FIRST FOCUS

MAKING CHILDREN & FAMILIES THE PRIORITY

Family Tax Policies: What They Are and Why They Matter

I. Tax Policy and the Economic Well-Being of Children and Their Families

Most Americans rightly associate federal tax law with the government's need to raise revenue to pay for government services. While this is clearly the first priority for the federal tax system, it is also true that federal tax law directs economic resources to certain taxpayers based on qualifying conditions deemed important by Congress. For instance, taxpayers who make charitable contributions can deduct those contributions from their income, thus lowering their federal tax liability.

For children and their families, there are several provisions of current tax law that provide significant tax relief and, for some families, additional cash support. Indeed, the value of the four largest of these tax provisions, highlighted in this backgrounder, far exceeds the level of federal spending on the programs more typically associated with helping children and their families. As shown in Table 1, the combined value of just the four tax expenditures discussed in this paper -- the Personal Exemption for Dependent Children, the Child Tax Credit (CTC), the Earned Income Tax Credit (EITC), and the Child and Dependent Care Tax Credit (CDCTC) -- is about $117 billion annually.

Table 1: Tax Expenditures for Key Child and Family Tax Provisions ($ Billions)

	2007	2008	2009	2010
Personal Exemption for Children	23.9	24.7	25.2	25.9
Child Tax Credit	47.5	46.7	46.1	45.6
Earned Income Tax Credit	41.8	42.9	43.7	44.7
Child Care Tax Credit	3.9	2.8	1.7	1.7
Total	117.1	117.1	116.7	117.9

Source: "Kids Share 2007," Adam Carasso, C. Eugene Steuerle, and Gillian Reynolds, March 2007 (data provided by authors); Analytical Perspectives, Budget of the United States Government, Fiscal Year 2008, table 19-1.

By way of comparison, funding in 2007 is $6.8 billion for Head Start, $17.1 billion for the Temporary Assistance to Needy Families (TANF) program, $12.7 billion for Title I education grants for low income schools, and $5.5 billion for the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC).[1]

II. Personal Exemption for Dependents

History: The personal income tax system has, for many decades, provided a basic personal exemption for taxpayers and their dependents. This exemption effectively adjusts federal income tax liability by family size and provides

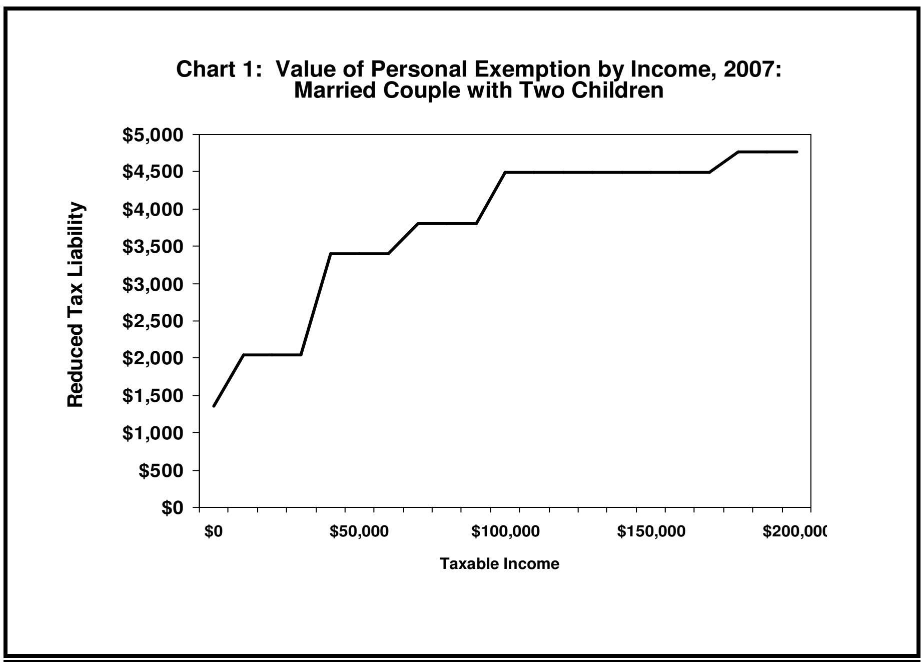
[1] Budget of the United States Government, Fiscal Year 2008 – Appendix.

indirect financial assistance to families with children. The personal exemption amount for 2007 is $3400 per person.

The economic value of the dependent exemption has fallen substantially in recent decades. According to Urban Institute researchers, the dependent exemption in 1960 -- $600 per person -- was worth about 1.2% of GDP; today, its value is just 0.2% of GDP.[2] The main reason for its decline in real value is that the exemption amount was not automatically indexed for inflation until 1984.

Eligibility: To qualify for the exemption, a taxpayer must provide at least half of the income support for the claimed dependent child.

