Considerations in Efforts to Restructure Refundable Work-Based Credits

Stephen D. Holt[1]
HoltSolutions
Georgetown Center on Poverty, Inequality, and Public Policy

Elaine Maag
Urban Institute
Urban-Brookings Tax Policy Center

Introduction

Historically, the primary role of the Internal Revenue Code has been to raise revenue for the federal government. Yet the nation's tax system also functions to encourage behaviors such as saving, working, owning a home, and supporting children. In recent decades, the Code has also replaced traditional means-tested spending programs as the principal means for transferring income to low-earning individuals and families with children, particularly through the use of refundable credits. The oldest and largest vehicle is the Earned Income Tax Credit (EITC), and it is now supplemented by both the Child Tax Credit (CTC) and the Making Work Pay tax credit (MWP).

In character with much of the tax code, the income support features are provisions with complicated and sometimes contradictory rules that lack overall coordination. Several benefits accrue to households with children, while low-earning workers without children at home receive relatively little attention. Credits phase in and out at different rates and income levels, complicating the incentive structures without considering interactions among policies targeting often overlapping populations. Recent initiatives tend to extend the patchwork, rather than rationalize the system. Beginning with the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) and extending through the American Recovery and Reinvestment Act (ARRA), recent initiatives have been implemented temporarily, adding another source of complexity.

This working paper looks at how the system has evolved, the important role now played by the tax system in assisting low-earning individuals and families, the complexities and issues presented by the current approach to providing assistance, and a set of proposals for reform. It then offers principles to guide the design of a new structure that would replace three existing provisions – the EITC,

[1] The authors acknowledge the substantial involvement of Mark Greenberg during his employment at Georgetown University. Mark completed his work on this project in August 2009. The analysis and conclusions here represent the views of the authors only and not the Administration for Children and Families, the U.S. Department of Health and Human Services, or the Federal government. The authors also thank the participants at a July 21, 2009 roundtable at the Georgetown University Law Center and Robertson Williams for review and comments.

CTC, and MWP – with a worker credit and a child benefit. The paper concludes by examining the costs and effects of a specific proposal consistent with those principles.

Evolution of Tax-Based Income Support

Inherent in the structure of the income tax is a concern with ability to pay. The tax code reflects this concern both through its progressive rate structure and by its rules relating to deductions, exemptions, and credits. A minimum amount of income is effectively exempted from taxation through the standard deduction and personal and dependent exemptions, and single parents—heads of household—benefit from having more income taxed at lower rates than individuals without children. The tax code provides additional deductions to households in special circumstances.

In recent decades refundable tax credits have been used to make transfer payments to low-income families and individuals. A traditional tax credit can only offset taxes owed. Refundable tax credits not only offset taxes owed but also provide a refund to the taxpayer if the credit exceeds her tax liability.

A tax credit might be made refundable simply to increase its effectiveness in accomplishing its goal. Batchelder, Goldberg, and Orszag (2006) argue that when a tax provision is intended to affect behavior, a credit structure is more effective than a deduction or exemption. A deduction or exemption provides its greatest benefits, and thus its greatest incentives, to those with the highest marginal tax rates. In contrast, a credit can provide equal benefits to all taxpayers. Making the credit refundable ensures that its behavioral effects extend to those with little or no income tax liability.

In addition, refundable credits can provide a highly efficient vehicle for providing income assistance to lower-income individuals and families while avoiding some of the most serious problems typically presented by means-tested income support programs. Common criticisms of current means-tested income support programs are:

- inherent work disincentives, because the maximum benefits typically go to those with no income, and the benefits phase out as income rises, so that a dollar of increased earnings results in less than a dollar of increased income;
- stigma, stemming in part from a perception that the benefits have not been earned and by an intrusive administrative approach used to determine initial and ongoing need; and
- divisiveness, because among households with similar needs, some do and others do not receive support.

Providing income assistance to lower-income individuals and families through the tax system avoids these problems. Through a structure of tax credits in which benefits grow with earnings–as is the case for the EITC, CTC, and MWP–the credit can encourage work. The credit can be delivered as part of the near-universal tax system and take advantage of its compliance mechanisms and lower administrative costs. Because the credit can be structured not to phase out or to phase out very slowly, it can avoid the historic divisive structure of means-tested assistance programs.

Although there are compelling arguments for delivering low-income assistance through the tax code, there are some common counter-arguments. One is that expanding the role of the tax code beyond the raising of revenues to include the making of transfer payments is inappropriate, resulting in undesirable mission creep, and burdening the IRS with administrative responsibilities it is ill equipped to handle. Another is that because tax-based benefits are typically delivered in the context of once-a-year lump sums, the delivery structure is ill-suited to provide the on-going assistance needed by lower-income families. A third is that any credit must either eventually phase out, effectively raising marginal tax rates, or remain in place, generating potentially significant costs.

The notion that the tax system is simply about the collection of revenues is belied by the multiplicity of provisions intended to accomplish a broad range of social and economic purposes. Once one acknowledges the broad range of purposes that the tax code can and does play, the notion that credits should, as a matter of principle, not exceed liabilities seems inherently arbitrary, particularly when balanced against the virtues noted above. The concern about the timing of payments is a real and legitimate one and suggests that tax credits may not be the most effective approach for addressing “in-time” needs and costs, but it is not a general argument against using the tax code for low-income assistance. We share the concern that credit phaseouts can create high marginal tax rates over specific ranges of income.

Principal Tax Provisions Benefiting Low-Income Households

Refundable Credits

The largest federal program providing cash assistance to low-earning individuals and families is the Earned Income Tax Credit (EITC). Having roots in the debates over the merits of a negative income tax or guaranteed minimum income, the EITC began as an offset to payroll taxes, but its transfers to families now substantially exceed the amount needed to offset payroll taxes. Periodic expansions of the EITC have transformed it into the nation’s largest anti-poverty program.

The amount of the EITC is based on earnings, the number of children in the home, and a person’s marital status. People without earnings receive no credit. The EITC rises with earnings at a fixed rate until the maximum credit is reached. It then provides a constant benefit over an earnings range (the “plateau”), and then phases out at higher incomes. The parameters vary based on the number of qualifying children and whether or not the unit is headed by a married couple or an individual. The EITC for a worker without a qualifying child is small and limited to very low-income workers. In 2009, individuals without qualifying children receive the maximum EITC of $457 if household earnings fall between $5,970 and $7,470 ($12,470 if married). Those earning more than $13,440 ($18,440 if married) receive no credit. By contrast, married taxpayers with three or more qualifying children can receive a maximum credit of $5,657 in 2009 if household earnings fall between $12,570 and $21,420. These households remain eligible until household earnings reach $43,729 ($48,729 if married). The higher credit for families with at least three children and the extended phaseout for married couples expire in 2011, unless legislative action is taken. Still, families with at least two children receive a substantially higher credit than those without children—as much as $5,028 in 2009.

The Child Tax Credit (CTC) was originally a non-refundable credit equal to a fixed amount per child that could be used to offset taxes owed.[2] In 2001, a broad refundability feature was added to the CTC, allowing families with incomes in excess of a minimum threshold to claim a partial credit. The earnings threshold in order to qualify was significantly reduced in 2008 and reduced further in the American Recovery and Reinvestment Act (ARRA) in 2009. Both of these reductions are temporary, expiring after 2010. In 2009, the CTC equals to 15 percent of earnings above $3,000, up to a maximum of $1,000 per child age 16 and under. For example, a family with earnings of $8,000 qualifies for a $750 credit (15 percent of $5,000). Thus the credit now has both work support and child benefit features analogous to the EITC; in contrast with the EITC, however, the CTC is only available for families with children under age 17, is not refundable for the first dollar of earnings, and phases out at much higher income levels. In 2011, the CTC is scheduled to revert back to its pre-EGTRRA level of $500 and very limited refundability.

New in 2009 is the Making Work Pay tax credit (MWP), adopted as part of ARRA and intended to fulfill the President's campaign pledge for broad middle-class tax relief. MWP, like the CTC, is not principally a low-income tax provision (the vast share of its benefits go to middle-class workers), but it significantly benefits lower-earning families. Similar to the EITC and the refundable portion of the CTC, it is limited to workers and phases in for the lowest earners. MWP equals 6.2 percent of earnings up to a maximum payment of $400 for individuals and $800 for married couples. Like the CTC, its phaseout affects only higher-income households. Unlike the CTC (and the larger versions of the EITC), its value doesn't change with the presence of children in the home. The credit exists only for tax years 2009 and 2010 although the president has proposed to make it permanent.

---

[2] Families with three or more children could receive a small portion of their CTC as a refundable credit to the extent that their payroll taxes exceeded their EITC.

Table 1 compares the current annual income parameters of the three credits for tax year 2009:

Table 1. EITC, CTC, and MWP Parameters

	Phase-in Starts	Phase-in Rate	Phase-In Ceiling	Max. Credit	Phaseout Starts	Phase-out Rate	Max. Income
EITC, no qualifying children (single filers)	$1	7.65%	$5,970	$457	$7,470	7.65%	$13,440
EITC, no qualifying children (married joint filers)	$1	7.65%	$5,970	$457	$12,470	7.65%	$18,440
EITC, 1 qualifying child (single filers)	$1	34.00%	$8,950	$3,043	$16,420	15.98%	$35,463
EITC, 1 qualifying child (married joint filers)	$1	34.00%	$8,950	$3,043	$21,420	15.98%	$40,463
EITC, 2 qualifying children (single filers)	$1	40.00%	$12,570	$5,028	$16,420	21.06%	$40,295
EITC, 2 qualifying children (married joint filers)	$1	40.00%	$12,570	$5,028	$21,420	21.06%	$45,295
EITC, 3+ qualifying children (single filers) *	$1	45.00%	$12,570	$5,657	$16,420	21.06%	$43,279
EITC, 3+ qualifying children (married joint filers) *	$1	45.00%	$12,570	$5,657	$21,420	21.06%	$48,279
CTC (single filers) **	$3,000	15.00%	$9,667+	$1,000 (per child)	$75,000	5.00%	$95,000+
CTC (married joint filers) **	$3,000	15.00%	$9,667+	$1,000 (per child)	$110,000	5.00%	$130,000+
MWP (single filers) ***	$1	6.20%	$6,450	$400	$75,000	2.00%	$95,000
MWP (married joint filers) ***	$1	6.20%	$12,900	$800	$150,000	2.00%	$190,000

* Under current law, beginning in tax year 2011 the parameters for the EITC for 3+ qualifying children will be the same as for 2 qualifying children.

