The President's Proposal to Accelerate the Child Tax Credit and Related Options

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Introduction

The President's January 7, 2003 economic stimulus proposal for enhancing the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) would, in addition to ending the corporate taxation of dividends and speeding up tax rate and marriage penalty relief, accelerate the increase in the child credit from $600 to $1,000. This brief provides revenue and distributional estimates for the President's proposal as well as for different types of amendments that might be considered.

The CTC was first allowed for the 1998 tax year, and is currently worth $600 for each child under age 17. The credit is not indexed for inflation. The credit is reduced by five cents for every dollar a couple earns above $110,000 ($75,000 if not married). These phase-outs points are also not indexed to inflation. The 2001 tax cut made the CTC partially refundable, meaning that whatever remains of the credit after it is used to offset tax liability can be received as a refund by families, provided that they also have sufficient income above a certain threshold. The refundable portion of the credit equals 10 percent earnings above $10,450 in 2003, increasing to 15 percent in 2005 and thereafter. Thus, a family earning $15,450 in 2003 could claim a child tax credit equal to its tax liability plus $500 (to a maximum of $1,000 total). Importantly, the 2001 tax cut also scheduled a gradual doubling of the credit from $500 to $1,000 by 2010.

Among the criticisms of the credit is that it is not indexed to inflation—the result is a supposed $1,000 credit that will only be worth $841 or so per child in real terms in 2010 (the future value is subject to the whims of inflation). Even if the credit is extended beyond 2010 but remains unindexed, its value will gradually approach zero as prices increase. If lawmakers do not extend the tax cut, then the CTC returns to $500 per child in 2011 ($400 in 2003 dollars). Also, more and more middle-income families will lose access to the credit over time as it starts phasing out at lower and lower real income levels.

The five options developed below either bump the child credit up to its full, 2010 value by 2003 (as proposed by President George W. Bush), index the value of the credit to inflation, or both.

Options

Option 1. Accelerate the Child Tax Credit to $1,000 in 2003. This option is what the Administration proposed January 7, 2003. The option immediately raises the value of the credit from $600 in 2003 to $1,000.

Option 2. Option 1, plus Accelerate the Refundability Rate to 15 percent in 2003. Building on option 1, option 2 raises the credit's refundability rate for families earning over $10,450 in 2003 from 10 percent to 15 percent.

Option 3. Option 2, plus index the Child Tax Credit to inflation after 2003. Same as Option 2, except the credit retains its real, 2003 value of $1,000 in every year thereafter.

Option 4. Option 3, plus index the phase out. In addition to indexing the credit itself, this option indexes that income level at which the credit begins to phase out—currently $110,000 for couples and $75,000 for singles—to inflation. Without doing so, the credit effectively creates a back-door tax hike on higher income families; that is, by 2010, these thresholds sink to $92,500 and $63,000 respectively in 2003 dollars, if they are not indexed, which means the credit phases out at increasingly lower incomes each year.

Option 5. Index Child Tax Credit after 2010 only. This option is the same as current law until 2010—but thereafter, the value of the credit is indexed for inflation.

All five options reduce taxes, although the degree varies. Attached are tables estimating the costs of each option and showing the distributional impact of each by AGI class and income quintile, for the 10-year period 2003-12. For the sake of brevity, we will only discuss options 1 and 4. Option 1 is the Administration's

proposal and option 4 is the accelerated credit with all parameters indexed for inflation starting in 2003 (and subsumes options 2 & 3).

Analysis

Tables 1 and 2 provide ten-year revenue estimates for each option. They show annual figures for two legislative scenarios: (1) "Current Law Baseline," which includes the law's current expiration at the end of 2010; and (2) "EGTRRA Permanent Baseline," which assumes Congress extends EGTRRA indefinitely. The tables estimate costs assuming that each child credit option is continued past 2010. The clear difference between the two baselines is in the cost of the options after 2010—options cost substantially more relative to the first baseline because EGTRRA is assumed to no longer exist. Table 1 shows figures in calendar years while Table 2 shows figures in fiscal years. For ease of exposition, only Table 1 will be discussed.

