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SIMPLICITY: CONSIDERATIONS IN DESIGNING A UNIFIED CHILD CREDIT

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Complexity plagues the tax code for low-income families, particularly with regard to child related credits. Many analysts advocate separating out the essential functions of these credits: subsidizing work, subsidizing children, and subsidizing specific activities such as child care. This paper analyzes design considerations in creating a unified child credit and offers options for reforms that range from a complete overhaul of the child and work incentives to a more minor consolidation of highly related tax incentives. Either could form the foundation for reform efforts aimed at simplifying and rationalizing the federal income tax code with respect to children.

Keywords: Child Tax Credit, Earned Income Tax Credit, Unified Child Credit, tax simplification

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I. INTRODUCTION

For decades, scholars and tax practitioners have expressed concern over the growing complexity of the U.S. Federal Income Tax Code. The last successful attempt at fundamental tax reform, the Tax Reform Act of 1986, emphasized three goals from the outset: simplicity, fairness, and economic growth. Analysts of that reform effort concluded that reformers gave the least weight to simplicity and questioned whether the reformed system was simpler than the one it replaced (Slemrod, 1992). More recently, President George W. Bush assembled an advisory panel on tax reform with the same goals. The effort culminated in recommendations that would have simplified the tax system, but to date, these recommendations have not been adopted (The President's Advisory Panel on Federal Tax Reform, 2005).

Families with children — particularly those with low incomes — face significant tax complexity. As the transfer system embeds itself in the tax system at all income levels (Batchelder and Toder, 2010), the temptation to create new tax incentives targeted at low-income families, rather than expand or simplify existing tax incentives appears too

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great for policymakers to resist. Each new benefit can carry its own set of eligibility rules, further complicating an already complex system. Early work by Ellwood and Liebman (2001) points out an odd pattern of child benefits in the tax code. Benefits from the refundable Earned Income Tax Credit (EITC) concentrate on low-income families. In contrast, the dependent exemption and the virtually nonrefundable (at the time) Child Tax Credit (CTC)[1] benefited higher income families more — with benefits gradually increasing as a person's tax liability increased. The analysis revealed that the combination of the EITC, CTC, and dependent exemption resulted in a U-shaped pattern of benefits where middle-income parents benefited less from child-related provisions than their high- and low-income peers. The authors termed this pattern of benefits the "middle-class parent penalty" and suggested reforms to rationalize the pattern. Since that early report, the tax code has grown more complex with respect to families with children, and this growth shows few, if any, signs of abating, despite numerous calls for restraint from analysts and tax policy administrators. The combination of benefits now forms a shape more akin to toddler's unevenly written W, with no clear pattern shining through. The various tax provisions ultimately boil down to three factors: rewards for working, benefits for having children, and benefits for spending money on a specific activity, for example, child care.[2] Complexity arises when these incentives interact. Thus, a natural direction for simplification is to clarify these incentives and remove conflicting elements. This paper discusses complexity with respect to low-income families, provides a framework for rethinking child benefits in the federal income tax system, and considers three options that could either form the basis of future reform efforts or start conversations for more limited reforms.

II. COMPLEXITY IN THE TAX SYSTEM

In 2009, the National Taxpayer Advocate's annual report cited complexity as the most serious issue taxpayers encounter — a criticism levied in many previous reports (National Taxpayer Advocate, 2009). This complexity imposes both direct and indirect costs. Direct costs — time and money spent complying with the tax law — can be substantial. In a study based on tax year 2000, Guyton et al. (2005) estimate total compliance costs of $87 billion ($19 billion of out of pocket expenses and 3.4 billion hours, valued at $20 per hour). Many tax filers, even low-income families, rely on paid preparers to file tax returns. Internal Revenue Service (IRS) Statistics of Income data from 2005 show that two-thirds of families with incomes below twice the poverty level used paid preparers.

[1] Prior to the 2001 Economic and Growth Tax Relief Reconciliation Act (EGTRRA), the CTC was refundable only for families with at least three children to the extent that their payroll taxes exceeded their EITC. EGTRRA made the CTC refundable for all families meeting a minimum income threshold.