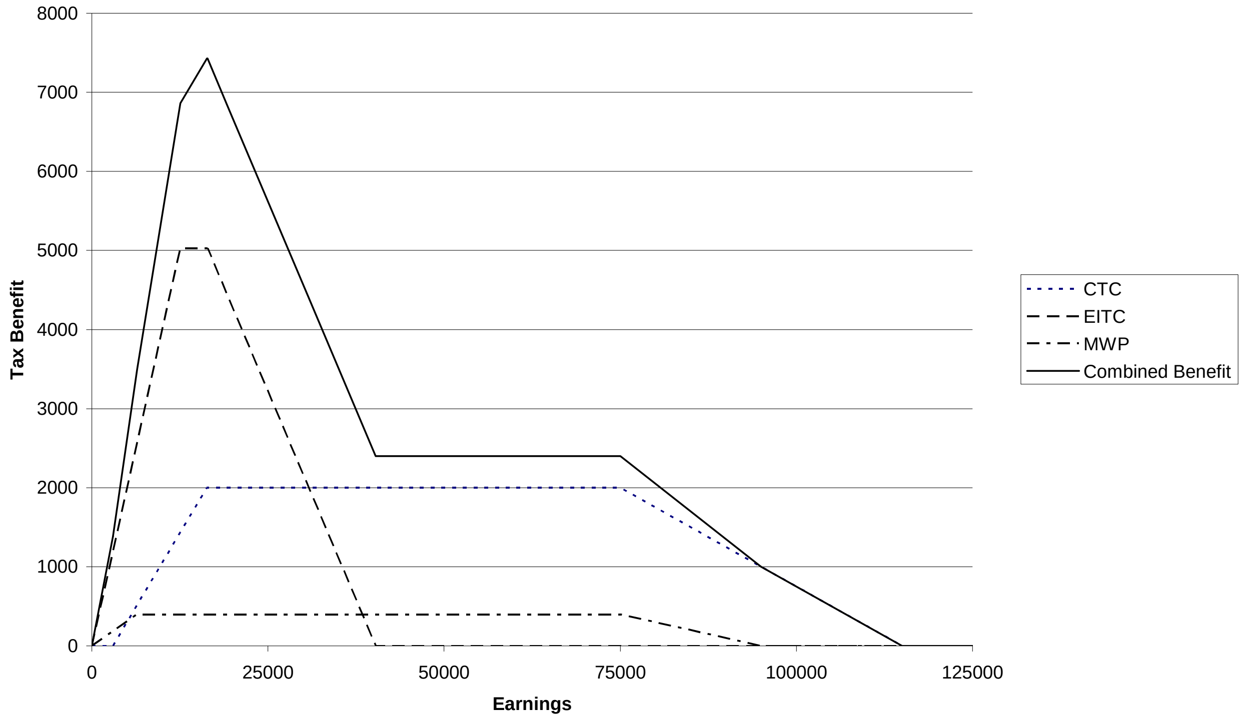
** Under current law, beginning in tax year 2011 the maximum CTC will be $500 per child, and refundability will be limited to those claiming three or more children (in an amount equal to payroll taxes paid less EITC claimed).

*** Under current law, the MWP will not be available beginning in tax year 2011.

+ The phase-in ceiling and maximum income limits of the CTC vary by the number of children for whom the credit is being claimed. The phase-in ceiling equals $3,000 plus $6,667 per qualifying child (for example, for 2 children, the CTC is fully phased-in at $16,333). The maximum income is $75,000 (single) or $110,000 (married joint) plus $20,000 per child.

Observing the EITC, CTC, or MWP individually might not raise many questions, but in tandem, the three credits do not create a clear incentive structure (Figure 1). Why, for example, would earnings below $3,000 be subsidized at a rate of 40 cents per dollar while those above merit 55 cents per dollar? Is there something special about earnings between $12,470 and $16,420 that call out for a different rate than those between $3,000 and $12,470? Finally, why would some credits phase out sooner than other credits, except as a matter of budget?

Figure 1. Benefit of Earned Income Tax Credit, Child Tax Credit, and Making Work Pay Tax Credit, Single Parent with Two Children (2009)



Exemptions and Deductions

Low-income households, as well as other tax filers, benefit from general tax code provisions that exclude some income from taxation through the use of exemptions and deductions. No tax liability arises unless the filer's income exceeds the tax threshold: the personal exemption plus the standard deduction. By reducing the amount of income subject to taxation, exemptions and deductions benefit higher-income families who face higher statutory tax rates more than poorer families who face lower tax rates.

A personal exemption—$3,650 in 2009—may be claimed for each tax filer and each dependent. The rules used to determine who qualifies as a dependent are largely consistent with those determining a qualifying child for purposes of the EITC and CTC but also include a broader category of qualifying. In 2009, personal exemptions are partially phased out at high incomes (beginning at $166,800 for single filers and $250,200 for married filers) to the effect that only two-thirds of the amount of each exemption is available above $289,300 (single) and $372,700 (married joint).

The standard deduction is the additional amount of income exempt from taxation for those who do not itemize deductions. In 2009, single filers may exempt an additional $5,570 of income and married filers may exempt twice that amount. It can be increased by up to $500 or $1,000, respectively, to account for real estate taxes paid. And the elderly and blind can claim additional deductions.

Another general provision benefiting low-income single parents is head-of-household filing status. This provides a higher standard deduction and a lower tax liability on incomes above the tax threshold.

Table 2 shows the usual amount of income not subject to taxation in 2009 for tax filers in various non-elderly household configurations:

Table 2. 2009 Tax Thresholds

Single, no dependents	$9,350
Married, no dependents	$18,700
Single, one dependent child	$15,650
Married, two dependent children	$26,000

The Case for Rationalization and Harmonization

The use of the tax code to encourage and support work via income support for low-earning families has been a substantial social policy success. The EITC for low-income workers with children at home has been particularly effective. A set of studies have found that the EITC has played an important role in increasing employment among single mothers. Although tax liabilities and credits are not considered in the current official poverty measure, studies using a more comprehensive definition of income that includes income taxes have found that the EITC has reduced the overall poverty rate, lowered the percentage of children in poverty, and reduced the poverty gap for families with children.

There is not a comparable body of research concerning the effects of the CTC (and MWP is new), but it is clear that the expanded CTC and MWP both provide potentially important sources of income support for low-earning individuals and families.

The existing approach can, however, be improved. Among the concerns:

- ***Gaps in Coverage:*** The current structure provides substantial support to families with children but very limited assistance to low-earners not residing with dependent children. This includes childless individuals and couples, parents whose children are older or no longer living at home, and non-custodial parents. Moreover, even with recent expansions, the very poorest working families cannot benefit from the CTC.

- ***High marginal rates:*** The phaseout of the EITC results in high marginal tax rates, particularly when the EITC is considered as part of an overall structure of income support for low-income workers.

- ***Marriage penalties:*** Even though potential marriage penalties in the EITC structure have been reduced in recent years, two low-income earners who marry may qualify for a sharply reduced EITC relative to what they would qualify for if they remained single.

- ***Complexity:*** Participation, compliance, and incentive effects are all likely impaired by the complexity of having three credits, each with its own rules.

Gaps in Coverage

Within the existing credit structure, there are two significant gaps in coverage: the provision of very limited benefits to workers without dependent children, and the exclusion of very low earners from the CTC.

Tax-based benefits for working parents with children are much larger than those for working adults without dependent children for three reasons:

- the EITC for families with children is substantially larger than for those without children;
- the EITC is unavailable to workers without children who are under age 25 or over age 64; and
- the CTC benefits only those with children at home.

To the extent credits are intended to assist with the costs of child-rearing, it is appropriate that the amounts available to families with children are larger. However, credits are also intended to provide a work incentive and to supplement the earnings of low-wage workers. In light of data about labor force participation trends for workers with limited education, the very low amounts available to those without children should be of particular concern.

Even before the recent economic contraction, there has been a dual crisis of wage stagnation and low labor force participation among low-skilled Americans. Labor force participation for men in general has declined in recent decades, but most sharply for men with limited educations and most starkly for young African-American men. Although labor force participation has actually increased for less-skilled women, their participation remains notably lower than that for higher-skilled women. Similarly, real wages have declined for less-skilled men, and grown for less-skilled women, but real wages remain low for both groups. The secondary effects of low labor force participation on criminal activity, incarceration, family formation, and the support of children reach deeply into society and our future (Edelman, Holzer, and Offner 2006).

Until 2009, the only tax-based assistance available to less-skilled workers without dependent children was the small EITC for workers without a qualifying child. However, not only is the maximum benefit of the EITC low, but a single person working full-time year-round at the minimum wage makes too much to receive anything (and all those under age 25 are ineligible for help). The new MWP – being independent of family status and age to provide assistance to all low-earning workers – helps. Nonetheless, the total income support provided (a maximum of $857 for single filers) remains relatively low.

Support that more effectively increases the economic return to work could boost labor force attachment for low-skilled workers who cannot claim a qualifying child. Even though the circumstances of individuals without children are different than those with children, it seems reasonable to anticipate that increasing returns to work will increase labor force participation. Increasing the real wage of a low-income worker in this way would ensure broader employment gains in the next economic expansion.

A second coverage gap is limitation of the partial refundability of the CTC to those with earnings above a designated statutory threshold. Although the ARRA's lowering of the threshold to $3,000 is a significant improvement over prior law, it still excludes the poorest working families. Moreover, it results in a credit that is $450 smaller for low-earners who do qualify due to the exclusion of their first $3,000 in earnings). The refundability feature is also scheduled to expire after 2010, so low-earning families will soon be excluded from the credit unless Congress takes additional action.

High Marginal Tax Rates

In designing any tax provision or benefit, policymakers must determine whether to reduce or eliminate the benefit as income rises and, if so, at what rate. In the tax system, reducing a credit as income rises contributes to the overall marginal tax rate faced by the tax filer. In the public benefits system, reducing benefits as income rises also functions as an effective marginal tax rate on income.

