

ISABEL SAWHILL AND ADAM THOMAS

# *A Tax Proposal for Working Families with Children*

## **Executive Summary**

How much and where to cut taxes was hotly debated during the 2000 presidential campaign. This debate is likely to continue as the 107th Congress considers the President's across-the-board tax cut proposal and alternatives to it. In this brief, we suggest a tax proposal that builds on one of President Bush's key ideas - an expanded tax credit for families with children - but modifies it in ways that might prove more acceptable to Democrats. Our analysis shows that it is possible to provide significant and broad-based tax relief to families with children in a way that is more progressive than the President's plan and that encourages work and marriage, thereby reducing the toll on the road to the middle class. The cost of the proposal is roughly \$400 billion over 10 years, leaving room for other tax measures to be added to the package or for some portion of projected surpluses to be used for debt reduction. Whether this idea or others will find a receptive audience in the new Administration or the new Congress remains to be seen.

One of the closest and most contentious presidential elections—and one of the slimmest congressional margins—in American history has left many skeptical as to whether there is any real prospect for constructive dialogue in Washington. These divisions could serve to heighten the level of partisanship and lead to legislative gridlock. Many observers, however, remain optimistic that President Bush and the new Congress will work together to develop an agenda that occupies the middle ground.

In the search for that middle ground, many ideas will likely bid for attention. After describing President Bush's tax plan and some earlier Democratic proposals designed to improve the economic fortunes of families raising children, we attempt to meld the two into a proposal that borrows something from both. In brief, this proposal builds on the President's plan to double the child tax credit

from \$500 to \$1,000 per child. But, in deference to Democratic concerns about fairness, it allows those with limited incomes—and thus limited tax liabilities against which to claim the credits—to receive some benefits as well.

Making tax credits refundable is controversial. Many Republicans, in particular, are likely to label it as social welfare by another name. Democrats will point out that, without some refundability, income tax cuts do little to help many Americans. For example, a two-parent family with three children will not benefit fully from President Bush's child tax credit until its income exceeds \$42,000. Moreover, almost a third of families with children would be completely unaffected by the child tax credit expansion. The only way to help such families is to reduce payroll taxes or to provide refundable credits. As Congress considers a tax cut this year, we expect these issues to be vigorously



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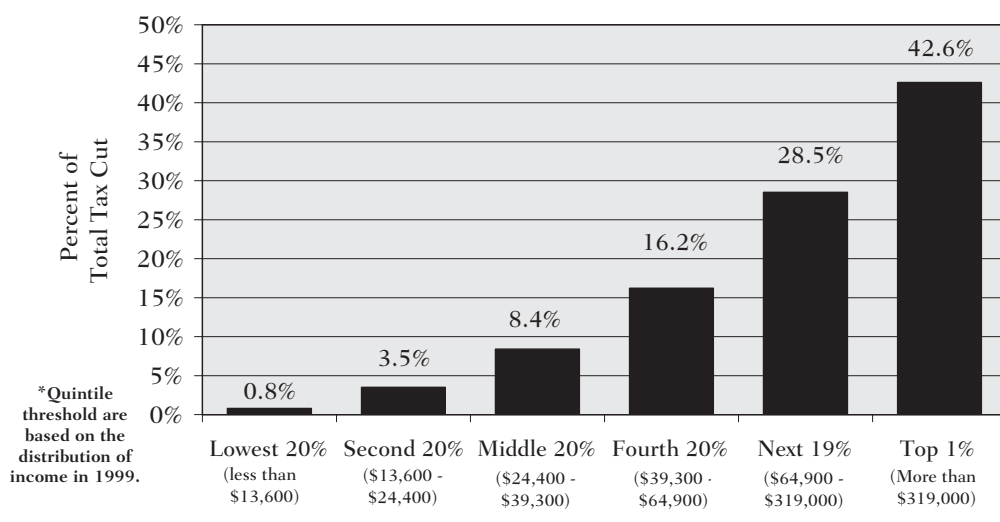


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**Chart 1: The Distribution of Benefits Under the Bush Tax Plan**



Source: Authors' tabulations of data from *Citizens for Tax Justice*, August 2000.

debated. This brief provides some background for the debate, including an analysis of the overall costs and distributional implications of several possible proposals.