[2] Another example of a specific activity subsidized by the tax system would be college attendance. Subsidies for college attendance include the dependent exemption, the EITC, the American Opportunity Tax Credit, the Lifetime Learning Credit, the tuition and fees deduction, and a host of college savings programs. These are discussed in more detail in Maag et al. (2007).

These results are consistent with the National Survey of America's Families (NSAF). The NSAF further showed that low-income families headed by someone with no more than a high school degree were more likely to rely on preparers than low-income families headed by someone with higher education (Maag, 2005), supporting the notion that complexity drives at least a portion of families to use preparers. In 2000, it cost low-income families about $200 to use a paid preparer, including both preparation charges and fees associated with refund anticipation loans (Berube et al., 2002). Complexity also makes families vulnerable to abuse by unscrupulous tax preparers who may charge high fees for poorly performed services (U.S. General Accounting Office, 2006; Treasury Inspector General for Tax Administration, 2008).

The indirect costs of complexity also give rise to concern. Among these are compliance errors — some people who qualify for benefits fail to claim them while others who do not qualify for benefits do claim them (National Taxpayer Advocate, 2009) — and the possible dampening of behavior responses, which may or may not be desirable, but is likely unintended (Congdon, Kling, and Mullainathan, 2009; Saez, 2010). For example, Chetty and Saez (2009) recently found that taxpayers in the phase-in range of the EITC would increase work effort if they were counseled that their EITC would increase as well. As incentive structures become more obtuse, families may find it more difficult to react to any one policy as policymakers intended, potentially dampening intended labor supply responses to programs such as the EITC and CTC.

Below I describe the key features of several provisions in order to better understand how the credits are targeted, and what benefits a family can expect to receive. However, it is important to note that along with the complexity described comes great benefit. In 2010, the federal income tax system will deliver substantial benefits to families with children.[3] Studies suggest that the tax system delivers these benefits to more of the eligible population than traditional spending programs (Burman and Kobes, 2003). The total benefits from the tax program most targeted at low-income families, the EITC, rival those paid out in the Supplemental Nutrition Assistance Program (SNAP, formerly Food Stamps) — about $53 billion in each program in FY09.[4] Benefits from the EITC can be as high as $3,050 for families with one child, $5,036 for families with two children, and $5,666 for families with three or more children. On top of that, families with children can benefit from the CTC and Additional Child Tax Credit (ACTC) — up to $1,000 per child — and the dependent exemption (which varies in value from $0 for those with no taxable income up to $1,277 per child for those in the 35 percent tax bracket). Moreover, single parents can benefit from head of household filing status, under which more income is taxed at lower rates than is the case for single individuals without children.

[3] After 2010, several provisions affecting children and work are scheduled to expire. The Tax Policy Center provides a list of expiring provisions at http://taxpolicycenter.org/taxfacts/Content/PDF/expiring_provisions.pdf. Whether and to what extent Congress will allow this to happen remains unclear.

[4] This calculation is based on U.S. Department of Agriculture Food and Nutrition Service, "SNAP Monthly Data," http://www.fns.usda.gov/pd/34SNAPmonthly.htm, and Table 1 from Isaacs et al. (2010).

A. Earned Income Tax Credit

One tax provision may have multiple goals. For example, the EITC clearly subsidizes work with benefits increasing as low-income individuals enter the labor market, but also subsidizes additional children, to a point (Forman, 2005). The credit phases in with each dollar of earnings until the maximum credit is reached. The credit phases in faster for larger families — 34 percent of earnings for families with one child; 40 percent of earnings for families with two children; and 45 percent of earnings for families with three or more children. The EITC also provides a small benefit (7.6 percent of earnings over a limited income range) for families without children. The credit remains constant over a period of income and then declines with subsequent earnings. Research shows that the EITC is successful in encouraging work, particularly along the extensive margin — the decision of whether to work or not work (Eissa and Hoynes, 2006). At least for single parents, the effect holds true along the intensive margin as well (Meyer and Rosenbaum, 2000). The EITC is fully refundable so families receive the full credit for which they qualify, regardless of their tax liability.

