Combining Child Credits, the EITC, and the Dependent Exemption (Part 2 of 2)

Part Two: The Various Rationales

C. Eugene Steuerle

"Economic Perspective" column reprinted with permission.
Copyright 2000 TAX ANALYSTS

Document date: May 01, 2000
Released online: May 01, 2000

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

Combining and integrating various tax provisions applying to households with children is an issue that has been put back on the public stage by a recent Economic Policy Institute (EPI) study (see part one of this series). Achieving this goal is important for several reasons. First, it would simplify the tax law. Second, it would reduce the work disincentives that currently apply to moderate- income households. Third, it is likely to significantly reduce the marriage penalties that moderate-income households face. Fourth, it might lessen the need for other welfare provisions to help moderate- income individuals. Finally, if a health tax credit—as is now suggested by both presidential candidates—is going to be considered in the near future, it offers the opportunity to fit such a credit more consistently into the tax system.

That combining the current provisions together could provide some simplification is obvious. Instead of applying for different benefits in different places (the earned income tax credit (EITC), dependent exemptions, and child credits—including the additional child credit), the taxpayer could apply for one basic or unified credit; at the least, all calculations could be done in one place.

The principal work disincentives in current law apply during the phase-out of the EITC. Although not required, a unified credit would most likely be designed to level out the value of various benefits. However, the tax law has come a long way already. With the recent addition of a child credit that gradually phases in often as the EITC phases out, the net marginal tax rate is reduced in some low- to moderate-income ranges (since the positive income tax rates take longer to come into effect). Taking into account the EITC, child credit, personal exemptions, and the positive income tax rates, the table below shows the net benefits at various income levels ("+" means credit from the government, "-" means net tax) for a single head of household with two children in 1999.

Net Credit (credit less income tax) for a Single Head of Household With Two Children 1999

Income	Net Tax Credit
$5,000	+$2,010
$10,000	+$3,816
$15,000	+$3,276
$20,000	+$2,223
$25,000	+$606
$30,000	-$1,197

What the table implies is that there is a net marginal tax rate of about 21 percent once the EITC starts phasing out, but the positive income tax rates are offset by the personal exemptions and the child credits. However, by the time the taxpayer earns a bit more than $20,000, she starts paying a marginal rate of about 36 percent as the 15 percent regular marginal tax rate kicks in. Combined with a social security tax rate of close to 15 percent (crediting the employer's payment to the employee who usually bears the cost), the tax system, including the EITC, starts taking away about one-half of additional earnings. As the taxpayer moves

a little beyond $30,000, there's no more EITC and the marginal rate falls again.

Although the marginal rate of about one-half is somewhat high, the real kicker comes from other means-tested and welfare provisions. Those range from Medicaid to food stamps to housing assistance. While there is only so much the tax system can do to deal with problems created by these other programs, it is possible to delay the phase- down of tax benefits while the other programs are phasing out.

A more severe problem at lower-income levels is the marriage penalty. Take a single head of household earning $10,000 a year who is considering marrying a single worker who also earns $10,000 a year and pays a net tax of about $444. Taken together, their combined credit (or negative tax liability) is $3,372 ($3,816 - $444). But if the two of them were to marry, their net credit would fall to $2,223—a drop of $1,151 simply for marrying! Worse yet, they would lose many of the other benefits noted above, such as Medicaid, food stamps, and housing assistance.

The fourth issue raised by integrating the EITC, child credits, and dependent exemption is how the result might integrate with other welfare programs. In recent years, our society has seemed to accept the granting of cash rather than in-kind benefits to those who demonstrate through their earnings that they are willing to work. As this tax credit-based system has expanded, it has taken some of the pressure off of purer, means-tested programs to deliver benefits. Indeed, whatever one thinks about the welfare reform that displaced the old Aid to Families With Dependent Children with Temporary Assistance to Needy Families, I seriously doubt that the substitution would have been possible without the tax credit programs that by then were in place. Any reform that might expand or change tax benefits would necessarily have an impact on the size and structure of those welfare benefits as well.

A final consideration—and it may be among the most important and most ignored to date—is how a President Gore or a President Bush might integrate any promised health tax or expenditure credit into the existing tax and welfare structure. Health credits can be expensive and they, too, are typically phased out as income rises. A unified credit structure is almost required simply as a matter of transparency if a health credit were to be added to the mix. In particular, any phase-out of a health credit likely would add substantially to marginal tax rates, and it should not be treated as a totally separate item that is independent in its effect from the incentive effects of other parts of the tax system.

None of these reasons by itself necessarily forces reform of the EITC, child credit, and dependent exemption. But a more unified structure offers a tantalizing set of opportunities and problems that clearly are worthy of attention at this point in time.

Other Publications by the Authors

- C. Eugene Steuerle

Usage and reprints: Most publications may be downloaded free of charge from the web site and may be used and copies made for research, academic, policy or other non-commercial purposes. Proper attribution is required. Posting UI research papers on other websites is permitted subject to prior approval from the Urban Institute—contact publicaffairs@urban.org.

If you are unable to access or print the PDF document please contact us or call the Publications Office at (202) 261-5687.

Disclaimer: *The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Copyright of the written materials contained within the Urban Institute website is owned or controlled by the Urban Institute.*

Source: The Urban Institute, © 2012 | http://www.urban.org