Value by Income: The personal exemption amount is not adjusted based on the taxable income of the taxpayer. The exemption effectively erases the income tax liability for many low income households as the exemption amount -- multiplied by the number of persons in the household -- exceeds the amount of taxable income for many families. As shown in Chart 1, upper income households benefit more from the exemption than lower income households because the value of the exemption increases with the tax rate that would have applied to the exempt income.



III. Child Tax Credit

Legislative History: The CTC was enacted in the 1997 Taxpayer Relief Act and was a pivotal provision in the bipartisan balanced budget compromise between

[2] "Kids Share 2007," Adam Carasso, C. Eugene Steuerle, and Gillian Reynolds, March 2007, p. 13.

President Bill Clinton and the then Republican-controlled Congress. The 1997 law originally set the credit at $400 in 1998 and $500 in 1999 and future years. It was subsequently raised to $1000 through 2010 in the 2001 and 2003 tax laws.

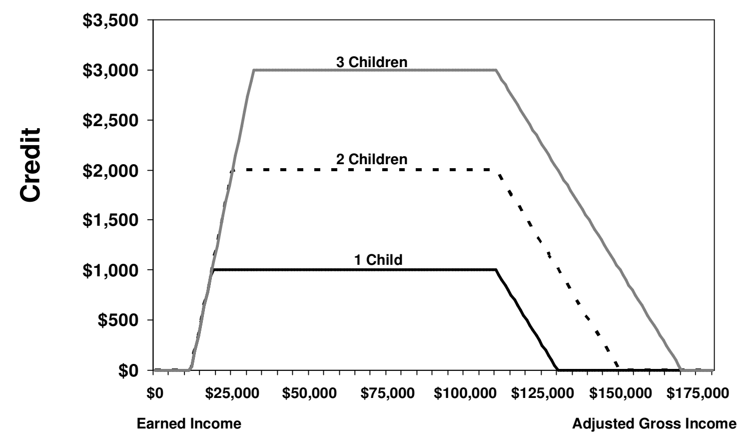
Eligibility: In general, taxpayers can claim the CTC for children under the age of 17 who are dependents in their household. In 2004, some 26 million households received some benefit from the CTC.[3]

Value by Income: Originally, the child credit was not refundable, which meant it could be claimed to reduce income tax liability but could not be fully claimed if a household was already paying no federal income tax. In other words, the child tax credit could not be used to provide direct cash assistance to households. In the 2001 and 2003 tax bills, partial refundability was provided for households with earned income exceeding a threshold, set at $11,750 in 2007.[4] This "refundability threshold" is indexed to inflation annually.

The child credit is phased out for upper income households. Married couples filing jointly with adjusted gross income exceeding $110,000 get a $50 reduction in their credit for every $1000 in income above the threshold. The $110,000 is not indexed to inflation. Consequently, the number of households eligible for the credit will shrink over time as more taxpayers exceed the upper income limit.[5]

Chart 2 provides a summary of the credit amounts by income for joint filers in 2007.

Chart 2: Child Tax Credits for Married Couples Filing Joint Returns, 2007*



*Replication of a chart appearing in "Who Gets the Child Tax Credit," Leonard E. Burman and Laura Wheaton, Tax Notes, October 17, 2005 (updated for 2007).

3 2004 Individual Income Tax, All Returns: Tax Liability and Tax Credits, Tax Policy Center.
4 2007 Key Tax Numbers, Steve Harvey, LLC.
5 "Who Gets the Child Tax Credit," Leonard E. Burman and Laura Wheaton, Tax Notes, October 17, 2005.