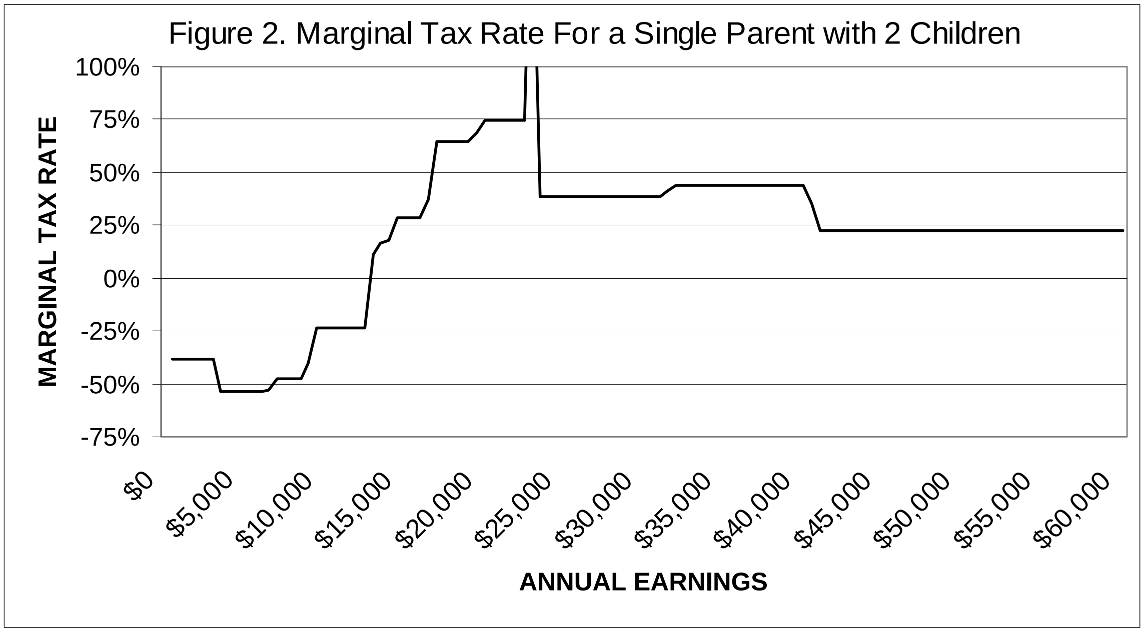
For low-earning families receiving both tax credits and public benefits, their cumulative effective marginal tax rates are the aggregate of the phaseouts of each plus the applicable payroll and income tax rates. Table 3 shows the effect of a $500 annual raise for a single parent with two children who had been earning $16,420 (the point at which the EITC phaseout begins):

Table 3. Effective Marginal Tax Rate when Combining Programs

	BASELINE	*WITH $500 RAISE*	*MARGINAL TAX RATE*
ANNUAL EARNINGS	$16,420	$16,920	
- Payroll taxes	$1,256	$1,294	7.65%
- Federal income taxes	$0	$0	0.00%
+ Federal EITC	$5,028	$4,923	21.06%
+ MWPC	$400	$400	0.00%
+ CTC	$2,000	$2,000	0.00%
+ SNAP (Food Stamps)	$4,199	$4,019	*36.00%
= NET DISPOSABLE INCOME	$26,791	$26,967	64.71%

* this rate reflects the combined impact of the SNAP earnings disregard, phaseout of the excess shelter costs deduction, and the benefit reduction rate.

Figure 2 displays the marginal tax rate at each $500 increment of income for a single parent with two children.



As seen in Figure 2, if the baseline income in the Table 3 example were above the federal income tax threshold ($19,300), a similar raise would add another 10 percentage points to the overall marginal tax rate. The table and chart do not include the effect of state income taxes including the phaseout of any state EITC. Also, if the family were receiving other benefits phasing out in this income range – *e.g.*, subsidized housing or child care – the effective marginal rate would rise.

Child support can also reduce the net gain to a worker from an increase in earnings, thus imposing its own effective marginal tax rate. Child support orders are typically based on a percentage of income (with the percentage varying by the number of children); for example, 17 percent of income for one child, 25 percent for two children, 29 percent for three children, and so on. Wage garnishments for child support arrearages can also capture a percentage of increased earnings.

One might contend that tax policy should be concerned only with marginal rates in the tax system and not the effects of the interaction of tax and benefit provisions. We disagree. The EITC design provides work incentives for some taxpayers and minimizes disincentives for others. Programs that work against the EITC structure undercut its overall effectiveness if they result in prohibitively high marginal rates. Considering each program aimed at the same population only on its own ignores the real impact on intended beneficiaries. Tax parameters must be mindful of cumulative marginal rates. Although the tax system cannot compensate for the operation of "cliffs" in benefits programs (when a dollar of earnings results in complete loss of eligibility), tax rules could aim to impose lower net rates when means-tested benefits are likely to be phasing out.

Marriage Penalties

A marriage "penalty" arises from the tax code when the act of marriage, without other changes in circumstances, results in lower credits and/or higher taxes owed. The inverse can also happen – a couple's tax liability declines merely by the act of marriage. The penalty or bonus is a byproduct of the aggregation of income for joint filers, the structure of credit phaseouts, and progressive tax rates. Whether this structure actually affects behavior is unclear, but there is a strong argument regardless that the tax code should affect marriage.

A tax credit can result in a marriage penalty in two principal ways. First, if there is a maximum credit per filing unit that is not double that of single units, and two separate filing units become one, they will necessarily face a penalty because they would then qualify for only a single maximum credit. Second, if a credit phases out with increased income, the act of marrying may result in additional income being counted as available to the unit, resulting in the credit phasing down or out. Conversely, if a single parent with no earnings marries someone with modest earnings, an EITC will be received, resulting in a marriage bonus.

The phaseout structure of the EITC makes it prone to producing marriage penalties. In response to this, first EGTRRA and later the ARRA, provided partial marriage penalty relief. Consider, for example, two single, childless workers, each earning $7,000 per year. If they remain single, each could qualify for the maximum EITC for childless workers and claim a total of $914. If they decide to marry, their combined earnings would make them completely ineligible in the absence of marriage penalty relief. Under current law, however, the phaseout of the credit begins at earnings $5,000 higher for married filers. This results in a credit of $797, so the loss or penalty equals $117.

Marriage can also reduce the EITC when a worker without children marries a working custodial parent or when two working parents marry:

- A single worker without children earning $14,000 is ineligible for the EITC, and a single working parent earning $14,000 with two children is eligible for the maximum $5,028; if married, the combined income of $28,000 would result in an EITC of $3,642, a reduction of $1,386.

- A single working parent with one child earning $14,000 qualifies for the maximum credit of $3,043, and a single working parent earning $14,000 with two children qualifies for the maximum $5,028; if married, the combined income of $28,000 and the three children would result in an EITC of $4,271, a net loss of $3,800.

The reduced EITC resulting from marriage can feel most stark for cohabitating couples: marriage does not affect their available household earnings, but it can dramatically lower net after-tax income.

Complexity

Some of the complexity affecting tax-based income support is the conscious byproduct of program design (targeting that requires various rules), and some is the inadvertent result of program fragmentation (lack of coordination among separately enacted programs). As evidenced by the table in the section above, the income guidelines for calculating the EITC, CTC, and MWP vary significantly. Other rules exacerbate the complexity. For example:

- Investment income of more than $3,100 is a disqualifier for the EITC but does not affect the CTC or MWP.
- A child who is seventeen years old, or twenty-one and a full-time student, or any age and totally and permanently disabled qualifies the parent for the EITC, but none of these qualifies the parent for the CTC.
- Parents and each qualifying child must have a valid Social Security Number permitting them to work legally in the U.S. in order to claim the EITC, but a parent with only an ITIN (Individual Taxpayer Identification Number) can claim the CTC for a child who is a citizen or resident alien and has either a Social Security Number or ITIN.
- A worker can put EITC dollars in savings for up to twelve months and not have it count in the asset test for SNAP (Food Stamps) eligibility, but CTC dollars in savings start counting the second month after they are received.

Complexity makes it hard for workers to know when they qualify for income supports. This can lead some not to take advantage of programs for which they qualify (depressing participation rates) and others to claim benefits to which they are not entitled (increasing error rates). Qualification tests based on factors outside of data available to the tax system complicate enforcement and create opportunities for fraud. Lack of clarity can also negate desired incentive effects.

Ideas for Restructuring Tax-Based Income Supplementation

The issues presented in design of tax-based income support are not new, and many improvements have been made.

A 2000 Brookings paper by David Ellwood and Isabel Sawhill detailed the marriage penalties associated with the EITC and outlined five proposed options for addressing them. One of them – extending for married couples the point at which the credit begins to phase out – was adopted in 2001, and the differential has since increased to $5,000. This change has reduced but not eliminated EITC marriage penalties.

Another significant improvement was made in 2004 through adoption of a uniform definition of a qualifying child for purposes of the EITC, CTC, Child and Dependent Care Tax Credit (CDCTC), dependent exemption, and head-of-household filing status. This greatly reduced the variability and complexity of the qualification tests and improved enforceability. However, the changes fell short of true uniformity and have resulted in some unintended consequences. The child-related tax benefits remain largely independent of each other.

There have also been a series of changes to improve the adequacy of tax-based income supports. The CTC has grown in size and has become increasingly refundable. The most recent change in the EITC is an additional amount for workers with more than two qualifying children. The MWP aids all low-wage workers. There remain gaps, however, most notably the low level of support available to those without qualifying children.

As summarized below, there have also been several proposals for more thoroughgoing reforms that would affect both tax-based income support and ability-to-pay elements linked to children:

Cherry & Sawicky (2000)

The proposed Universal Unified Child Credit (UUCC) would have converted the dependent exemption into a credit and combined it with the EITC and CTC, making it available to all taxpayers with children and earnings. As with the EITC, there was a phase-in range, plateau, and phaseout range; however, the unified credit phased down at a more gradual rate (maximum of 7.65 percent) and did not phase out to zero. The residual minimum available to all taxpayers (varying by the number of children) was set at the value of the dependent exemption and CTC for taxpayers in the 28 percent bracket. The revised phaseout structure would have reduced marginal tax rates (at least for previously eligible claimants) and marriage penalties.

Progressive Tax Act (2003)

This legislation, introduced as H.R. 3655 in the 108th Congress by Rep. Kucinich, would have replaced the EITC, CTC, and dependent exemption with a Simplified Family Credit. The credit would have equaled 50 percent of earned income up to a maximum of $2,000 per child and phased out for higher-income taxpayers (who would have retained the ability to claim dependent exemptions). Another credit component would have given low-income households an additional amount based on Social Security taxes paid.

Ellwood & Liebman (2001)

This set of policy options was based on ameliorating what was identified as the middle-class parent penalty: the U-shaped pattern by income of tax benefits associated with children. Lower-income parents receive the EITC; higher-income taxpayers receive greater benefits from the dependent exemption (because of their higher tax rates); middle-income parents receive the least. The proposals were designed to penalize no taxpayer but equalize benefits across income groups. Among the options were an increase in the size and refundability of the CTC (since adopted in large part), eliminating the dependent exemption and CTC but not phasing out the EITC (except for high-income families), and a working family credit with features similar to the UUCC.

Carasso, Rohaly, & Steuerle (2003, 2005)

The proposed Earned Income Child Credit (2003) would have combined the EITC and CTC and harmonized the eligibility rules. The more extensive Unified Child Credit (2005), like the UUCC, converted the dependent exemption into a credit. Although a unified credit, the proposal described it as having two elements: an earnings supplement, and a child credit. The proposal also addressed the effective erosion of the dependent exemption for higher-income taxpayers resulting from its inclusion as a preference item for purposes of the Alternative Minimum Tax.

Rep. Emanuel / Weinstein, Jr. / Progressive Policy Institute (2005)

Another version of a unified credit – the Family Tax Credit – would have replaced the CDCTC as well as the EITC and CTC. The credit amount (without regard to child care expenditures) would have been 50 percent of earned income up to a maximum of $3,500 for a family with one child and increased maximums for larger family sizes.

