HOW THE HOUSE BILL TO EXPAND THE CHILD TAX CREDIT AND REDUCE TAXES FOR MARRIED COUPLES WOULD AFFECT LOWER-INCOME FAMILIES

by Robert Greenstein and Isaac Shapiro

Summary

Twelve million low-and moderate-income families with 24 million children would be left out of the Bush Administration’s tax cut, despite the proposed expansion of the child tax credit. These families would not benefit because they do not owe income taxes. Yet most of these families are working families that pay significant amounts of other taxes, most notably payroll taxes. Moreover, many of these families face some of the nation’s highest marginal tax rates, and a number of them face some of the nation’s largest marriage tax penalties.

Furthermore, if the goal of enlarging the child credit is “to leave no child behind” and “to help families rear and support their children,” as President Bush has said, the credit should assist families that have the hardest time in providing adequately for their children and making ends meet. This is particularly important because the tax package may consume most or all of the available surplus outside of the Social Security and Medicare trust funds, leaving few if any resources available to help these families and children in other ways.

The House approved legislation (H.R. 6) on March 29 that represents a step forward from the Bush proposal in that it recognizes that low- and moderate-income working families should have more of their payroll taxes offset and that marriage penalty tax relief should extend to these families rather than just to families at higher income levels. Unfortunately, however, the marriage penalty tax relief the House bill accords to low-income working families eliminates only a modest portion of the marriage tax penalties that many of these families face as a result of the structure of the Earned Income Tax Credit. In addition, while the provision to extend the child credit to some families that pay payroll and other taxes but not income taxes would help a significant number of moderate-income families with incomes above $20,000 or $25,000, the proposal continues to deny the credit to nearly all working families that incur payroll and other taxes but have incomes below these levels.

In fact, an analysis of the House bill by Citizens for Tax Justice finds that the bottom 40 percent of taxpayers would receive only six percent of the tax benefits the bill provides. Furthermore, while certain parts of the House bill represent a step forward, much more ground remains to be covered in providing relief to low-income families, and other parts of the bill would add to the problems the overall tax package would create by making it more likely that the total cost of tax cuts this year will substantially exceed the already high levels in the President’s
Some of these families would receive no increase in their child credit under the Bush plan but would receive an increase in the credit under the House bill. (See a companion Center analysis, “House Ways and Means Committee Action to Date Adds $300 Billion to Cost of Administration’s Tax Cuts.”)

Child Credit Improvement is Limited

A single working mother with two children would not benefit from any component of the Bush tax plan, including the child tax credit, until her income surpasses $23,562 (in 2001 dollars), at which point she would begin to benefit from the new 10-percent tax bracket. This figure is unchanged under the House-passed bill. The table below shows the income levels that a family would have to attain under the House legislation before it could benefit from the proposed expansion of the child credit.

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<tr>
<th>Income Levels Below Which Families Would Not Benefit from the Child Credit Expansion Under House Bill</th>
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<tr>
<td>Single parent, one child</td>
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<td>Single parent, two children</td>
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<td>Married couple, one child</td>
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On the other hand, working families with incomes above these levels would get larger child credits as a result of the House-passed bill. Many families with incomes above these levels would have gotten only a partial child credit under the Bush plan but would get a larger or a full credit under the House bill. As examples, single working mothers with one child that have incomes between $19,130 and $22,450, and married families with two children that have incomes between $24,958 and $38,030 would receive a larger child credit under H.R. 6 than under the Bush proposal.¹

Under the House bill, the child credit could be provided as a refund to the extent that the employee share of a family’s payroll taxes exceed its EITC. The proposal is limited in the degree to which it would offset the payroll taxes that low-income working families pay, because it does not take account of the employer share of the payroll tax. The Joint Committee on Taxation, the Congressional Budget Office, and President Bush’s National Economic Council — as well as nearly all economists — concur that employees pay the employer share of the payroll tax as well as the employee share. Employees pay the employer share because employers pass this tax through to employees in the form of lower wages than the employees otherwise would receive.