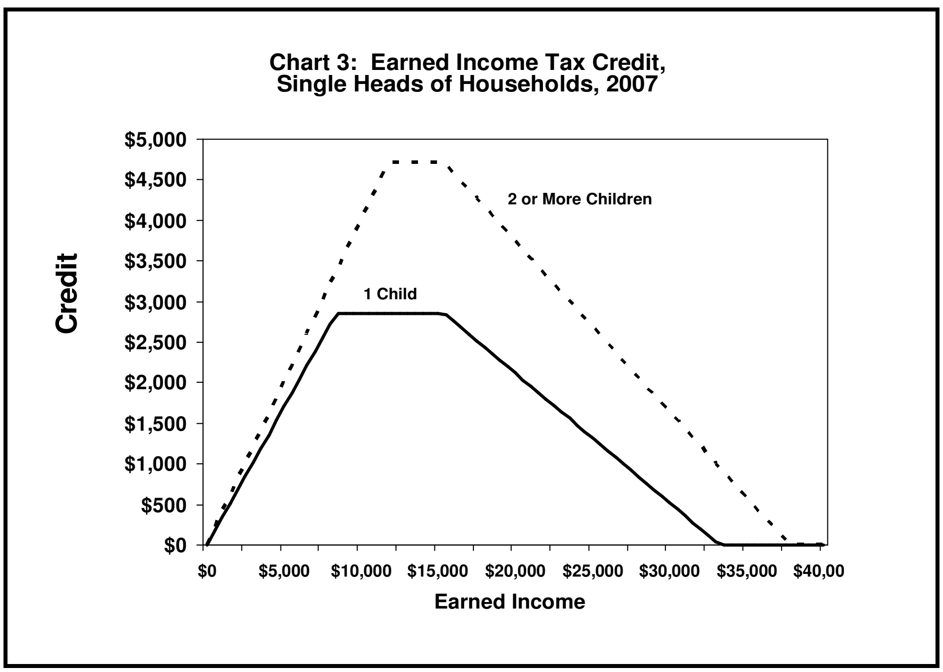
IV. Earned Income Tax Credit

Legislative History: First enacted in 1975, the Earned Income Tax Credit (EITC) was expanded substantially in 1990 and 1993 and is now the federal government's largest antipoverty program for low income working families.

Eligibility: Households with low levels of earned income are eligible for the EITC, with the largest credits available to households with dependent children. The EITC pays a credit based on the level of earned income, tax filing status, and the number of EITC-eligible children in the household. In general, a child is someone under the age of 19, except that full-time students living in the same home as the taxpayer and under age 24 can qualify as an EITC-eligible child. Over 19 million households claimed the EITC in 2003.[6]

Value by Income: Like the CTC, the maximum EITC is phased-in over a certain range of earned income until it reaches a maximum level. The maximum level is then phased-out for households exceeding a certain level of income. Unlike the CTC, the EITC is fully refundable. Also, the EITC parameters -- the maximum credit and the phase-out thresholds -- are indexed to inflation annually.

Chart 3 shows the credit amounts for single heads of households in 2007 by level of earned income.



[6] Distribution of Tax Provisions, Earned Income Tax Credit, 2003, Tax Policy Center.

V. Child and Dependent Care Tax Credit

Legislative History: Congress created the Child and Dependent Care Tax Credit (CDCTC) in 1975 to replace a previous federal tax deduction for child care expenses. The credit is intended to support parents paying for child care while they work or look for employment.

Eligibility: Households can claim the CDCTC if they pay for child care expenses for a dependent child under the age of 13 or for a disabled dependent. The maximum credit amount is reduced for any tax-free child care expenses paid by an employer.

Value by Income: The CDCTC is not refundable; therefore, it provides no assistance to households that face no federal income tax liability. For households with tax liabilities and incomes below $15,000, the credit is set at 35% of the household's child care expenses. The credit rate is phased down from 35% at $15,000 to 20% for households with incomes of $43,000 or more. The maximum CDCTC amount is $3000 per child, or $6000 per household.

The CDCTC parameters were liberalized in the 2001 tax law. These liberalizations, however, are set to expire after 2010. Beginning in 2011, the credit rate will be reduced to 30% for low income households, and the maximum credit amounts will be $2400 per child or $4800 per household.

VI. Outlook

The outlook for tax policy is highly uncertain at this time. However, there are reasons to expect substantial changes in the tax law in the coming years, which may provide an opportunity to improve the economic environment for children and their families.

The current income tax law is particularly unstable because of the growing numbers of taxpayers caught in the Alternative Minimum Tax (AMT), which is unpopular in Congress among members from both political parties. It is highly likely that significant tax changes will be necessary to reduce the importance of the AMT in the revenue baseline without substantially increasing the federal budget deficit. The changes required to fix the AMT without reducing total revenue could have significant consequences for taxpaying families with children.

Further, two provisions of current law will substantially erode the value of the CTC if not corrected:

- ***$1000 Per Child Credit Is Expiring***: The $1000 per child tax credit is scheduled to expire after 2010. If it does expire, the per child amount would revert to $500, unindexed for inflation.

- ***The Phase-Out Thresholds Are Not Indexed***: The income thresholds for phasing out the CTC -- $110,000 for married couples filing jointly, $75,000 for single heads of households -- are not indexed for inflation. As a consequence, as wages increase over time, more families will be pushed beyond the income range eligible for the CTC, and the total number of families benefiting will decline.

Several proposals have been offered by tax experts to simplify the federal income tax system for families. One proposal would collapse the personal exemption for child dependents, CTC, and the EITC into a unified children's tax credit. This and other proposals could improve the progressivity of the tax law by allowing full refundability of the new unified credit, thus helping low income households more than the current combined personal exemption/EITC/CTC. However, if this or any other proposal is to be revenue neutral, some families will necessarily face higher taxes than under current law to offset the costs of greater generosity toward others. This redistribution aspect of many proposals makes them harder to pass in Congress. On the other hand, proposals which are simply more generous to all families with children would increase the federal budget deficit, which many economists believe would be imprudent.