B. Child Tax Credit

The Child Tax Credit (CTC) provides families up to $1,000 per child. It has both a refundable and nonrefundable component. The nonrefundable component is available to qualifying families with children who owe taxes. This portion of the CTC offsets taxes owed up to the maximum credit for which a family qualifies. The refundable portion of the credit (the ACTC) provides 15 cents for each $1 of earnings after $3,000. The sum of the nonrefundable and refundable portions of the CTC cannot exceed the total CTC to which a family is entitled. The CTC encourages work through its refundable component. This potentially adds a greater work incentive for affected families than the EITC alone.

C. Making Work Pay

Families with and without children can benefit from the Making Work Pay (MWP) credit. The MWP is refundable and provides up to $400 to individuals or single parents and $800 for couples, phasing in at a rate of 6.2 percent starting with the first dollar of earnings.

D. Child and Dependent Care Credit and Flexible Spending Accounts

Families with young children may also benefit from the Child and Dependent Care Tax Credit (CDCTC) or from Flexible Spending Accounts (FSAs) used to offset child care costs associated with working. Both of these tax benefits lower taxes for families with child care expenses. The CDCTC provides a credit between 20 percent and 35 percent of childcare expenses of up to $3,000 per child ($6,000 per family). Higher credit rates apply to lower-income families. However, the credit is not refundable so few families actually qualify for the highest credit rates (Burman, Maag, and Rohaly, 2005). Flexible Spending Accounts exempt up to $5,000 of income from both income and payroll taxes.

E. Summary of Benefits

Taken separately, each of the programs serves a clear purpose. Combined, what the programs are intended to do becomes murkier. Figure 1 shows the benefits a single parent with two children under age 17 can expect to receive, assuming all of her income comes from earnings. The rules of these programs vary along multiple dimensions, as summarized in Table 1.

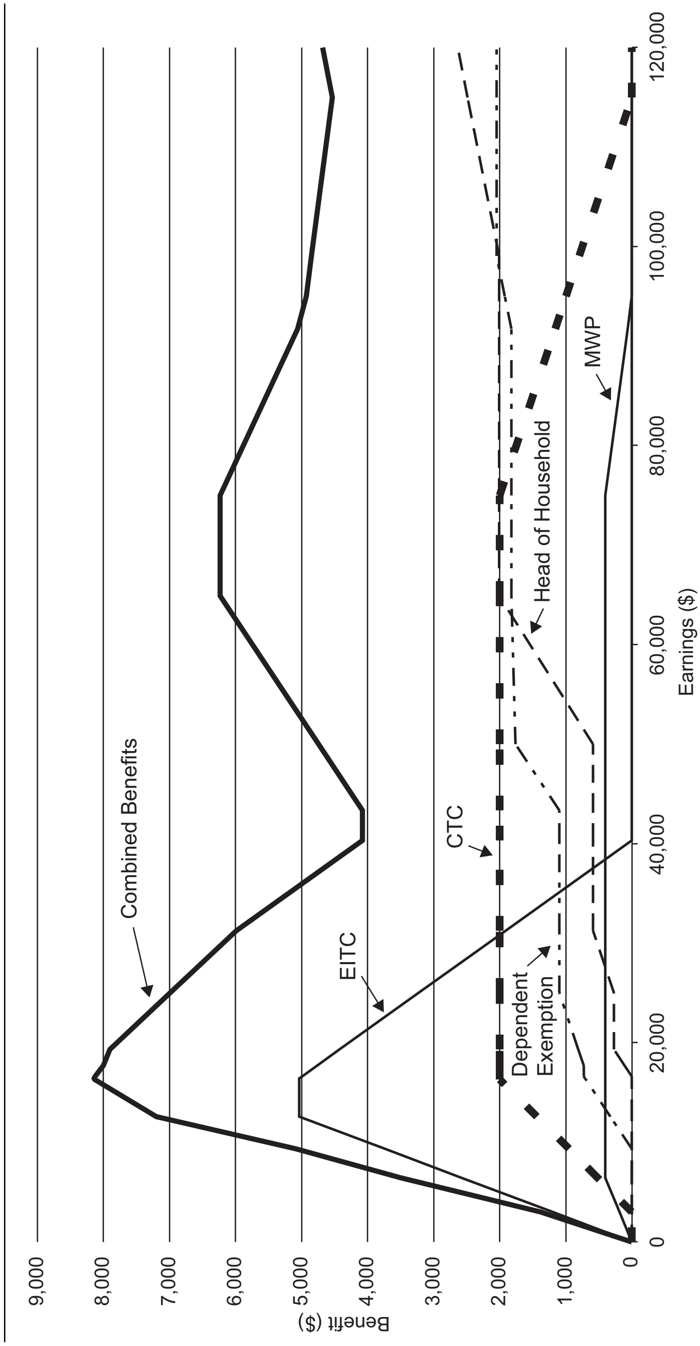
Which children qualify varies across different tax benefits. In order to determine whether a child serves as a qualifying child for the various tax benefits, one must know not only the age of the child, but, in the case of older children, also whether or not they are enrolled in school as full-time students. One must know where and with whom a child lives for what part of the year, a child's relationship to the adults they live with, and who provides support to the child — even in cases where the child lives with a parent.