¹ Some of these families would receive no increase in their child credit under the Bush plan but would receive an increase in the credit under the House bill.
For this reason, the child tax credit in the original Contract with America was designed to offset both the employee and the employer share of the payroll tax for low-income working families. The Contract proposed that the child tax credit be refundable to the extent that a family’s total payroll tax (including the employer share) exceeded its EITC. The House-passed legislation does not take this course. Many low-income working families with significant tax bills consequently would benefit little, if at all, from the House package. The House bill provides less in tax relief to these families in a time of budget surpluses than the original Contract with America proposed to provide in a time of budget deficits.

It should be noted that while the Contract with America proposal in this area is superior to the House bill, it also shares some problems with the House approach. The calculations that taxpayers must make to determine to what extent their payroll taxes exceed their EITC — and whether they have an unused portion of the child credit that can be taken as a refund against their payroll taxes — are inordinately complicated and not well-suited for low- and moderate-income families. Moreover, while the Contract approach does more than H.R. 6 to reduce the high marginal tax rates that many low-income working families face, it leaves marginal tax rates unchanged for large numbers of those families. Other alternatives — such as extending the child credit to low-income working families and simply phasing up the credit as a family’s earnings rise (so the credit increases with earnings until it reach $1,000 per child) — would be less complicated, would help more low-income families in raising their children, and would do substantially more to lower the high marginal tax rates these families can face.

**Marriage Penalty Provision is Modest**

The proposal’s marriage penalty relief provision for low- and moderate-income working families, which would cost a little over $1 billion a year, would leave in place the large majority of the marriage tax penalties that many working poor families face as a result of the structure of the Earned Income Tax Credit. The EITC marriage penalty relief in the bill would reduce the large marriage penalties the EITC can create by no more than $240 for married couples with one child and $400 for married couples with two children. EITC marriage penalties can easily exceed $1,000 and reach several thousand dollars for some low-income working families.

The amount of EITC marriage penalty relief that H.R. 6 provides is about one-fourth the size of the EITC marriage penalty relief for low-income working families that the Heritage Foundation has recommended. Isabel Sawhill of the Brookings Institution, an expert in marriage penalty issues, also has recommended EITC marriage penalty relief several times larger than the House bill provides.

**Treatment of High-Income Taxpayers**

The House-passed bill would eliminate provisions of the Bush proposal that would provide large increases in the child tax credit to high-income families. Under the Bush proposal, married-couple families with two children and incomes between $130,000 and $200,000 would
receive an increase in the child credit of $1,000 per child, double the increase that middle-income families would receive. The House dropped this aspect of the Bush package, improving the distribution of the benefits from the proposed child tax credit expansion. On the other hand, H.R. 6 would extend more marriage penalty relief to high-income taxpayers than the Bush plan would.

Of the major tax cut bills based on the President’s plan that Congress is expected to consider, this bill is likely to be the proposal that provides the largest share of its benefits to moderate- and middle-income taxpayers and the smallest share to high-income taxpayers. Yet, Citizens for Tax Justice estimates that under this bill, nearly half of the tax benefits — 49 percent — would go to the top 20 percent of taxpayers. When this measure is looked at in combination with the measure to reduce tax rates the House passed on March 8 and the measure to repeal the estate tax the House adopted on April 4, the tax package as a whole is found to remain heavily tilted toward high-income taxpayers.

**Marginal Tax Rate Problems of Low-Income Families Remain Unaddressed**

In addition, H.R. 6 fails to address the extremely high marginal tax rates faced by many families that earn between $13,000 and about $20,000. These families face the highest marginal tax rates of any families in the nation. For each additional dollar that families in this income range earn, they lose 16 cents to 21 cents in EITC benefits, pay 15.3 cents in payroll taxes (including the employer’s share), lose 24 cents to 36 cents in food stamp benefits, pay a few cents in state income taxes in many states, and can lose some child care, housing and health benefits if they receive such benefits and the benefits decline as earnings rise. Many of these families face overall marginal rates that substantially exceed 50 percent.

