washington Post. January 5, 2008.

[2] Michael Barbaro. "Poor December at Retailers; Most Report Drop in Sales." New York Times. January 11, 2008.

[3] Associated Press. "Consumer Confidence Sinks to Record Low." January 11, 2008

[4] Louis Uchitelle and Michael M. Grynbaum. "Fed Chief Signals Further Rate Cut." New York Times. January 11, 2008.

[5] For an analysis of state budgets see Elizabeth C. McNichol and Iris Lav. "13 States Face Total Budget Shortfall of At Least $23 Billion in 2009; 11 Others Expect Budget Problems." Center on Budget and Policy Priorities. December 18,2007. Foreclosure data can be found at realtytrac.com. For more on diminishing housing sales see Pamelah M Prah and Eric Kelderman. "State Finances Expected to Dip." Stateline.com. August 9, 2007.

[6] Some economists believe that a better approach would be to focus on the "supply side" of the economy, rather than the "demand side," by providing subsidies and benefits to businesses in order to prevent a rise in unemployment. This approach, however, is best applied when the downturn stems not from shrinking demand but rather from shortages for goods and services. In the current case, that does not appear to be the problem.

There are essentially two different ways that the federal government might seek to increase demand. First, Congress could immediately increase demand on goods and services by directly increasing federal spending. The Federal Government is a massive consumer in our economy and, as such, increasing its demand for goods would provide a boost to overall demand. The second method is to provide increased financial resources to consumers, and depend on them to increase demand. More specifically, this would mean tax cuts, tax rebates, or increased benefits to those who already collect some form of government assistance. All three of those policies would put more money in the hands of American consumers who would then, conceivably, spend more in the American economy.

It is important to note that not all stimuli are equally effective. Some policies take longer to have their intended effect and some policies miss the mark entirely. As an example, take the following hypothetical policy: the federal government decides to provide an immediate $1,000 benefit to the one million taxpayers who paid the most in taxes last year. This policy is unlikely to quickly stimulate demand because those same taxpayers are the least likely to be contributing to the slowdown in demand. Those taxpayers, as the wealthiest Americans, would be unlikely to change their spending habits based on such a small benefit (small relative to their normal income). Thus, even though the government directed 1 billion additional dollars to American consumers, that money is unlikely to end up circulating throughout the economy.[7]

Additionally, some economic stimuli are more efficient than others. Efficiency, in this context, refers to the ratio of increased economic demand to spent resources. Policies that require $2 spent for every $1 of increased activity are relatively inefficient. The hypothetical example described above, in addition to being ineffective, would also be inefficient. Though that $1billion might eventually end up boosting demand, it is likely that only a portion of it will ever reach the market. In this hypothetical case, the government will have spent $1 billion for only a fraction of increased economic activity.[8]

Effective, Efficient, Fair

Improving the Child Tax Credit would provide a much needed, efficient and effective economic stimulus. In its current form, the CTC provides a tax refund of up to $1,000 for every dependent child claimed by a taxpayer, as long as that taxpayer earned a certain amount of money the previous year (this is called the "income floor"). The more a taxpayer earned, the more refund he or she can claim (again, up to $1,000). The income floor, in place to reward earned income, is currently indexed to inflation, meaning that it rises each year. Unfortunately, wages have not, in recent years, risen at the same pace. Millions of low-income families have become ineligible to claim the credit as the income floor has risen, and millions more have seen amount of refund they can claim reduced significantly. Reducing the income floor from its current level at about $11,000 to $8,500 would mean added benefits to the families of 13 million children.

Implementing this improvement to the Child Tax Credit would provide an immediate boost to the economy because the taxpayers who benefit are precisely those who are most likely to spend

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[7] For more on how to evaluate economic stimuli, see Lawrence Summers. "Why America Must Have a Fiscal Stimulus." Financial Times. January 6, 2008. for

[8] For an excellent overview of the principles of economic stimulus and an evaluation of potential policies refer to Chad Stone and Kris Cox. "Economic Policy in a Weakening Economy." Center on Budget and Policy Priorities. January 8, 2008.

added resources and thereby generate increased demand. The beneficiaries of an improved CTC are, by definition, low-income, working taxpayers with children. These Americans have been spending less because they have less. A greater CTC benefit would increase their resources and thus increase their ability to spend. Indeed, an analysis conducted by Dr. Mark M. Zandi, chief economist for Economy.com showed that for every dollar the federal government spends on the Child Tax Credit, $1.04 in economic activity is generated, making it one of the most efficient ways to stimulate the economy.[9]

Improving the Child Tax Credit would also direct much needed economic resources to the states that are facing the most difficult economic conditions. There are 37 states in which the CTC improvement would impact more than 15% of the state's child population.[10] 22 of those states experienced steep declines in home sales last year.[11] Nineteen of those states either have higher unemployment than the national rate, or saw their unemployment rate rise over the past year.[12] Fifteen of those states anticipate a budget deficit in the coming years.[13] A better CTC will have an important impact in these states that need an economic stimulus, and need it to work.