### President Bush's Plan

During his campaign, President Bush promised that, if elected, he would place an ambitious tax-cut package at the top of his list. Among the most important facets of the Bush tax plan are a reduction in marginal income tax rates, an expansion of the child tax credit (CTC), a repeal of the estate tax, and the partial alleviation of marriage penalties in the tax code. The Bush plan would cost about \$1.6 trillion dollars over 10 years.

President Bush has said that his tax package would help to "take down the tollbooth on the road to the middle class" by reducing marginal tax rates for low-income workers. He points out, for instance, that a single mother with two children earning \$22,000 a year would have all of her federal income tax burden relieved under his plan. Critics respond that the family in question would owe less than \$100 in income taxes in the first place, and that the substantial majority of the tax savings under the Bush plan would go not to low-income families, but to those who are already

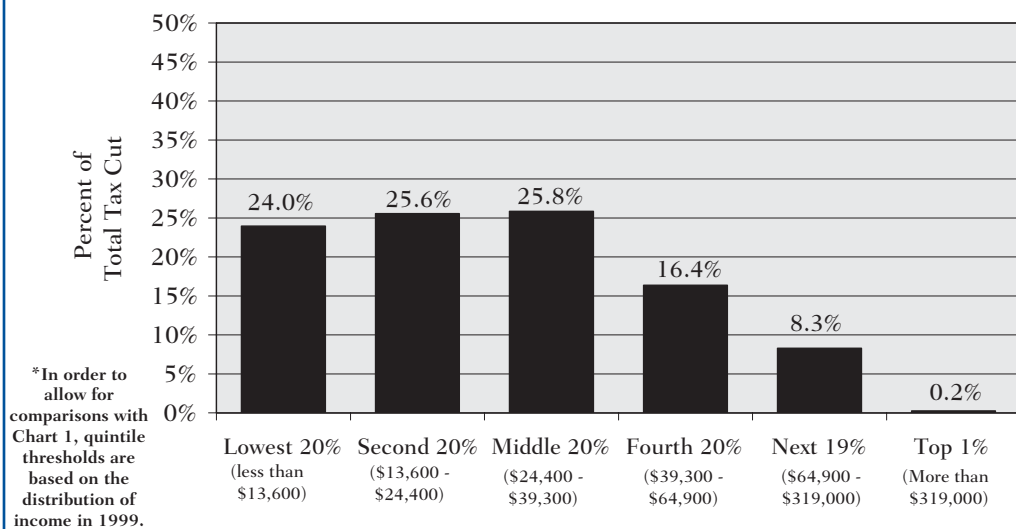
among the most well-off. Indeed, Chart 1 shows that more than 70 percent of the Bush tax cuts would go to the wealthiest 20 percent of taxpayers, and that more than 40 percent of the cuts would go to the wealthiest one percent.

President Bush and his supporters suggest that it is only fitting that the bulk of tax relief go to those who make the most money, since these are the taxpayers who bear a disproportionate share of the income tax burden. However meritorious, this argument will do little to convince Democrats to support such an initiative. Indeed, although his tax proposals are supported by many Republicans in both the House and Senate, some observers believe that only the less contentious aspects of his tax plan—such as marriage penalty relief and a reduction in the estate tax—are likely to receive broad bipartisan support.

### Democratic Priorities

Many Democrats have a different agenda in mind: one focused on providing more help to low- and moderate-income families. Their priorities are best understood by reviewing a number of earlier proposals put forward by party leaders. Although there is little chance that these ideas will be enacted as originally

**Chart 2: The Distribution of Benefits Under a Possible Democratic Proposal**



Source: *The Brookings Institution* (January 2001). Distributional estimates are based on analyses of the 1999 Current Population Survey, which contains data on respondents' income in 1998.

proposed in the current political environment, they could become part of a compromise package and are, in any case, a useful backdrop for understanding the debate.