These marginal tax rates could be reduced either by reducing the rate at which the Earned Income Tax Credit phases down for families in this range or by extending the child credit to these families by phasing up the child credit as earnings increase in this income range. The House legislation takes neither step. Moreover, the House bill continues to leave out millions of low-income families with children, many of which are working families that are net taxpayers.

**Cost of Tax Package Rises Further**

Finally, the House bill further increases the cost of the tax package. The bill would cost $115 billion more over the next 10 years than the child credit and marriage penalty provisions in the Bush proposal; this includes $95 billion more in revenue reductions and $20 billion more in interest payments.

The increased costs reflected in H.R. 6 are not primarily the result of extending additional assistance to low- and moderate-income families; for example, the new marriage penalty relief for these families would cost $13 billion over 10 years, plus a small amount of interest payments. The increase in the refundability of the child tax credit apparently costs somewhat more than this,
but a separate cost estimate for this provision has not been made available. The substantial 
majority of the increased costs of the House bill stem from its significantly larger tax cuts for 
middle- and upper-income married families than the marriage penalty relief provisions in the 
Bush plan. The Bush plan targets marriage penalty tax relief on those middle- and upper-income 
families that face marriage penalties; it accomplishes this by targeting this relief on two-earner 
couples, which are the families most likely to face marriage tax penalties. The House-passed 
legislation, by contrast, provides these tax cuts to middle- and upper-income married families in 
general, including the more than 20 million married families that already receive marriage tax 
bonuses.

According to the Joint Committee on Taxation, the combined cost of the three bills the 
House has passed to date — H.R. 3, to reduce rates; H.R. 6, to reduce the marriage penalty and 
increase the child credit; and H.R. 8, to repeal the estate tax — equals $1.5 trillion over ten years, 
not including the increased interest payments on the debt. This leaves room for about $100 
billion of further revenue reductions within the supposed $1.6 trillion constraint. However, the 
House has yet to take up such Bush Administration proposals as permanent extension of the 
research and experimentation credit, charitable giving provisions, creation of a health income tax 
credit, and a number of smaller tax cut provisions in the President’s budget. These remaining 
components of the Bush plan cost about $250 billion over ten years, according to Administration 
estimates. As a result, the House now appears to be on track to pass tax cut provisions that 
ultimately will cost $1.8 trillion over ten years, even before one adds in interest payments on the 
debt, and $2.2 trillion with interest payments. In addition, Joint Tax Committee data indicate 
that another several hundred billion dollars will be needed to prevent the Alternative Minimum 
Tax from exploding in coming years, a problem the Bush tax cut aggravates. If one includes the 
cost of addressing the AMT problem, the total cost rises to $2.5 trillion or higher. Moreover, this 
is before other popular tax-cut legislation, such as legislation to expand pension tax preferences, 
is added.

As the cost of the tax package continues to grow, so does the likelihood that it will 
eliminate any remaining part of the surplus (outside the Social Security and Medicare trust funds) 
that might otherwise be available for national priorities, as well as the likelihood that it 
eventually will lead either to using Social Security and Medicare trust fund resources for other 
purposes or to enacting substantial budget cuts beyond those reflected in the Administration’s 
budget. This analysis examines several of the above issues in more detail below.

The Marriage Penalty Provision for Low- and Moderate-Income Taxpayers

Marriage penalties for EITC families can be severe. For example, if a man with $10,000 
in earnings and a child marries a woman with $10,000 in earnings and a child, they face an EITC 
marriage penalty of $2,300.²

² When single, they would each receive an EITC of $2,428, or a total of $4,856. After they marry, they would 
receive an EITC of $2,553.
For married families, the House bill would increase by 10 percent the income range over which the Earned Income Tax Credit phases in. Since the structure of the EITC differs for families with one child and families with two or more children, the effect of the bill on EITC marriage penalties would differ by the number of children in the family:

- For a married family with one child, the EITC currently is phased in at a 34 percent rate until earnings reach $7,140. Under the House legislation, the EITC would phase in for these families until their earnings reach $7,854. The result would be that for married families with one child and earnings above $7,854, the EITC would increase by $240; the EITC thus would be $240 larger for married families with one child that earn at least $7,893 than for single-parent families with one child that earn the same amount. Most low-income families that face a marriage penalty as a result of the EITC, however, face a penalty much larger than $240.