III. DESIGNING A UNIFIED CHILD CREDIT

When designing tax policies, policy makers must consider not only complexity, but also distribution of gains and losses, budget impacts, and other effects. Sometimes, these interact in unexpected ways. For example, when Carasso, Rohaly, and Steuerle (2005) set out to design their Unified Child Credit (UCC), cost estimates greatly exceeded what they originally anticipated. This stemmed from the fact that under current policy many people who could claim a dependent exemption have all or part of that exemption denied because of the Alternative Minimum Tax (AMT). When the authors simulated a UCC that could be claimed regardless of AMT liability in lieu of other child benefits including the dependent exemption, they observed a large drop in predicted tax revenues as scores of families with children were no longer subject to the AMT — an unexpected outcome of their reform proposal. On the opposite end of the spectrum, contracting programs to harmonize them will raise taxes for some families. Even in reforms designed to be revenue neutral, there will be individual winners and losers since it is impossible to hold tax revenues constant overall while lowering taxes for a targeted group without also increasing taxes for another group. Reformers will need to decide to what extent they will tolerate losers or design a complementary program to offset tax increases for certain portions of the affected population. In any case, the risk of increasing complexity in one area of the tax code while decreasing complexity in another exists and has thwarted previous reform efforts.

Figure 1

Value of Child Benefits at Various Income Levels: Single Parent with Two Children (2010)



Notes: Calculation assumes all income comes from earnings, both children are under age 17 and are qualifying children for the Child Tax Credit, Additional Child Tax Credit, Earned Income Tax Credit, and dependent exemption. Benefits from the dependent exemption are stacked before head of household filing status.

Source: Tax Policy Center, http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=600&Topic2id=30&Topic3id=35.

Table 1

Design Elements of Work and Child Benefits in the Federal Income Tax System, 2010

Tax Provision	Unit of Analysis	Age of Qualifying Child	Income Range for Eligibility	Does Income Include More than Earnings?
Dependent Exemption	Per child	<19 or 19–23 and full-time student or any age if totally and permanently disabled	Unlimited, though can be reduced by persons subject to AMT	Yes
Head of Household Filing Status	Per tax unit	<19 or 19–23 and full-time student or any age if totally and permanently disabled	Up to $190,550. After that, same schedule as single filers.	Yes
MWP	Single versus Married		Up to $200,000 for married couples; $100,000 for single filers	No
EITC	Per child up to 3 plus marital status	<19 or 19–23 and full-time student or any age if totally and permanently disabled	Up to $13,460 with no children; $35,535 with 1 child; $40,363 for 2 children; $43,352 for 3 or more children. $5,010 higher for married couples.	Yes
CTC	Per child	<17	Credit is reduced by 5 percent of AGI over $110,000 for married couples, $75,000 for single parents. End of phase-out depends on number of children.	No
CDCTC	Per child up to 2	<13 or any age if totally and permanently disabled	Unlimited	No
FSA	Per tax unit	<13 or any age if totally and permanently disabled	Unlimited	No