Forman, Carasso, & Saleem (2005); Forman (2006)

These proposals examined ways of reducing marginal tax rates on low- and moderate-income workers. One approach was distinguishing the work benefit from the child benefit. The first would be supplied by exempting a portion of earnings from payroll taxes, and the second would come from a per-child fully-refundable credit; neither benefit would be phased out. Alternatively, a per-worker EITC could be phased out slowly or not at all. A more radical option explored was to replace all exemptions, the standard and itemized deductions, the CTC, and the child component of the EITC with a universal refundable credit for each adult and child. There would be no phaseout, but there would also be no work requirement to receive the personal tax credits. Forman also looked at the conversion of the EITC from an earnings subsidy to a wage subsidy.

President's Advisory Panel on Tax Reform (2005)

This proposed tax code overhaul pursued simplification by consolidating exemptions, the standard deduction, head-of-household filing status, and the non-refundable portion of the CTC into a Family Credit, and combining the EITC and refundable CTC into a single Work Credit. The Family Credit base amount varied by household type, there were additions for each child and for each non-child dependent, and there was no phaseout. The Work Credit had phase-in and phaseout and family-size adjustment features similar to the EITC.

Carasso, Holzer, Maag, & Steuerle (2008)

This analysis included a proposal to separate the EITC into a worker credit and a credit for families with children. The worker credit was based on individual earnings, eliminating most marriage penalties.[3] The credit for workers without qualifying children increased substantially and the remainder of the EITC became the child credit – phasing in on one schedule instead of two. The specific parameters were designed to minimize the number of taxpayers disadvantaged by the transition to the two-credit approach.

National Taxpayer Advocate (2008)

Similar to the Advisory Panel on Tax Reform's recommendations, the tax code's family status provisions would be consolidated into a Family Credit and a Worker Credit. A refundable Family Credit would replace all exemptions, head-of-household filing status, the CTC, and the family-size components of the EITC. Taxpayers would claim their own portion of the credit and could also claim additional amounts for qualifying children or relatives. Other child-related credits (including perhaps one for non-custodial parents who pay child support) would be considered add-ons to the Family Credit. The Worker Credit (perhaps still called the EITC) would be claimable by all independent adult workers, calculated solely on individual earnings.

Design Principles for an Improved Credit Structure

As the summary of proposed approaches makes clear, multiple design options may be considered in moving to simplified and better-integrated income support through the tax system. We think a redesign should reflect and be guided by the following principles:

- Workers with and without children need income support through the tax code.
- Tax provisions should avoid high marginal tax rates, both in themselves and when viewed in connection with phaseouts experienced by low-earning workers benefiting from other means-tested programs.
- Tax provisions should minimize losses of benefits for individuals when they marry, with particular concern for marriage penalties affecting low-wage earners.
- Tax provisions should maximize clarity about benefits, incentives, and obligations.

In addition, it is both probably necessary and desirable to preserve the income support that is – through the piecemeal process of the last few decades – now available to low- and moderate-income families through refundable credits. We do make a notable exception to this principle however, and look for comparison to the individual-based version of the MWP originally proposed.

[3] This is also a feature of proposals to expand the current EITC for workers without qualifying children by Berlin (2009) and was part of the original design of MWP.

Is it possible to design a new structure consistent with these principles? We developed a proposal for a consolidated structure of a worker credit and a child credit, applying five rules to operationalize the principles above:

- To avoid high marginal tax rates, tax credit phaseouts should begin only after SNAP assistance is already phased out. A good guide would be when families and workers have income reaching 130 percent of the federal poverty level.
- At any given point, a worker's or family's marginal tax rate, taking into consideration positive tax liabilities and credit phaseouts, should not exceed the marginal rate faced by the highest-earning taxpayers (41 percent).
- A proposal should not make marriage penalties worse than current law and preferably should reduce such penalties.
- Policies should be easily understood.
- Taxpayers should generally be "held harmless"; that is, not incur a greater tax liability than under current law, excepting one-earner couples currently eligible for a $800 MWP.

Consolidation Proposal: Worker Credit and Child Credit

Our proposal would consolidate the existing EITC, CTC, and MWP into two credits: a worker credit and a child credit. The following sections present the parameters of the proposed credits, the rationale for key design aspects, and the results of modeling. We conclude that a proposal meeting these criteria is technically feasible, but only at a cost that likely exceeds what could be considered in the current and foreseeable budget context. Assuming reasonable cost constraints, it would be necessary to compromise one or more of the above principles. In addition, the hold harmless constraint tends to undermine efforts at simplification.

Worker Credit

Workers age 18 through 65 who are not claimed as dependents by other taxpayers could claim the worker credit. The credit would equal 20 percent of the worker's individual earnings up to the income equivalent to working year-round (50 weeks) for 30 hours a week at the minimum wage. With the current minimum wage of $7.25 an hour, the phase-in would be complete at $10,875 for a maximum credit of $2,175. Dual-earner married joint filers would each be able to claim a worker's credit.

The worker credit would phase down to $400 beginning at the adjusted gross income equal to 130 percent of the federal poverty guideline for the filing unit size. The rate of phase-down would be determined in conjunction with other tax provisions to ensure a marginal rate not in excess of 41 percent; that is, 41 percent minus the 7.65 percent FICA tax minus the applicable income tax rate for the filing unit. For workers with individual earnings in the phase-in range of the credit, no phase-down would apply.

The $400 credit would phase out completely for higher-income filers using the MWP parameters under current law. This would apply to all workers.

Child Credit

A child credit could be claimed for each child under the age of 19 and for permanently and totally disabled adult children. The taxpayer eligible to claim the credit would be determined according to the qualifying child rules currently in place for the CTC.

The child credit would equal a percentage of the filing unit's earnings up to an income determined by the maximum credit amount for the number of children claimed:

Table 4. Proposed Child Credit Parameters

Number of Children	*Phase-in Rate*	*Maximum Credit*	*Phase-in Income*
1	25%	$2,350	$9,400
2	41%	$5,250	$12,805
3+	46%	$5,900*	$12,826
** The credit for larger families (6+ children) eventually equals $1,000 per child.*			

For taxpayers claiming five or fewer children, the child credit would phase down to $1,000 per child. This could begin at the adjusted gross income equal to 130 percent of the federal poverty guideline for the filing unit size. However, because the phase-down of the child credit would be subject to the overall marginal rate cap of 41 percent described above, most taxpayers would see no reduction in the child credit until the worker credit is phased down to $400.

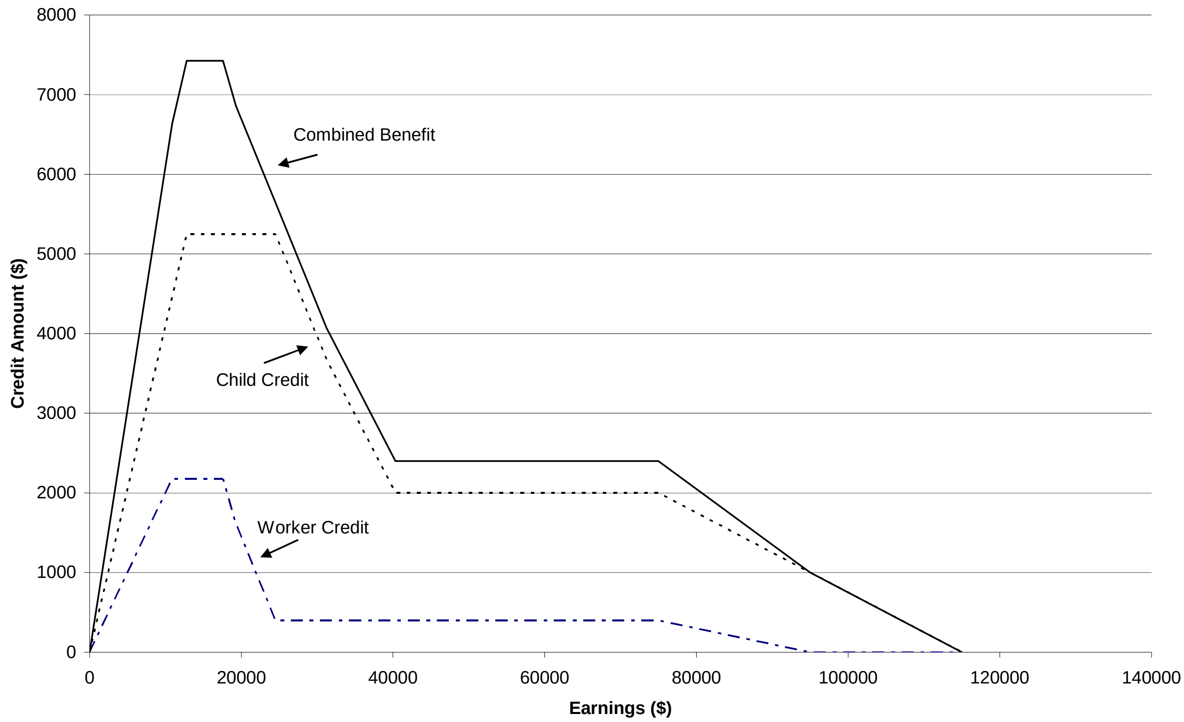
For taxpayers claiming six or more children, the child credit would phase up to $1,000 per child at a 10 percent rate beginning at 130 percent of poverty income.

The $1,000 per child credit would phase out completely for higher-income filers using the CTC parameters under current law. That is, single filers would see their credit reduced by 5 cents for every dollar earned over $75,000; joint filers would see the same phase-out, beginning at $110,000.

Benefits under the proposed credits would begin to phase in with the first dollar of earnings – and neither would be reduced until family earnings exceed 130 percent of poverty. Because the phase-down periods of the two credits are coordinated, taxpayers would face the same marginal tax rate as the credit declines when combined with the statutory rate they face – an end result that would be clearer than the current system. The proposal retains some complexity associated with the current credits by mimicking the current phaseouts of MWP and CTC.

Figure 3 shows the value of the proposed worker credit and child credit (individually and combined) for a single parent with two children.

Figure 3. Proposed Worker Plus Child Credit for Single Parent with Two Children



Design Rationale

<u>What should be consolidated?</u>

We would consolidate the existing EITC, CTC, and MWP into the worker credit and child credit, but we would not incorporate either the dependent exemption or the CDCTC. There is merit in converting the dependent exemption into a credit, but doing so in the context of a child credit is quite complex and would also require a separate provision for households with adult dependents. Additionally, costs would rise dramatically if we were to adopt the higher age limits associated with the dependent exemption for the child credit. Conceptually, the CDCTC is quite different, because it is designed to be a reimbursement for actual expenditures for child and dependent care necessary for work. In that sense, it is more closely analogous to higher education credits or other provisions intended to offset costs for specific incurred expenses.

<u>Who should be eligible for the worker credit?</u>

All workers ages 18 through 65 would be eligible for the worker credit unless another taxpayer is claiming the dependent exemption for the worker. The credit would thus extend to younger independent workers, unlike the current EITC for workers without dependent children that is unavailable to workers under age 25. We propose that the credit at this time extend to workers through age 65, because current retirees qualify for full Social Security benefits at age 66. This is one year above the current age limit for the EITC, but it does maintain an age limit, in contrast with the MWP. As changes to retirement age for Social Security benefits occur, this age limit would need to be revisited.