Former president Clinton made several proposals during his last two years in office that have been taken up by congressional Democrats and were supported by Vice President Gore during his campaign. Three of the most important proposals in terms of their ability to help lower-income working families with children are expansions in the Earned Income Tax Credit (EITC) and the Dependent Care Tax Credit (DCTC) and a \$1.00 increase in the minimum wage. The EITC is a refundable credit for low-income working families. Benefits under this program total around \$30 billion a year. Democrats proposed to expand the credit by providing larger benefits to families with three or more children (current law provides maximum benefits of up to \$4,000 a year to families with *two* or more children).

The DCTC provides a very modest tax offset to families that pay out-of-pocket child care expenses. Under current law, DCTC benefits are capped at \$720 a year for one-child families and at \$1,440 for families with

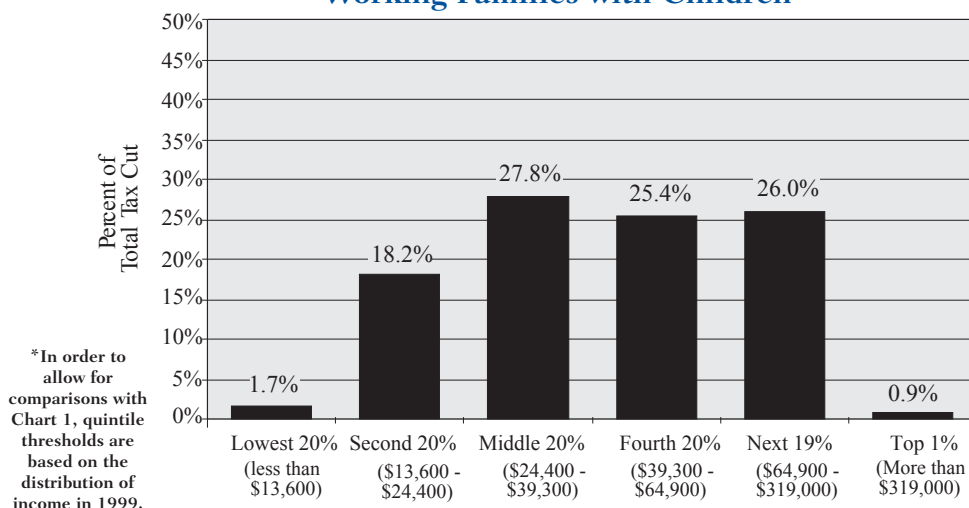
two or more children. Unlike the EITC, it is not refundable, which means that a family only receives the credit if it owes income taxes. For these reasons, some Democrats have suggested that the DCTC be expanded and made refundable in order to provide larger benefits (as much as \$2,400) to working families with modest levels of income (\$60,000 or less).

Many Republicans argue that tax cuts should be reserved for those who pay taxes. They further note that expanding the DCTC favors mothers who work over those who do not. Their preferred strategy is a tax credit that goes to all families with children, not just to working mothers.

We estimate that this hypothetical Democratic package of DCTC and EITC expansions would cost the government about \$6 billion a year. Chart 2 shows the distribution of benefits from such a package. Twenty-four percent of benefits would go to the bottom 20% of families, whereas only 8.5% would go to those in the top 20%.

Some of these initiatives are more likely than others to see political daylight in the new Congress. A minimum wage increase appeared imminent last year until the tax bill to which

**Chart 3: The Distribution of Benefits Under the Proposed Tax Cut for Working Families with Children**



Source: *The Brookings Institution* (January 2001). Distributional estimates are based on analyses of the 1999 Current Population Survey, which contains data on respondents' income in 1998.

it was attached fell apart in the wake of the presidential election. Supporters are holding out hope that they will be more successful in the 107th Congress. Although President Bush has talked about the need to help low-income families, and even went so far as to criticize members of his own party when they tried to cut back the existing EITC last year, neither he nor the Republican congressional leadership has indicated much support for expanding the EITC or the DCTC.

### A New Proposal

Perhaps the most effective sound bite used by either candidate during the presidential campaign was George W. Bush's promise to "end the bitterness in Washington." That promise is now being put to the test as he begins to forge relationships with a narrowly-divided Congress and seeks to enact his agenda. At this writing, both parties seem poised to support a large tax cut, although Democrats prefer one about half as large as the President's. The package will almost certainly include some estate tax relief, a reduction in the marriage penalty, and perhaps some rate cuts, especially for those in the bottom tax bracket. Other reforms may well be added to this mix.