Source: Dependent Exemption and Filing Status, Internal Revenue Service, 2009. "Publication 501 (2009), Exemptions, Standard Deduction, and Filing Information," http://www.irs.gov/publications/p501/index.html; Making Work Pay http://www.irs.gov/newsroom/article/0,,id=204447,00.html; EITC, Internal Revenue Service, 2009. "Publication 596 (2009) Earned Income Credit," and http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=36; CTC: IRS 2009 "Publication 972 (2009) Child Tax Credit," http://www.irs.gov/publications/p972/index.html; CDCTC and FSA: IRS 2009 "Publication 503 (2009), Child and Dependent Care Expenses," http://www.irs.gov/publications/p503/ar02.html.

A. Design Issues

1. Defining Qualifying Children

Starting with the 2005 tax year, the Working Families Tax Relief Act created a "uniform definition of child." The definition applies three tests for most child-related benefits — relationship, residence, and support — but does not address qualifying age. This act also implemented a consistent tiebreaker rule for cases where a child qualifies as a child for more than one person. Though this represented a big step in simplifying tax law for families with children, work remains. For example, the support test for the CTC and dependent exemption does not apply to the EITC. Also, there are special circumstances such as a pre-1985 divorce decree that allow a noncustodial parent to claim a dependent exemption or CTC, but not an EITC. Age remains the largest factor that varies among the benefits (as shown in Table 1). Notably, attempts to make the definition of child uniform with respect to age if Congress decides to act will be the most far-reaching reform, affecting a relatively large number of households regardless of whether reformers adopt the broadest definition ("under 19 or 19–23 and a full-time student") or a narrower definition (such as "under 17," as applies for the CTC), or something in between (such as "18 or under"). The Tax Policy Center estimates that children under age 17 account for approximately 73 percent of dependent exemptions; 9 percent are for children ages 17 and 18, 12 percent for children between ages 19 and 23, and the remaining 6 percent are for people over age 23 who are totally and permanently disabled.

2. Calculating Benefits

Larger families require more resources than smaller families. As a result, policy makers have decided that families with children should pay less tax than childless households with the same income. But how much should that tax advantage vary with the number of children? Research suggests that each additional person in a household requires fewer resources than the previous person, a view reflected in measures of poverty that are adjusted for family size. In contrast, however, the CTC/ACTC and dependent exemption both provide the same benefit for each child in the household. That approach means that, all else equal, bigger families get relatively larger tax benefits than smaller families do.

Head of household filing status offers a "per tax unit" adjustment that only applies to single parents relative to childless individuals. Married couples get no similar adjustment. In essence, the tax code provides a special subsidy for the first child for single parents, but not for the first child of married parents.

The EITC is based on a hybrid approach, whereby tax units receive additional benefits (but decreasing in size) for the first, second, and third children. Benefits do not increase for children beyond 3. In 2010, childless families with one full-time worker earning the federal minimum wage receive no EITC. The first child in the family is worth $3,050 in EITC, the second is worth an additional $1,986, and the third garners the parents an additional $630 in credits. Any additional children add no additional benefit.

Mumford (2009) shows that, relative to the poverty line, tax benefits based on children *over*-subsidize very large families and *under*-subsidize small families, largely because of the structure of CTC benefits. This might indicate that reformers may consider a structure that benefits successive children less than initial children to more align tax benefits with assumed costs associated with children.

Adopting a consistent approach for all child benefits could simplify the tax system. As with using one qualifying age for a child, subsidizing one type of unit (per child or per family) can change a family's tax liability dramatically. Providing a smaller benefit for each successive child through one credit — rather than a multitude of overlapping provisions — would at least improve transparency.