How should the worker credit phase-in rate and amount be determined?

In determining a phase-in rate and amount, the current-law context is:

- The MWPC is 6.2 percent of initial earnings, up to a maximum of $400 for a single worker or $800 for a married couple.
- The EITC is 7.65 percent of initial earnings for workers without qualifying children.
- For parents with children, the EITC phases in at 34 percent to 45 percent of earnings; the share intended to support children as opposed to encourage work is not expressly differentiated.
- The CTC also phases in based on earnings, but we treat this as being entirely for children rather than having "child support" and "worker" components.

We propose that the worker credit be 20 percent of earnings up to the amount equal to year-round (50 weeks) work of 30 hours a week at the minimum wage ($10,875 as of July 24, 2009) for a maximum credit of $2,175.

These parameters would provide workers without dependent children both a higher overall percentage (20 percent compared to the current 13.85 percent—6.2 percent MWP plus 7.65 percent EITC) and a higher point at which the credit reaches its maximum than under current law. We believe the incentive for getting and keeping a job should be substantial, and we think a larger earnings subsidy is appropriate for lower-earning workers whether or not they are parents. Existing research does not clearly point to the requisite credit percentage for a substantial incentive effect; our choice of 20 percent is consistent with other proposals (Greenberg, Dutta-Gupta, and Minoff, 2007).

Should the worker credit be calculated based on individual or joint earnings?

We propose that the worker credit be calculated based on individual earnings in married couples (as was originally proposed for the MWP). We reached this conclusion in order to provide the same work incentive to all earners and to limit marriage disincentives. There are two necessary (but not sufficient) conditions to creating marriage penalties and bonuses, joint filing by couples and tax rates that vary based on income (Steuerle 1999). Moving toward a universal worker credit moves the proposal in the direction of eliminating marriage penalties and bonuses in a more complete manner than other attempts at reducing marriage penalties in the EITC have done. We considered a range of approaches to reducing marriage penalties in a joint earnings structure but faced a basic challenge: if the worker credit is substantial and only one is available per tax unit, there necessarily will be a substantial marriage penalty when two workers receiving the maximum credit marry. Basing the credit on individual earnings avoids this issue.

What should happen to the worker credit as income rises?

In determining how the credit should be affected as income rises, there are two broad design options:

- The credit might be structured not to phase out at all or to phase out at only a very high income level.
- The credit could be structured to partially phase out at moderate incomes and then remain available in a lesser amount with no phaseout at all or only for very high incomes. For example, the credit might phase down to $400 for individuals and $800 for joint filers and then remain in place for an extended income range (as does the current MWP).

From the standpoint of a simpler tax code with clear incentives, we believe that the best approach would be to provide for no phaseout and to recoup all or a substantial share of the resulting costs through adjusting rate brackets and increasing high-bracket tax rates. However, given the difficulty of enacting such a change, we opted for the two-tier design: a phase-down to the MWP level as earnings rise ($400 per earner, as originally proposed), with an eventual complete phaseout for the highest-income taxpayers consistent with the MWP.

We propose to begin phasing out the credit at the point when household income reaches 130 percent of the poverty line. This is the point at which the household ceases to be eligible for SNAP in most jurisdictions. It would ensure that phaseouts occur above the poverty level and that taxpayers are would not face simultaneous phaseouts of SNAP benefits and tax credits.

For married couples with two earners, each worker's credit would phase in based on individual earnings. This is consistent with the intent of the credit: that every working-age adult earning below $10,875 is eligible for an earnings supplement. If an individual worker's earnings are below the phase-in endpoint, there would be no phasedown regardless of household income. Once fully phased-in, a married worker's credit would be subject to the regular phasedown rules if household income exceeds 130 percent of poverty (this could be immediately after phase-in).

In determining an appropriate rate for phasing down the credit, a clear trade-off exists: a very slow decline would minimize work disincentives, but the slower the decline the greater the costs. Some compromise must be made, and we propose a guiding principle that lower-earning taxpayers should not face a higher marginal tax rate than that experienced by the highest-earning taxpayers. Under current law, after 2010 the very highest earners will have a marginal rate of 41.05

percent, based on a combination of the top tax rate of 39.6 percent and a Medicare tax on earnings of 1.45 percent.

A phase-down beginning at 130 percent of the poverty level with an overall marginal rate cap of 41 percent would mean that a single person without children would see the maximum credit of $2,175 begin to phase down at an income of $14,079 at the rate of 23.35 percent[4], decreasing to 18.35 percent above $17,700 (reflecting the increase in the income tax rate at that point from 10 percent to 15 percent). The worker credit would be completely phased down to $400 for single workers without children with household incomes above $24,945.

Who should be eligible for the child credit?

The child credit would, in effect, combine the current CTC with the "child element" of the current EITC. In a number of instances, however, the rules for the two existing credits differ, and one must determine which rule to apply.

Broader child eligibility rules apply to the EITC than to the CTC. The EITC provides benefits for 17- and 18-year-olds, full-time students up to age 24, and adult children with full and permanent disabilities. We propose making children under age 19 eligible for the new child credit to provide a benefit through the year in which they become adults. We would extend the credit to adult children with disabilities, both as a policy matter and to ensure that these households are not worse off from the proposed changes. We exclude adult full-time students from child credit eligibility; taxpayers would remain able to claim a dependent exemption and education-related benefits for them.

How should the maximum child credit amount be determined?

A key decision is whether to provide the same credit amount for each child or make the incremental amount smaller for the second and subsequent children (recognizing that no politically-feasible credit can fully offset the actual costs of child rearing). The current tax code reflects both approaches. The EITC varies: the incremental amounts for the second or third child are different and are lower than the amount for the first child (and the EITC makes no adjustments for additional children after the third child). The CTC provides an equal amount ($1,000) for every qualifying child.

Each approach finds support. Clearly, the income required to support a child varies across the number of children. Calculations made for the National Academy of Sciences' work on developing a new poverty measure indicate that a second child adds only 53 percent to 56 percent as much to expenses as a first child does, and the amount declines gradually for each additional child. Giving each child in a household the same child credit amount covers a disproportionate share of the cost of each child.

[4] This percentage is calculated as the 41 percent cap minus 7.65 percent employee share of payroll taxes, minus the 10 percent statutory tax rate. As the statutory tax rates rises, the phase-down rate falls.

On the other hand, families can easily understand an equal amount per child and this replicates the CTC for families that get the full credit. Moreover, if the amount for a child varied depending on whether the child was the first or a subsequent child, it could create an incentive to distribute children over multiple tax filing units to maximize the benefit value or add to marriage penalties when each partner in the couple has children.

Moreover, given the guiding principle of generally preserving total child benefits under current law and the structure of the CTC, our credit is best designed with a consistent maximum per child regardless of any alternative policy rationales.

What phase-in rules should apply to the child credit?

In designing phase-in rules, policy makers must decide whether the credit should extend to families with no or very low earnings. From the standpoint of helping the neediest children, the full child credit would be available to the caretaker without regard to work or earnings. However, this approach would not include the work incentive found to be successful in the EITC. The phase-in of our proposed worker credit could be sufficient to sustain this incentive. Nonetheless, delinking the child credit from labor force participation would be a significant new step for the tax code and result in the IRS needing to deal with a new population of families without earnings. Newly eligible families may not know they should file tax returns and the IRS seems ill-equipped to handle this new population. Therefore, we propose phasing in the child credit, beginning with the first dollar of earnings and at a higher rate than the worker credit.

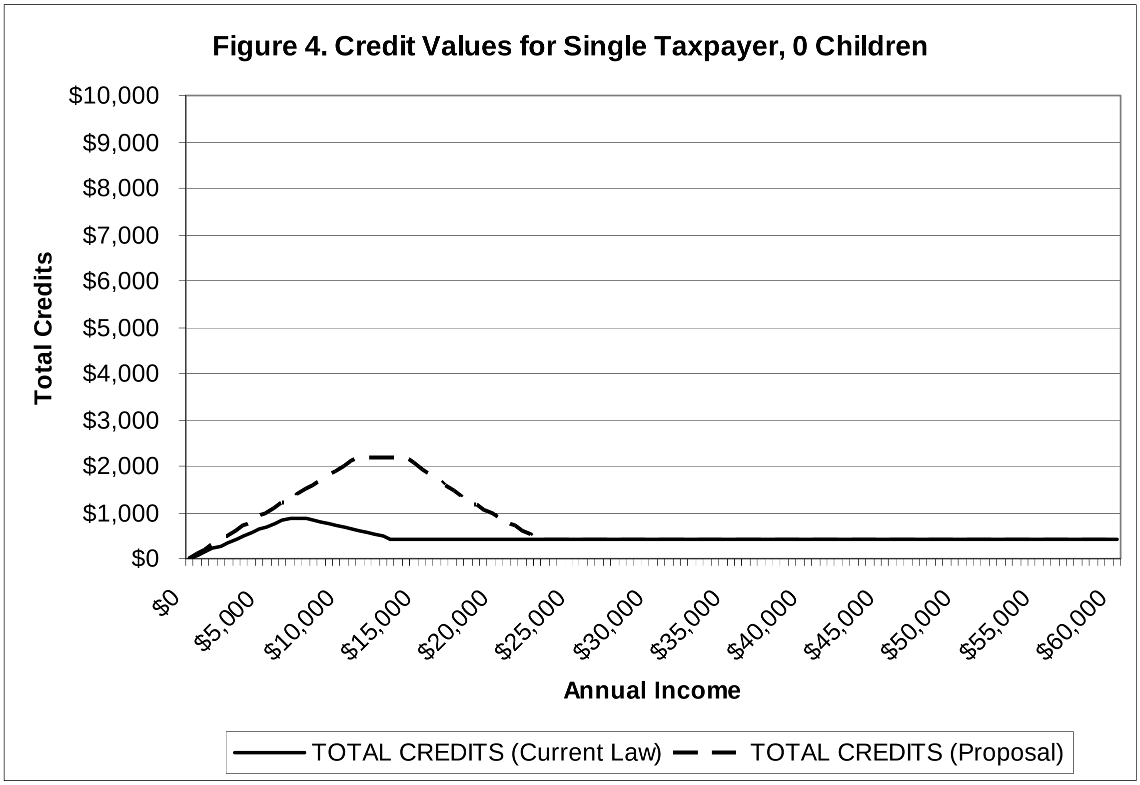
What phaseout rules apply to the child credit?

The child credit would phase down from its maximum levels to $1,000 per child. As with the worker credit, phase-down does not begin at incomes below 130 percent of poverty, and the phase-down rate is capped to ensure that taxpayers do not face a combined marginal tax rate considering the statutory tax rate and credit phaseouts exceeding 41 percent. Because the worker credit will phase down first, the marginal rate cap effectively increases the income level at which the child credit begins to phase down to well above 130 percent of poverty.