- For a married family with two or more children, the EITC currently phases in at a 40 percent rate until earnings reach $10,020. The House bill would continue phasing in the EITC for such families until their earnings reach $11,022. As a result, the EITC would rise by $400 for married families with earnings of at least $11,022. Once again, this is well below the marriage penalties that many such families face.

This EITC marriage penalty relief is much smaller than that recommended by a number of experts and organizations. For example, in budget proposals that it issued this January, the Heritage Foundation called for EITC marriage penalty relief of $5 billion per year for low- and moderate-income families with children. As noted, the House bill provides EITC marriage penalty relief of a little more than $1 billion per year, about one-fourth as much. Under the Heritage proposal, a married family with two children that has income of about $21,000 would receive an increase in the EITC of more than $1,300 to combat the marriage penalties it otherwise would encounter. Many EITC families face marriage penalties of this magnitude or larger. A proposal designed by Isabel Sawhill of the Brookings Institution includes an EITC marriage penalty relief provision that would provide a married family with two children and earnings of $21,000 an EITC increase of about $1,050.

**The Expansion of the Child Credit**

Under current law, the child credit is generally not refundable — that is, it can be used only to offset income taxes that a family otherwise would owe, and a family forfeits any amount of a child credit that remains unused after the family’s income tax liability has been eliminated. There is one exception to this rule: working families with three or more children may, in a limited number of cases, claim some or all of the child credit as a refund. In these cases, the refundable component of the credit is limited to the amount by which the employee share of a
family’s payroll tax liability exceeds its Earned Income Tax Credit. IRS data show that about 750,000 families benefitted from this provision in 1998.

Married families with three children that currently qualify for this provision have incomes between about $23,562 and $32,100. (These figures assume these families use the standard deduction and do not claim the dependent care tax credit.) Under the House-passed bill, this same approach would be extended to families with one or two children. That is, the child credit would be made refundable for such families to the extent that the employee share of a family’s payroll tax liability exceeds the family’s Earned Income Tax Credit. As a result, a single-parent family with one child would receive a larger child credit than it would get under the Bush proposal if its income falls between $19,130 and $22,450. Married-couples with two children would receive a larger credit than under the Bush proposal if their income is between $24,960 and $38,030.

This aspect of the House legislation, while helpful to a number of families, would not extend the child credit to most of the low-income working families that would not receive it under the Bush plan. Instead, this proposal would primarily provide a larger child tax credit to many moderate-income families that would receive a small child credit under the Bush plan.

The House bill consequently would fall far short of providing the child tax credit to all working families with children that are net taxpayers. As noted above, the child credit would offset only half of payroll taxes. Most economists (including Lawrence Lindsey, director of President Bush’s National Economic Council), the Joint Committee on Taxation, and the Congressional Budget Office agree that workers bear the burden of both the employee and employer share of payroll taxes. The House bill would allow the child tax credit to offset only the employee share. In addition, the child credit would not offset any federal excise taxes on gasoline or telephone service or any state taxes.

The proposal to establish a child tax credit contained in the original Contract with America unveiled by House Republicans in the fall of 1994 called for making the credit refundable against both the employer and the employee share of payroll taxes. (This provision was dropped by the House Ways and Means Committee early in 1995.) Under the Contract, the child credit would have been refundable to the extent that a family’s total payroll taxes, including the employer share, exceeded the family’s EITC. The original Contract consequently would have provided more tax relief than H.R. 6 would provide and would have extended the child credit to several million low-income working families that the House legislation would leave out.