3. *Defining Income*

Under current law, the definition of income varies for different tax benefits. Although the benefit a family receives from the dependent exemption is based on their tax bracket, which depends on adjusted gross income, the other benefits generally rely on earnings. The EITC adds the additional complication with its asset test for households in the phase-out range of the credit. The inconsistent definitions arose out of a desire to target certain provisions more narrowly. IRS data for 2005 indicate that 870,000 families had incomes in the EITC earnings range but appeared ineligible for the EITC because of their assets. This is a small fraction of the 22.8 million families that received the credit that year (Marcia and Bryan, 2007).

4. *Targeting Benefits*

When designing a tax benefit, policymakers ought to consider not only whom the benefit is intended to help but the transparency of how the benefit gets delivered. Hidden effective tax rates induced by phasing out benefits do reduce costs, but also increase the complexity associated with the provision. And in some cases, phasing out the benefit makes little sense. The 2005 tax reform panel sharply criticized the use of phase-outs because they make the tax code more complex; at best they are a nuisance and at worst a negative force (The President's Advisory Panel on Federal Tax Reform, 2005). However, absent a commitment to broad reform, not phasing out a program may be infeasible.

To the extent that phase-outs must occur, tax reformers can choose to consider or ignore transfer benefits likely to affect similar families. As the tax code and transfer system attempt to target assistance on families in similar situations, not considering tax and transfer benefits simultaneously could lead to unintended consequences including very high marginal effective tax rates. Giannarelli and Steuerle (1995) showed that for welfare recipients, taking a job could yield little or no reward because reductions in program benefits reduced net earnings to the same extent or nearly same extent as working would increase net earnings. More recent work confirms this finding (Sammartino, Toder, and Maag, 2002).

As tax programs targeted at low-income families expand, benefit phase-outs continue to threaten incentives to work. However, expanding tax benefits beyond the phase-out point of transfer benefits can add to a proposal's cost considerably (Holt and Maag, 2009).

Reformers must also consider whether the benefit will be refundable or non-refundable. Refundable benefits are available to everyone, while non-refundable benefits can only offset taxes owed. Batchelder, Goldberg, and Orszag (2006) argue that all tax benefits intended to promote socially-valued activities should be refundable credits to improve efficiency and economic growth.

5. *Winners and Losers?*

Reforms that allow few or no losers inherently accept the existing tax system's structure as appropriate. That belies the call for tax reform focusing on simplicity. In addition, it necessarily results in large costs since benefits can only be expanded, not contracted. Holt and Maag (2009) estimate that simply combining the CTC, EITC, and MWP into a worker and child credit without creating losers but creating a structure similar to the EITC would cost roughly $18 billion. Including the dependent exemption would increase costs dramatically (Carasso, Rohaly, and Steuerle, 2005).

B. Reform Options

The first question reformers must answer is the most basic: what programs will be combined? Reforms can be broad or limited, and the value of the reform effort likely depends on how broad are the proposals for reform. Most existing proposals would combine credits and exemptions into two benefits: one focused on encouraging work and one focused on subsidizing children. This allows two goals to be met: making the work incentive clear and applicable to all workers (not just those with children) and subsidizing families with children differently from families without children.

Space limitations preclude summarizing all the ways the tax code could be reformed, but certain classes of reforms crop up repeatedly. I summarize these below with examples. Note that other examples of reform proposals are summarized in Holt and Maag (2009), Marguerite Casey Foundation (2005), and Meyer (2007). All of the reforms attempt to move closer toward a uniform definition of child, simplify the calculation of the credits, and make programs easier for the IRS to administer — all important elements of successful reform. Ultimately, the various tax provisions directed at families incorporate three factors: rewards for working, subsidies for having children, and subsidies for spending on child care. Complexity arises from the interaction of multiple programs. A variety of paths can be taken to encourage simplification, from a full-scale redesign of all of the benefits to a more modest combining of very similar benefits — either because they target the same population or because they target the same activity. Below are three options.