As with the worker credit, there is a strong philosophical argument for structuring the child credit without a full phaseout and recouping the cost of universality by adjusting tax rates. However, to maintain a focus on the changes proposed here for low- and moderate-income taxpayers, we have maintained current law rules for phasing out the child credit for high-income taxpayers.

Structural Comparison to Current Law

Figures 4 through 9 compare the total proposed credits (worker credit plus child credit) to the total credits available under current law for the following household types: single worker with no children, single working parent with two children, married couple with one worker and no children, married couple with one worker and two children, and married couple both working (each earning the same) with either no children or two children.



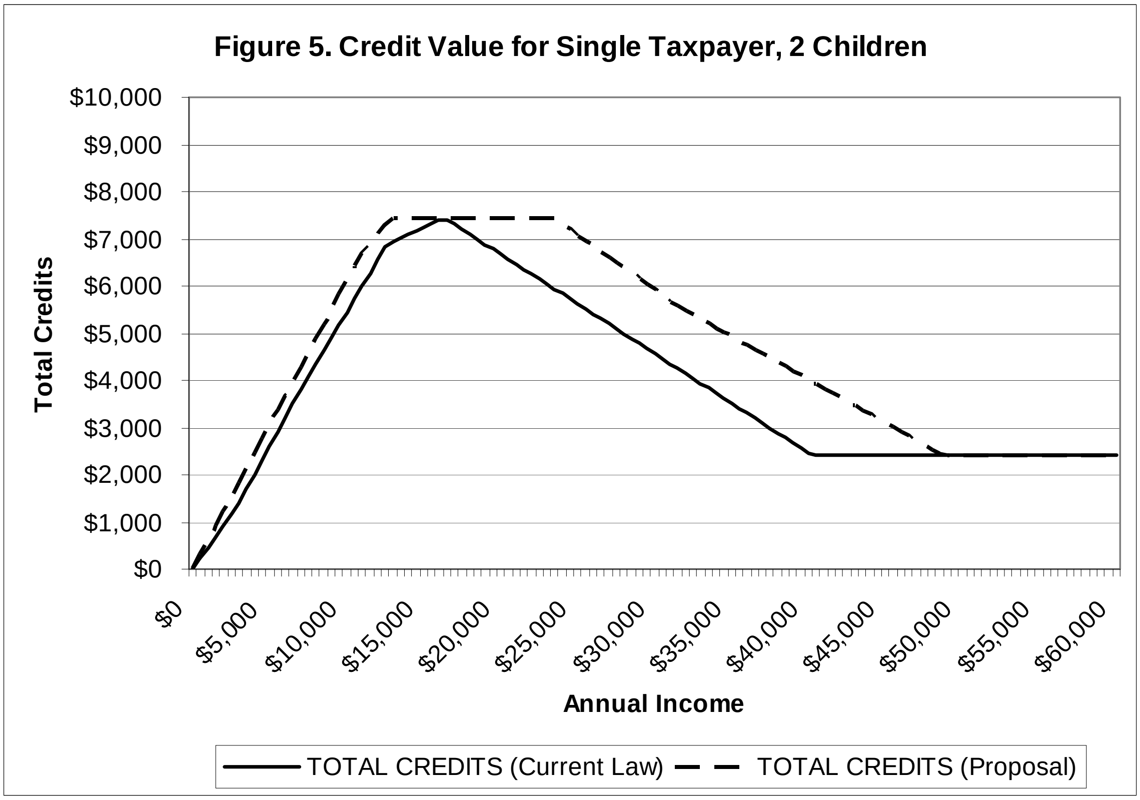


Figure 5. Credit Value for Single Taxpayer, 2 Children
Total Credits
$10,000
$9,000
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
$0
$5,000
$10,000
$15,000
$20,000
$25,000
$30,000
$35,000
$40,000
$45,000
$50,000
$55,000
$60,000
Annual Income
TOTAL CREDITS (Current Law)
TOTAL CREDITS (Proposal)

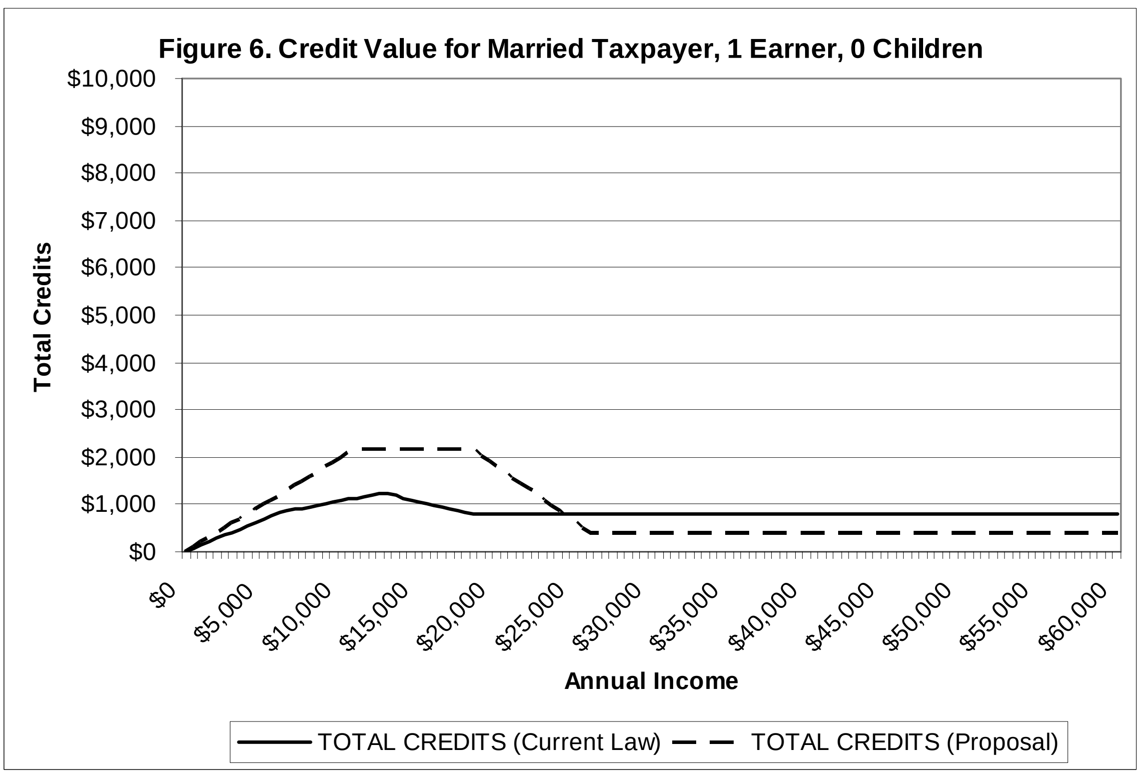


Figure 6. Credit Value for Married Taxpayer, 1 Earner, 0 Children
Total Credits
$10,000
$9,000
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
$0
$5,000
$10,000
$15,000
$20,000
$25,000
$30,000
$35,000
$40,000
$45,000
$50,000
$55,000
$60,000
Annual Income
TOTAL CREDITS (Current Law)
TOTAL CREDITS (Proposal)