- For a two-parent family with two children and income of $25,000, the House bill would provide an increase in the child tax credit of $12, the amount by which the family’s employee share of the payroll tax exceeds its EITC. Yet the family’s full payroll tax exceeds its EITC by $1,925. (This family would, however, receive

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3 All the calculations in this analysis are done in the year 2001 and assume that all provisions of H.R. 3 and H.R. 6 would be in full effect.
Since families with children tend to have higher incomes than single individuals and childless couples, the bottom 40 percent of taxpayers includes a disproportionately large share of individuals and childless couples, and a disproportionately small share of families with children. The bottom 40 percent of taxpayers include 30 percent of families with children. At the other end of the income spectrum, the 20 percent of taxpayers with the highest incomes include 27 percent of families with children.

In other words, the House bill would provide a child tax credit that would offset $12 of the $1,925 in net federal payroll taxes this family owes after the EITC is taken into account (and before counting excise taxes the family also pays).

Under the original Contract, such a family would have received a child tax credit of $1,000, rather than $12. It still would be a net taxpayer, but the amount by which its payroll taxes exceed its EITC would fall to $925.

As described below, the Contract approach, itself, has drawbacks, despite being a significant advance over the House bill. Other approaches are available that would be more effective.

### Other Options Should be Considered

Even with its EITC and child tax credit improvements, the House bill still provides a relatively small share of its benefits to the bottom part of the population. An analysis of the bill by Citizens for Tax Justice has found that only six percent of the tax-cut benefits would go to the bottom 40 percent of taxpayers.\(^4\) By contrast, nearly half of the bill’s tax-cut benefits — 49 percent — would go to the top 20 percent of taxpayers. In addition, when this bill is considered in conjunction with the other elements of the Administration’s tax package, the overall package still is found to skew its tax cuts heavily to high-income taxpayers and to further exacerbate disparities in after-tax income, which already are at their widest levels on record. More tax relief for the bottom part of the population is appropriate.

To address more adequately the marriage penalties that low- and moderate-income families face, the various approaches the Heritage Foundation and Isabel Sawhill of Brookings have proposed merit consideration. These approaches would reduce the marriage penalties the EITC can create to a much greater degree. These approaches also have several advantages, including that they partially address the high marginal tax rates that families with incomes between $13,000 and $20,000 face. By extending the EITC “plateau” (the income range over which the EITC remains at its maximum level before it begins to phase down) by $4,000 for married-couple families under the Heritage approach and by $5,000 under the Sawhill approach, these proposals would reduce the high marginal tax rates that some low-income married families face by 16 to 21 percentage points.

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\(^4\) Since families with children tend to have higher incomes than single individuals and childless couples, the bottom 40 percent of taxpayers includes a disproportionately large share of individuals and childless couples, and a disproportionately small share of families with children. The bottom 40 percent of taxpayers include 30 percent of families with children. At the other end of the income spectrum, the 20 percent of taxpayers with the highest incomes include 27 percent of families with children.
The House bill also would be improved if it took the approach followed by the original Contract with America and enabled the child tax credit to offset both the employee and employer share of the payroll tax. Better yet, the child tax credit could be made refundable in a simpler and more effective way that would reach more families.

The Complexities of Relating Child Credit Levels to the Degree to which Payroll Taxes Exceed the EITC

Treasury and IRS officials have warned in the past that the provision of the current tax code under which the unused portion of the child credit for a family with three or more children can be provided as a refund against the employee share of the family’s payroll tax is exceptionally complicated. Under this approach, a family must figure if any of its child credit will be used to eliminate any income tax liability it may have after other credits are figured, but before its EITC is taken into account. The family then figures the unused portion of its child credit. The family then computes its EITC and subtracts the EITC from the employee share of the payroll taxes it paid during the year. Next, the family compares the result of this last computation to the unused portion of its child credit. The portion of the child credit that the family can receive as a refund equals the lesser of these two amounts (i.e., the lesser of its unused child credit and the amount by which the employee share of its payroll taxes exceeds its EITC).