1. *Separate Work and Child Incentives and Provide Substantial Work Incentive to all Low-Income Workers*

The calls to reform work incentives in the tax code are many. Recent work by Holt and Maag (2009), Edelman et al. (2009), Carasso et al. (2008), and Berlin (2009) points out that the current design of work incentives excludes most workers without custodial children. Although some of these individuals may indeed be parents supporting children via child support payments or other mechanisms, they receive little to no parental benefit from the tax system. One way to change this would be to separate out the work and child incentives in the tax system.

A pure work incentive would be based on individual rather than joint earnings. As originally designed, the MWP credit achieved the goal of having a pure work incentive in the tax code. As proposed in the 2008 presidential campaign, the credit was based on individual earnings, rather than marital status, so that two-earner couples had the potential to benefit more than one-earner couples. This design answered a criticism of the EITC: that it may discourage work among second earners (Eissa and Hoynes 2006). As implemented, the MWP credit does not differentiate between one- and two-earner couples. Regardless, policy analysts, including Berlin (2009), Holt and Maag (2009), and Carasso et al. (2008), continue to push for a credit based on individual earnings and one that will include individuals and couples without children.

Often, proposals that call for an increase in work incentives for families without children or a separation of work and child incentives simply divide the current EITC into two pieces: a work incentive and a child incentive. Carasso et al. (2008) describe examples and show the effects of varying the percentage of EITC designated as a work incentive available to individual workers. The most modest proposal — offsetting the employee share of payroll taxes for incomes equivalent to the phase-in range of the one-child EITC — would cost $23.7 billion in 2007 dollars (2007 law). Offsetting both the employer and employee share of the payroll tax over the same income range would increase that cost by about $10 billion. Several other proposals seek to do essentially the same thing, with varying eligibility parameters (summarized in Carasso et. al, 2008).

The proposal by Holt and Maag (2009) would be more far reaching. It would not only separate out the work and child incentives in the EITC but also roll the CTC into a child credit and the benefits from MWP into a work credit. The proposal would allow "losers" by basing the worker credit on individual earnings rather than marital status. Relative to current law, a married couple with one worker would receive lower benefits. This avoids issues associated with couples losing tax credits when they marry, but raises an issue of fairness. Should the tax code treat a family with one worker earning $50,000 differently from a family where two workers earn the same total income?

Holt and Maag (2009) also consider the growing issue of entitlements in the tax system. They opt for a policy that would not phase out tax credits until most families no longer received SNAP benefits, which occurs when income exceeds 130 percent of the poverty line.

The 2005 Tax Reform Panel offered the most far-reaching separation of work and child incentives. Its proposal combined benefits from the standard deduction, head of household filing status, the 10 percent bracket, and the CTC into a single credit based on household type (married couples, single parents, unmarried taxpayers, and dependent taxpayers) with additional benefits for each child or other dependent. Their proposal made the definition of child more uniform by covering "children" and "other dependents" in one program. On top of the family credit, the panel recommended consolidating the EITC and ACTC into a new Work Credit. This differed sharply from other work credit proposals by maintaining variation based on the number of children in the family. As a result, work and child benefits remained linked. Conversations with panel members indicate this outcome resulted from trying to build a system with few losers and control costs. Absent those constraints, the work credit might have abandoned the idea that it ought to be larger for larger families. The current structure of the EITC makes it difficult to create a work incentive based on individual workers without either increasing costs greatly by expanding the work benefit to secondary earners and workers without children or creating losers among families with children.

It is impossible to create simpler programs that do not either increase costs dramatically or result in losers. Bold reform will recognize that either benefits will need to be distributed differently, or costs will be high.

2. Combine Child Benefits Not Directly Tied to Work: CTC, Dependent Exemption, Head of Household Filing Status

The CTC, ACTC, dependent exemption, and head of household filing status all start from the premise that families with children are less able to pay taxes than childless households — or that families with children need assistance. Although head of household filing status implies that the distinction is between those with and without children, the other provisions imply that each additional child decreases a household's ability to pay taxes, or increases its need for assistance. Limiting reform to these elements of the tax system, rather than tackling the reform of work incentives as in Option 1, allows for more flexible reform.