Child Tax Credit Changes Should Be Part of Economic Stimulus Package

With the complexity of the economic situation, efforts to stimulate economic activity are likely to include a variety of policy changes, and an improved Child Tax Credit would fit well among them. As discussed, an increased investment in the CTC will provide additional resources to Americans who are most likely to then contribute those additional resources to the greater economy. Additionally, the improving the CTC is an efficient way of stimulating the economy, producing more activity per dollar spent than other alternatives such as reducing marginal tax rates across the board.[14] Of course, improving the CTC as part of a wider economic stimulus package has the added benefit of increasing supports to America's children, an investment that will pay long-term as well as immediate dividends.

Finally, it should also be noted that improving the CTC would draw wide bipartisan support. A similar change has already been passed by the House of Representatives twice as part of a larger tax reform package.[15] Furthermore a CTC reform bill (S. 218) has been offered in the Senate by Senators Snowe (R-ME) and Lincoln (D-AR). Even intellectual luminaries such as Ramesh Ponnuru and David Brooks have written about the benefits of improving the Child Tax Credit.[16]

With the benefits clear, and the need evident, Congress would be wise to include an improved Child Tax Credit in any stimulus package.

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[9] Dr. Mark M. Zandi. "Assessing President Bush's Fiscal Policies." Economy.com. July 2004.
[10] Estimates of the number of children impacted in each state from Aviva Aron-Dine. "Improving the Refundable Tax Credit." Center on Budget and Policy Priorities. October 24, 2007. Total population of children is based on the 2005 American Community Survey as reported by kidscount.org.
[11] Pamelah M Prah and Eric Kelderman. "State Finances Expected to Dip." Stateline.com. August 9, 2007.
[12] Bureau of Labor Statistics.
[13] Elizabeth C. McNichol and Iris Lav. "13 States Face Total Budget Shortfall of At Least $23 Billion in 2009; 11 Others Expect Budget Problems." Center on Budget and Policy Priorities. December 18,2007.
[14] Dr. Mark M. Zandi. "Assessing President Bush's Fiscal Policies." Economy.com. July 2004.
[15] The House passed two versions of its AMT relief act that included a change to the CTC. This provision was stripped out in the final version of the bill.
[16] Ramesh Ponnuru. "Tax Cuts for the Poor." National Review. May 20, 2005. David Brooks. "Middle Class Capitalists." New York Times. January 11, 2008.

Appendix A: State by State Impact of an Improved CTC

State	Number of Children Benefiting From an Improved CTC	Percent of Children Who Would Benefit from an Improved CTC
Alabama	235,305	21.6%
Alaska	23,530	12.5%
Arizona	343,777	21.8%
Arkansas	150,334	22.3%
California	2,047,154	21.1%
Colorado	181,708	15.4%
Connecticut	87,585	10.5%
Delaware	28,760	14.7%
Florida	756,898	18.6%
Georgia	431,393	18.3%
Hawaii	49,676	16.6%
Idaho	83,664	22.4%
Illinois	512,442	15.8%
Indiana	261,450	16.3%
Iowa	99,351	14.8%
Kansas	122,881	18.2%
Kentucky	166,021	16.9%
Louisiana	226,155	19.7%
Maine	37,910	13.7%
Maryland	156,870	11.2%
Massachusetts	143,798	9.9%
Michigan	393,482	15.6%
Minnesota	155,563	12.7%
Mississippi	164,714	22.0%
Missouri	247,070	17.9%
Montana	36,603	17.9%
Nebraska	66,670	15.4%
Nevada	118,960	19.2%
New Hampshire	20,916	6.9%
New Jersey	261,450	12.1%
New Mexico	121,574	24.8%
New York	720,295	15.8%
North Carolina	430,086	20.1%
North Dakota	19,609	14.4%
Ohio	422,242	15.3%
Oklahoma	179,093	21.0%
Oregon	155,563	18.3%
Pennsylvania	409,169	14.5%
Rhode Island	37,910	15.5%
South Carolina	202,623	19.7%
South Dakota	31,374	16.7%
Tennessee	267,986	19.3%
Texas	1,539,941	24.3%
Utah	138,568	18.7%
Vermont	20,916	15.8%
Virginia	227,461	12.5%
Washington	235,305	15.9%
West Virginia	79,742	20.8%
Wisconsin	180,400	13.9%
Wyoming	19,609	17.2%

Estimates of the number of children impacted in each state from Aviva Aron-Dine. "Improving the Refundable Tax Credit." Center on Budget and Policy Priorities. October 24, 2007. Total population of children is based on the 2005 American Community Survey as reported by kidscount.org