Figure 7. Credit Value for Married Taxpayer, 1 Earner, 2 Children

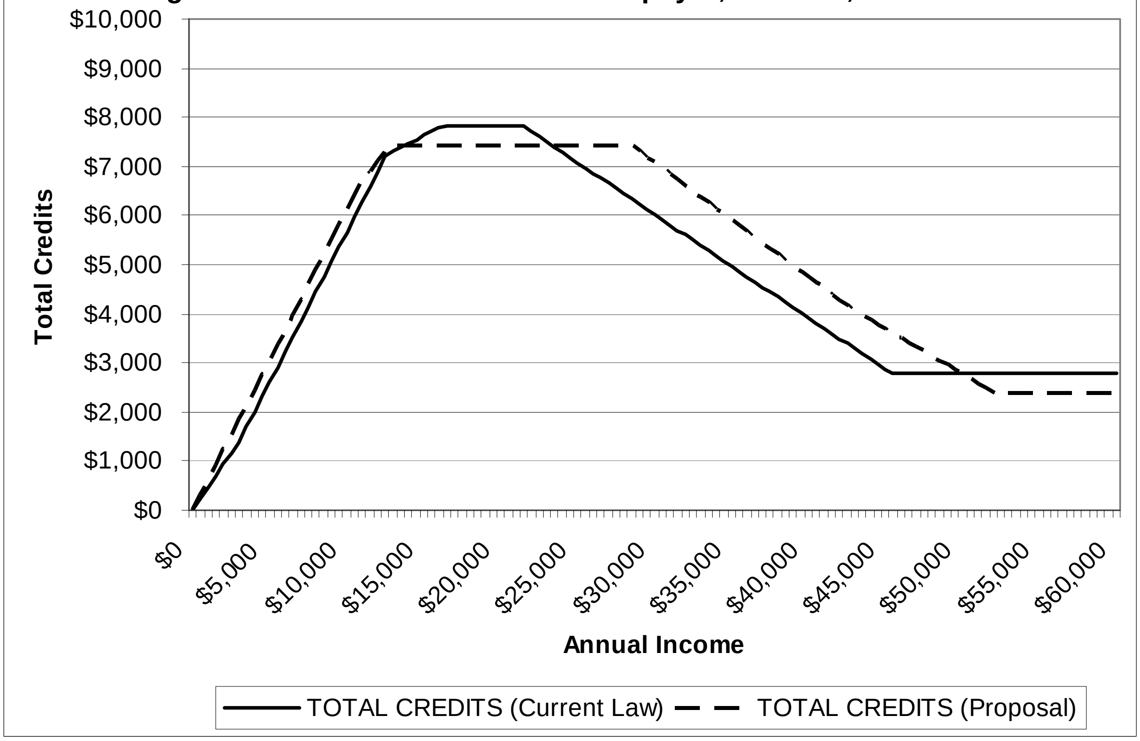


Figure 8. Credit Value for Married Taxpayer, 2 Equal Earners, 0 Childern

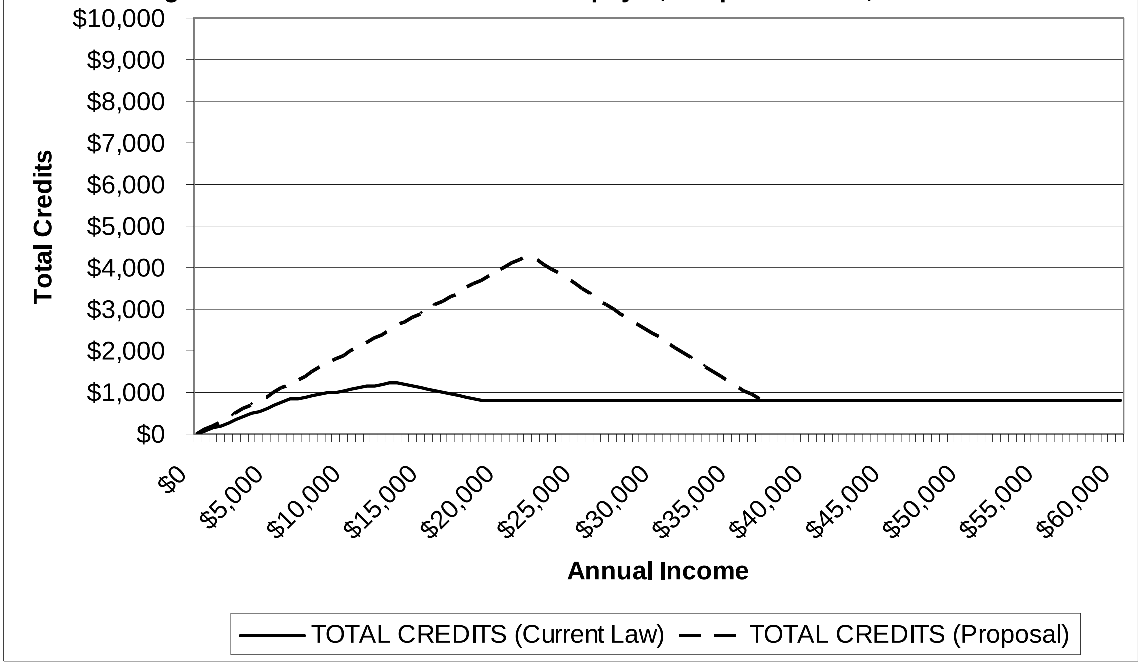
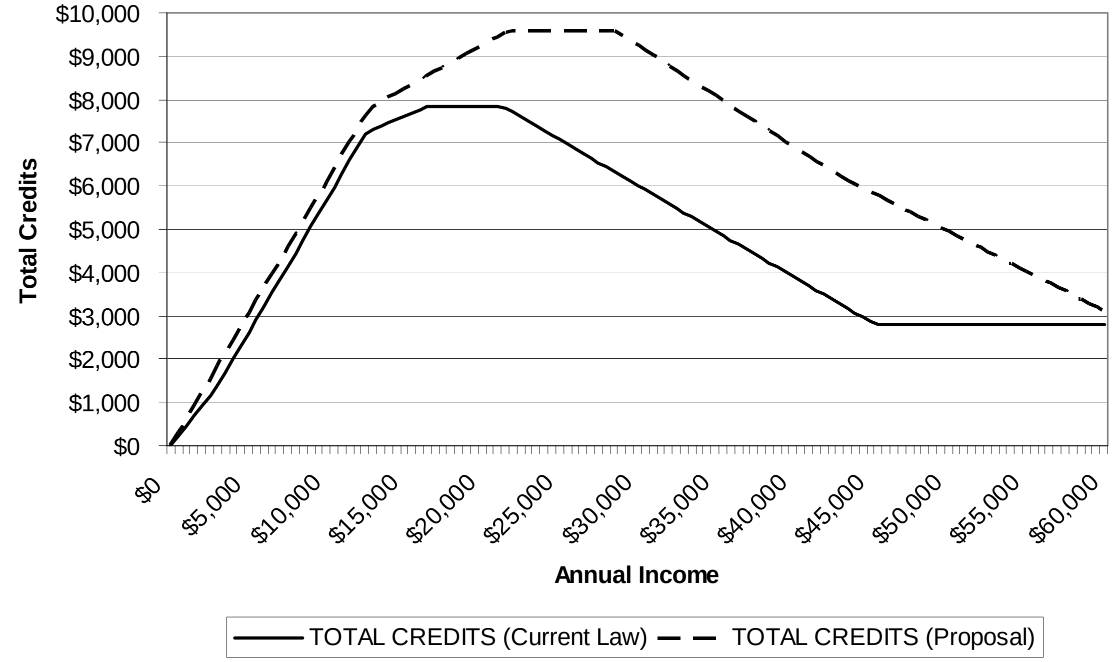


Figure 9. Credit Value for Married Taxpayer, 2 Equal Earners, 2 Children



These figures demonstrate how the proposal would be largely effective at holding households harmless compared to current law. The principal exception – resulting from the worker credit design – would be for middle-income married couples with only one earner. Because these households can currently claim a MWP of $800 but would be eligible for only one worker credit of $400 under the proposal, they would receive a lower total benefit compared to post-ARRA law.

Results of Modeling

Using the public-use version of the Transfer Income Model (TRIM)[5], we estimate the proposal would transfer an additional $33.0 billion in 2010 compared with current law. This cost may be broken down based on the design components. Converting a) the current MWP and "worker portion" of the EITC into a single worker credit but with a universal eligible age range of 18 through 65 and b) the CTC and "child portion" of the EITC into a single child credit would together generate a net estimated cost of $13 billion. Minimizing marriage penalties in the worker credit by basing in on individual earnings would increase costs by an additional $18 billion. Finally, moderating the phasedown of both the worker

[5] Information presented here is derived in part from the Transfer Income Model, Version 3 (TRIM3) and associated databases. TRIM3 requires users to input assumptions and/or interpretations about economic behavior and the rules governing federal programs. Therefore, the conclusions presented here are attributable only to the authors of this report. TRIM3 is maintained and developed at the Urban Institute under primary funding from the Department of Health and Human Services, Office of the Assistant Secretary for Planning and Evaluation.

credit and child credit to limit the overall marginal tax rate any family faces to 41 percent would add an additional $2 billion [6]

The overall cost increase of $33 billion reflects both winners and losers. We estimate the proposal would result in an increase in benefits to some families of $41.3 billion and a decrease in benefits to others of $8.3 billion (Table 5). The proposal would lower taxes relative to current law for 28 percent of households (winners) and raise taxes relative to current law for 12 percent of households (losers). Taxes under current law and the proposal would not change for the remaining 60 percent of households.[7] Taxes would fall an average of $900 for those families who would see reduced taxes. Those who face increased taxes would owe, on average $410 more under the proposal than under current law.

Table 5. Demographic Characteristics of Winners and Losers Under Proposal, Relative to 2009 Tax Law

	Tax Units (millions)	Winners	Average Tax Cut for Winners ($)	Total Benefits for Winners (billions $)	Losers	Average Tax Increase for Losers ($)	Losses for Losers (billions $)	No Change
Total	146.8	28%	890	41.3	12%	410	8.3	60%
Cash Income								
$1 - $4,999	4.5	56%	240	0.7	5%	190	0.1	39%
$5,000 - $9,999	11.0	37%	670	3.1	5%	320	0.2	58%
$10,000 - $14,999	11.5	45%	1,170	6.8	5%	480	0.3	50%
$15,000 - $19,999	10.6	57%	1,050	7.2	8%	470	0.5	35%
$20,000 - $29,999	18.6	50%	590	6.2	11%	520	1.2	39%
$30,000 - $39,999	15.9	23%	1,170	4.8	16%	440	1.2	61%
$40,000 - $49,999	12.6	23%	1,420	4.7	14%	420	0.8	63%
$50,000 - $74,999	20.8	17%	1,130	4.7	19%	380	1.7	63%
$75,000 - $99,999	12.6	14%	780	1.6	19%	380	1.0	67%
$100,000+	24.2	9%	670	1.6	13%	360	1.3	78%
Filing Status								
Married	62.9	23%	1,190	17.6	23%	460	17.6	54%
Head of Household / Single	83.9	31%	900	23.7	4%	460	23.7	64%
Number of Children								
0 children	105.3	13%	950	23.8	5%	490	23.8	82%
1 child	18.8	39%	740	4.1	18%	430	4.1	43%
2 or more children	22.7	18%	1,250	13.3	13%	470	13.3	68%

Notes:
(1) Tax units with no and negative cash income are excluded from the lowest income class but are included in the totals.
(2) Cash income includes income in Adjusted Gross Income as well as the employer and employee share of payroll taxes, SSI, TANF, and child support.
(3) A child is any dependent under age 18 or under.

Given the hold harmless design principle, the number of losers may be surprising. A substantial portion of these would result from the exception affecting middle-income married couples with one earner. Nonetheless, there are some taxpayers who would incur greater tax liability as a result of the worker credit's other eligibility provisions.

Individuals and couples without qualifying children, married couples with two workers, young workers, and individuals currently subject to high phaseout rates of the EITC would be big "winners" under the proposal. Those that would tend to owe more taxes are individuals older than 65 who qualify for MWP but would not

[6] The size of the incremental cost of each design element depends on the order in which the changes are made.
[7] A household must have a tax change of at least $5 in order to be classified as a winner or loser.

qualify for the worker credit, low-earning parents under age 18 who currently qualify for the EITC for families with children but would not qualify for the worker credit under the proposal, and workers under age 18 who qualify for MWP but would not qualify for the proposal, and one earner couples.

More low-income filers win than lose under the proposal, relative to current law. We estimate a greater proportion of filers with income below $50,000[8] would receive a tax cut than face a tax increase. For example, 57 percent of filers with income between $15,000 and 19,999 can expect a tax cut, compared to only 8 percent that will have higher taxes levied on them as a result of the proposal. In higher income classes, the inverse is true. Almost 20 percent of families with incomes above $50,000 and $99,999 would expect a tax increase under the proposal relative to current law while only about 15 percent would benefit from a tax cut.

Low-income individuals and families win primarily because many individuals without children at home would find themselves newly eligible for the worker credit – or eligible for a substantially larger worker credit than the EITC they qualify for under current law. These low-income workers would receive a credit of 20 percent of earnings up to $10,875. This maximum credit - $2,175 – is more than four times as much as the current maximum EITC for individuals and families without children at home. Presumably, it should provide an incentive for some individuals not working to begin working – just as the EITC induces single moms to work. To that end, the estimate we provide here represents a lower bound since it does not take changes in the labor market into account. Losers in low-income groups tend to be very young parents who can get the current EITC; they would be too young to get the proposed worker credit, and the child credit they could receive would be smaller than the EITC. Higher-income families tend to lose when only one person in the household works. At present, they qualify for the maximum MWP credit ($800) but would qualify for only one worker credit ($400).

The proposal would provide additional income to unmarried individuals and single parents. While almost one-third of families headed by one parent or an individual without children would receive a tax cut under the proposal, about 4 percent of these families would pay higher taxes. Among married couples, roughly similar proportions of families win and lose under the proposal (23.5 percent and 22.8 percent, respectively). The reasons for winners and losers are the same as those described above.