A better approach would be to replace this baroque set of calculations with a simple system for extending the child credit to more low-income families. Instead, the House-passed approach extends this complicated approach to a few million additional families.

There is an alternative approach that can help address four of the principal problems of the House approach: the fact that it does little to extend the child credit to low-income working families that pay payroll and other taxes but would not benefit from the child credit expansion (in part because the proposed expansion fails to consider the employer share of the payroll tax); the fact that H.R. 6 does nothing to lower the extremely high marginal tax rates that families in the $13,000 to $20,000 range face; the fact that so many low-income families and children continue to be left out under the House bill; and the inordinate complexity of this approach. (The Contract approach shares several of these problems to the same or a lesser degree.) The alternative approach would be to phase in the child credit as the earnings of low-income families rise.

The credit could begin to phase in with the first dollar of a family’s earnings and phase in slowly over an extended income range. Alternatively, the child credit could begin to phase in at the income level at which the EITC begins to phase down, which is $13,090 in 2001. Under this latter approach, the credit would phase in at a 15 percent rate — that is, for each dollar earned above $13,090, the credit would rise 15 cents — until the credit reached a level of $1,000 per child. Under these approaches, the current complicated system that requires families with three or more children to undertake the calculations described above would be replaced by this new, simpler system. The result would be a child credit that more fully recognizes other taxes that low-income working families pay, that (especially in the second approach described here) would substantially reduce marginal tax rates on the families that face the highest marginal tax rates of
any families in the nation, and that would provide more support to low-income working families in raising their children.

Another alternative to expanding the child credit to more low-income families was proposed by Representative Connie Morella (R-MD) in testimony she submitted to the Ways and Means Committee on March 21. Rep. Morella proposed to make $500 of the child tax credit refundable for all low-income families with children (without regard to their earnings levels). She testified that this approach would lift more than one million children out of poverty. Under her proposal, every family with children in the country would benefit from the tax package. Providing a child tax credit to all children was a central element of the bipartisan National Commission on Children whose 1991 report was one of the earliest and most important calls for a child tax credit.

Any such expansions in the child credit and EITC marriage penalty relief should not, however, make the tax package more expensive but should be accompanied by provisions scaling back the cost of the overall package. The tax package already is far more costly than is fiscally prudent. The most expensive parts of the package are the reductions in rates in the brackets above the 15 percent bracket and the elimination of the tax on large estates. Reducing the rates above the 15 percent rate would benefit only the top quarter of taxpayers, while reducing the 31 percent, 36 percent, and 39.6 percent rates would benefit only the top five percent of taxpayers. Estate tax repeal would benefit only the estates of the wealthiest two percent of individuals who die; all other estates already are exempt from taxation. These provisions could be scaled back substantially without diminishing the tax cuts for most middle-income taxpayers. For example, family farms and small business could be provided with substantial estate tax relief at a fraction of the cost of eliminating the estate tax.

**Conclusion**

The tax package contains such big tax cuts for those at the top of the income spectrum that the welcome changes in the House-passed bill that extend some support to low- and moderate-income families with children make little difference to the tax package’s overall distribution. The House legislation also falls well short of providing appropriate tax relief to many low-income families, whether it is families that face large marriage penalties, families that face high marginal tax rates, or families that are trying to work their way out of poverty and could benefit considerably from an increase in their after-tax income. Finally, H.R. 6 threatens to increase further the price tag of the total tax package and, in combination with the other tax bills, to push it well above the $1.6 trillion figure.

The first steps forward that the bill takes for low- and moderate-income families need to be followed by other steps, which should be offset by scaling back the tax cuts that would be conferred on the nation’s wealthiest residents. Even if the tax cuts those individuals receive are scaled back substantially, they still would receive quite sizable tax reductions from the tax package.