Combining benefits that increase with a person's marginal rate (such as the dependent exemption), credits with a fixed subsidy per child (such as the CTC), and a credit that changes based on the number of children, up to a defined number (the EITC) presents many challenges. Reformers must first create a uniform definition of child, and then determine how to structure the new benefit. The Uniform Child Credit proposed by Carasso, Rohaly, and Steuerle (2005) provides an example of this type of reform. This proposal describes a child credit for children under age 19 that essentially turns the dependent exemption into a credit and adds that amount to the CTC and EITC for which a family would qualify by tweaking EITC parameters. In doing so, the proposal solves a glaring problem with the AMT — the treatment of dependent exemptions as tax shelters. The proposal gives the benefits of the tax incentives that people at the 15 percent bracket receive to everyone — so those in higher brackets lose while those in lower brackets win. Absent offsetting rate increases, the proposal would cost roughly $40 billion in tax year 2010 in 2003 dollars. The authors propose increasing the highest tax rate by one percentage point to offset about one-third of the costs.

3. *Create Uniform Incentives for Similar Activities: Combining CDCTC and Dependent Care Spending Accounts or Combining Subsidies*

If a lack of political will stands in the way of broad reform, or even a reform of the child-related provisions, steps toward simplification of the tax code with respect to low-income families can still be made. Two obvious targets are the consolidating provisions related to child care or in-school subsidies for college students.

The CDCTC and FSAs both subsidize child care, targeting different but overlapping populations and providing different benefits to qualifying individuals. Some parents can maximize benefits by participating in both programs. Participants in an FSA can designate up to $5,000 of earnings to be "pre-tax." As with the dependent exemption, the resulting tax savings depends on the taxpayer's marginal tax rate; families facing higher marginal rates benefit more than families with low marginal rates. Contributions to FSAs are exempt from both the federal income tax and the payroll tax. However, any dollars set aside for childcare not used are lost to the individual who set them aside. At least one parent must work to benefit from this provision. In contrast, the CDCTC is a credit with higher rates for lower income families. Since the credit is not refundable, very low income families receive no benefit. In 2010 eligible expenses for the CDCTC are $3,000 for families with one child and $6,000 for families with two or more children, in contrast to the FSA limit of $5,000 per tax unit. If eligible families spend more on childcare than the amount set aside in an FSA, they can claim the CDCTC for the excess spending, up to a total benefit on $6,000 of child care spending.

Knowing whether a family will benefit more from the CDCTC, an FSA, or both is difficult to predict. Families must know what their marginal rate will be, and whether they will have taxes to offset. For example, very-low-income families who do not owe income tax can gain some benefit from the exclusion of payroll taxes on money set aside in an FSA, but families with low incomes that do have tax liability to offset might benefit more from the CDCTC. Making the CDCTC refundable — so that all families could benefit — and eliminating the FSA would greatly simplify the calculation. Very-low-income families would get higher benefits while benefits for higher income families would fall. Since low-income families are more likely to need assistance paying for decent child care, this policy might shift resources to where they are most needed. Burman, Maag, and Rohaly (2005) offer such a proposal.

Another proposal would consolidate in-school college subsidies — the EITC and dependent exemption for full-time students ages 19–23, the American Opportunity Tax Credit, and the tuition and fees deduction. Combining such a proposal with a uniform age limit for dependent children could further simplify the tax code. Combining the various college subsidies would make subsidizing college through the tax code more transparent while also simplifying child related provisions.

IV. CONCLUSION

Complexity undermines the tax system and comes at great cost, both direct and indirect. Despite not paying a large share of taxes, low-income families share fully in the complexity of the system. They face a maze of benefits that vary in terms of who is targeted, the measure of income used in the calculation of the benefit, and the various phase-ins and phase-outs of the provisions. As complexity grows, it comes at the risk of undermining benefits already in place and the ability of people to understand and react to incentives.

The road to a unified credit will come only with either some parties "losing" — receiving fewer benefits than they do under current law — or at a cost not currently considered feasible by many. Reform proposals highlighted in this paper — both far-reaching and more conservative — provide examples that could form the basis for decreasing complexity for families with children.

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