The table shows costs relative to the current law credit—hence, under both baselines, the annual costs for options 1-4 are largest in the earlier years--about $17-$20 billion annually—when the current law credit amount most lags the value of the credit under the option. Option 5, because it does not differ from current law until after 2010, only registers the cost of indexing the credit after 2010. All options appear significantly more expensive under the current law baseline, which assumes lawmakers will let the 2001 tax cut sunset—as a result, the large figures for years 2011 and 2012 project the revenue loss required to sustain any of these credit options independent of the tax bill.

The cost of the Administration's CTC proposal is $161 billion under current law and $95 billion if lawmakers make EGTRRA permanent. Accelerating the refundability rate from 10 to 15 percent, as in option 2, only adds another $4 billion or so to the total cost. Option costs rise appreciably when the CTC and its associated parameters are indexed for inflation—$51 billion just for indexing the CTC value starting in 2003 and an additional $25 billion ($76 billion total) if the high income phase-out thresholds are also adjusted each year. To index all parameters reduces revenues $242 billion under the current law baseline and $175 billion under the permanence baseline. Since option 5 differs from current law only in that it indexes the credit past 2010, its revenue requirements are comparatively low—$70 billion under the first baseline and $3 billion under the second.

Table 3 shows the nominal and real-2003 dollar values of the five options compared to current law. Because the credit in options 3 and 4 is indexed to inflation, its real 2003 value (under "Constant 2003 Dollars") remains constant at $1,000 for each year while its nominal value (under "Current Dollars") necessarily increases each year. Because options 1, 2, and 5 are not indexed for the 2003-10 period, their real values fall each year while their nominal values remain constant. In option 5, the real 2003 value of the credit that gets indexed after 2010 is $841. As intended, the first two options differ the most from current law in the early years—and as shown in Tables 2 and 3, this is where the bulk of the additional cost lies. Option 3 only differs from current law after 2010, where the value of the credit is thereafter indexed for inflation.

Tables 4-13 show the distributional impact of these options by the adjusted gross income (AGI) on tax returns, by option and year of interest: 2003, for options 1 and 2 (as there is no consequence in 2010), 2010 for options 3 and 4, and 2012 for option 5. A variety of breakdowns are provided. There are two tables for each option—the even-numbered tables break down the option's impact on taxes by AGI class while the odd-numbered tables break down by income quintile.

Under all five options, all filers either gain or are held harmless. Those filers who are unaffected have no children, earn in the bottom income quintile and thus have too little income or tax liability to receive any child credit, or are in the highest quintile and earn too much. The options tend to help those in the middle and upper income ranges the most. However, keep in mind that some of those in the lower and upper income ranges are there only temporarily and that a larger percentage of households fall in the middle-income ranges at different points in their lives.

We only discuss here the distributional impact by quintile for the first option, increasing the CTC to $1,000 by 2003, which is Table 5. The table is for 2003 as this is the year when the accelerated benefit will make the largest difference. The first two columns show the number of tax returns by AGI range and the percentage of all returns falling into this range—this distribution includes filers with and without children, as well as young filers who likely earn little and live with their family. According to the next column, percent change in after-tax income, the middle and upper quintiles benefit the most. Again, filers in the bottom quintile do not earn enough to get the credit while the top five percent earn too much. The next column gives the percentage of the total tax change going to families in different income ranges. The last two columns show average income tax rates before and after the option. Under the first option, these rates are anywhere between a half and a tenth of a percentage point lower, although for the top five percent of tax filers, there is no change.

In summary, accelerating the CTC to $1,000 in 2003 results in meaningful tax cuts for lower- to upper-middle income families, but not to the bottom quintile of families (who generally pay no income tax or have net refunds) nor to those nearer the top of the income distribution (where the credit phases out). Indexing this credit value to inflation locks in the value of the credit, producing a CTC about $160 more valuable in 2010 against what it would be worth under current law. Alternately, simply indexing the current child credit for inflation after 2010—a smaller cost option either to the current law or the President's proposal—would at least preserve most of the credit's value for workers and families in the next decade and beyond.

For the tables discussed above, click here.

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Other Publications by the Authors

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