Childless individuals and couples would more likely see a tax cut than a tax increase. Almost three times as many individuals and couples with no children would receive a tax cut (13.0 percent) as an increase (4.7 percent). This results from the expansion of the worker credit which individuals can now qualify for if

[8] Unless otherwise noted, income in this section refers to cash income. Cash income includes all components of Adjusted Gross Income (AGI) as well as TANF, SSI, the employer and employee share of payroll taxes, and child support income. Benefit amounts come from the TRIM3 database which imputes missing TANF, SSI, and child support such that totals in the database come close to administrative totals.

they are between the ages of 18 and 25 and currently do not receive the childless EITC, but more important, the expansion of the worker credit to higher incomes would benefit many. In a few cases, a childless couple faces a tax increase over current law if only one spouse works due to the design difference between the MWP and the proposed worker credit.

Families with children would be more likely to face a tax cut under the proposal than see their taxes increase. In large part, families would see their taxes go down as a result of extending where the child credit begins to phase out. Because the phaseout under the proposal starts at higher incomes, more families would keep the maximum child credit, rather than receiving only a partial credit. Families would also see their taxes reduced because the proposal would reduce the maximum marginal tax rate they face, essentially lowering the phaseout rate for many. On the other hand, one earner couples with children would often pay more tax, because they would qualify for only one worker credit rather than the maximum credit under MWP.

More than half of the additional tax credits would go to families with incomes below $30,000 (58 percent) (Table 6). In contrast, almost half (48 percent) of credit reductions would fall on families with incomes of $50,000 or more.

Cash Income	Total Tax Units (%)	Tax Units That Win (%)	Benefits to Winners (%)	Tax Units that Lose (%)	Tax Increase to Losers (%)	Tax Units with No Change
$1 - $4,999	3.1%	6.2%	1.7%	1.3%	0.6%	2.0%
$5,000 - $9,999	7.5%	9.8%	7.4%	3.1%	2.5%	7.3%
$10,000 - $14,999	7.8%	12.6%	16.5%	3.1%	3.6%	6.6%
$15,000 - $19,999	7.2%	14.7%	17.4%	4.7%	5.5%	4.2%
$20,000 - $29,999	12.6%	22.6%	15.1%	11.3%	14.6%	8.3%
$30,000 - $39,999	10.8%	8.8%	11.7%	13.7%	14.8%	11.1%
$40,000 - $49,999	8.6%	7.1%	11.3%	10.0%	10.2%	9.0%
$50,000 - $74,999	14.2%	8.8%	11.3%	22.0%	20.5%	15.0%
$75,000 - $99,999	8.6%	4.3%	3.8%	13.1%	12.1%	9.6%
$100,000+	16.5%	5.0%	3.8%	17.6%	15.7%	21.6%
Filing Status						
Married	42.8%	35.9%	42.7%	79.6%	79.4%	38.5%
Head of Household / Single	57.2%	64.1%	57.3%	20.4%	20.6%	61.5%
Number of Children						
0 children	71.7%	60.7%	57.5%	57.1%	60.4%	80.0%
1 child	12.8%	13.5%	9.9%	23.7%	22.1%	10.2%
2 children	15.5%	25.9%	32.3%	19.2%	19.8%	9.8%

Notes:
(1) Tax units with no and negative cash income are excluded from the lowest income class but are included in the totals.
(2) Cash income includes income in Adjusted Gross Income as well as the employer and employee share of payroll taxes, SSI, TANF, and child support.
(3) A child is any dependent age 18 or under.
*Details may not sum to totals due to rounding.

Households headed by a single parent or a single individual make up 64 percent of the winners under the proposal, receiving 57 percent of the benefits. This is the same as the share of households they represent. Tax increases fall disproportionately on married couples due to the difference between the MWP and the worker credit for those with only one earner. They make up 42 percent of the population, but would pay 79 percent of the tax increase.

More than half of the tax cuts (57 percent) would go to childless couples and individuals. Families with one child would receive 10 percent of the benefits and families with at least two children would receive the remaining 32 percent.

Variations on the proposal

We analyze four variations to the proposal (see Table 7). In order to reduce costs, we could increase the maximum marginal rate allowed from 41 percent to 45 percent (saving $4 billion) or to 49 percent (saving $7.5 billion). Either change would reduce credits for people who are currently in the phase-down range, since they would lose a larger share of their credit for each additional dollar earned. Those already receiving the minimum benefit would not be affected by the faster phaseout.

Table 7. Alternatives to Proposal
(billions 2010$)

	Total Cost	Winners	Losers	Net Saving Over Proposal
Proposal: Child Credit and Worker Credit	33.0	41.3	8.3	
Option 1. Phase proposal out with rate cap at 45%	28.5	37.3	8.8	4.5
Option 2. Phase proposal out with rate cap of 49%	25.5	34.8	9.2	7.5
Option 3. Begin phase-down of proposal at poverty	15.3	26.7	11.5	17.7
Option 4. Offer worker credit only to individuals age 25 - 64	16.0	31.7	15.6	17.0

Proposal is the combined worker and credit child described in this paper.
Option 1 phases the maximum marginal tax rate from 41 percent in Option 1 to 45 percent.
Option 2 phases the maximum marginal tax rate from 41 percent in Option 1 to 49 percent.
Option 3 begins the phase-down of the proposal in Option 1 at poverty rather than 130 percent of poverty.
Option 4 only allows the worker credit for individuals ages 25 - 64 instead of 21 - 65 as in Option 1.
*Details may not sum to totals due to rounding.

Beginning the phase-down at the amount equal to 100 percent of the federal poverty level rather than 130 percent would also reduce the proposal's cost. Although this option would save $17.7 billion, it is problematic. Because some families would be losing benefits from transfer programs (principally SNAP) at the same time they are losing tax benefits, this would replicate the current system of very high marginal rates when tax and transfer programs are combined.

Making the worker credit available only to individuals who currently qualify for the childless EITC – between the ages of 25 and 64 – would result in substantial savings of $17.0 billion. However, there would be many young families who would pay higher taxes if the worker credit were implemented in this manner. These are families that currently qualify for the EITC for families with children who would only qualify for a smaller child credit and no worker credit under this option. In addition, the upper age limit for the proposal was set with Social Security benefits in mind.

Conclusions

The current structure of tax-based income support for workers through refundable tax credits is the product of four decades of uncoordinated legislation. The EITC, CTC, and MWP provide significant support to lower-income working households, but they are neither coordinated nor coherent. There are gaps in coverage, the rules are complex, and beneficiaries can face very high effective marginal tax rates and marriage penalties.

This paper looks at a proposal to rationalize tax-based income support by replacing three current credits with two refundable ones, each with a clear and distinct purpose. A worker credit would supplement the earnings of all low-earning working-age adults. A child credit would supplement the incomes of households with children. The objective is a more transparent approach with clear benefits, incentives, and obligations.

Our proposal would curtail high marginal tax rates by eliminating any phase-down of the credits below 130 percent of the federal poverty level (when a household could be subject to a high benefit reduction rate from SNAP) and by capping the overall marginal rate effect of tax provisions at the level faced by highest-earning taxpayers. It would make the worker credit an individual benefit to limit the losses incurred by dual-earner couples who marry. The proposal also largely follows a "hold harmless" principle that would try to protect benefits payable under current law.

This can all be done, but it is expensive, and when done all together the result is arguably no simpler than the existing system. This exercise highlights some of the policymaking choices.

It makes sense to separate benefits based on work from those directed toward children. Adequate earnings supplementation would require new outlays. This spending would particularly benefit young independent adults not raising children whose labor force participation could yield significant social benefits.

Low-earning single workers who marry could lose much or all of their credits unless the worker credit is available based on individual and not joint earnings. However, protecting those workers would also provide benefits to higher-income households where one spouse earns relatively little. This could be addressed through additional tests and formula adjustments, but cost savings would be accompanied by even greater complexity.

The negative combined effect of credit phaseouts and benefit reductions as income rises (often experienced unknowingly) rarely receives attention. Those who do consider moderating these high marginal effective tax rates often expect it to be prohibitively expensive. Our proposal helps to quantify the cost of effecting a more just policy.

Much of the cost and complexity of our proposal results from the hold harmless principle. Protecting the benefits provided by the patchwork of current law would continue its problems and inconsistencies. A truly new design could be simpler and more rational, but it could also require accepting that some households would receive less assistance than they do now.

The upcoming expiration of the refundable CTC, MWP, and some features of the EITC presents an opportunity to improve the provision of income support through the tax code. Our review here illuminates some of the possibilities and pitfalls associated with restructuring these refundable work-based credits.

REFERENCES

Batchelder, Lily, Fred T. Goldberg, Jr., and Peter R. Orszag, “Efficiency and Tax Incentives: The Case for Refundable Credits,” *Stanford Law Review*, Vol. 59 (2006).

Berlin, Gordon, ‘Transforming the EITC to Reduce Poverty and Inequality,” *Pathways*, Winter vol. (2009).

Carasso, Adam, Jeffery Rohaly, & C. Eugene Steuerle, “Tax Reform for Families: An Earned Income Child Credit,” Welfare Reform & Beyond Policy Brief #26, Brookings Institution (2003).

Carasso, Adam, Jeff Rohaly, and C. Eugene Steuerle, “A Unified Children’s Tax Credit,” Urban Institute (2005).

Carasso, Adam, Harry J. Holzer, Elaine Maag, & C. Eugene Steuerle, “The Next State for Social Policy: Encouraging Work and Family Formation among Low-Income Men,” Discussion Paper No. 28, Urban-Brookings Tax Policy Center (2008).

Cherry, Robert and Max B. Sawicky, “Giving Tax Credit Where Credit is Due,” Economic Policy Institute (2000).

Edelman, Peter, Harry Holzer, and Paul Offner, *Reconnecting Disadvantaged Young Men*, Washington, DC: Urban Institute Press (2006).

Ellwood, David T., and Jeffrey B. Liebman, “The Middle Class Parent Penalty: Child Benefits in the U.S. Tax Code,” in J. Poterba (ed.), *Tax Policy and the Economy*, Volume 15, MIT Press (2001).

Elwood, David T. and Isabel V. Sawhill, “Fixing the Marriage Penalty in the EITC,” Brookings Institution (2000)

Forman, Jonathan Barry, *Making America Work*, Washington, DC: Urban Institute Press (2006).

Forman, Jonathan Barry, Adam Carasso, and Mohammed Adeel Saleem, “Designing a Work-Friendly Tax System: Options and Trade-Offs,” Discussion Paper No. 29, Urban-Brookings Tax Policy Center (2005).

Greenberg, Mark, Indivar Dutta-Gupta, and Elisa Minoff, “From Poverty to Prosperity: A National Strategy to Cut Poverty in Half,” Report and Recommendations of the Center for American Progress Task Force on Poverty (2007).

National Taxpayer Advocate, “2008 Annual Report to Congress: Volume One,” (2008).

President's Advisory Panel on Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," (2005).

Steuerle, C. Eugene, "Valuing Marital Commitment: Radical Restructuing of Our Tax and Transfer Systems," *The Responsive Community* 9(2): 35-45 (1999).

Weinstein, Paul, Jr., "Family-Friendly Tax Reform," Progressive Policy Institute (2005).