What follows is a discussion of a proposal that might become at least one part of a larger tax package. It provides tax relief to almost all working families with children. Its benefits are broadly distributed, but most of them go to the middle class. It rewards work and marriage. And it is fiscally disciplined, adding only about \$14 billion per year to the cost of the President's original child tax credit proposal. The core of the plan is a more generous child tax credit similar to the one that President Bush has proposed, but it extends these benefits to lower-middle-income families by making the credit partially refundable. It also includes an extension of the EITC that is designed to encourage work and marriage among lower income families with children. The details of the proposal can be found in Table 1.

In the remainder of this brief, we discuss the distribution of tax benefits under this proposal, its cost, and the reasons it can be expected to encourage work and marriage.

### Who Would Benefit?

This proposal would provide substantial benefits to lower-middle-income and middle-class families. Chart 3 shows that more than 70 percent of the benefits would go to

## Table 1: Summary of the Proposed Tax Cut for Working Families with Children

- **CTC Expansion and Refundability:** We adopt President Bush's proposal to double the Child Tax Credit by providing families with \$1,000—rather than \$500—per child. We also make the credit partially refundable for families who do not earn enough to owe taxes, but whose annual earnings are at least high enough to correspond with full-time, minimum-wage work. We take full-time employment to be defined as working 30 hours a week, 50 weeks a year. At an hourly wage rate of \$5.15, this works out to a little less than \$8,000 annually. We therefore use a phase-in threshold of \$8,000. Beginning at this threshold level, we phase in benefits at a rate of 15% of earnings until they reach a maximum of \$1,000 per child. Thus, a two-child family earning \$19,000 a year receives a credit of \$1,650 [ $.15 \times (\$19,000 - \$8,000)$ ]. This particular structure was chosen because it encourages full-time work, helps to offset the high marginal tax rates associated with the loss of means-tested benefits in this income range, and merges smoothly with the bottom rate of the income tax system. We also maintain the credit's current phase-out thresholds (\$110,000 for two parents filing jointly), rather than raising them to \$200,000, as President Bush has proposed.
- **EITC Plateau Extension:** We make two changes to Earned Income Tax Credit benefits for families with children. First, we begin phasing out EITC benefits \$3,000 “later” than is the case under current law. Thus, while benefits currently begin to be phased out at an income level of \$13,090 for families with children, we do not begin the phase-out until a family reaches \$16,090 in income. Second, we raise these phase-out thresholds by an additional \$5,000 for two-parent families with children.

families in the middle three-fifths of the income distribution, those with annual incomes between \$14,000 and \$65,000. A considerable proportion (almost 27 percent) would also flow to families in the top 20 percent. Only about one percent of benefits would go to the wealthiest one percent of the population. In addition to providing most of its benefits to the middle class rather than to the wealthy, our initiative would lift almost 2 million people out of poverty.

The biggest benefits would go to the lower-middle class. As indicated in Table 2, a two-parent family with two children making \$24,000 a year would receive an extra \$3,517 relative to both current law and the Bush plan. But, as the table shows, almost everyone gains. Even families with \$100,000 of income would be better off than they are now.

### How Much Would It Cost?

We estimate that this proposal would cost roughly \$35 billion per year (see Table 3 for

additional cost information). Most of the cost of this proposal—about \$21 billion—reflects the cost of President Bush's original proposal to double the CTC. Making the credit partially refundable would add about another \$7 billion a year. And reducing the disincentives to work and marry associated with the EITC adds about \$7 billion annually. Our cost estimates are rough and would need to be refined by using the more sophisticated models employed by the Treasury Department or the congressional Joint Committee on Taxation.

### Encouraging Work and Marriage

In addition to providing a substantial amount of assistance to low-income families, our proposal has a number of other attractive features. First, it would encourage work by linking benefits to earnings. Second, it would encourage people to move up the economic ladder through work or marriage by reducing marginal tax rates for those who now pay a steep toll to enter the middle class. And



**Table 2: Net Income Tax Burdens Under Current Law, the Bush Plan, and the New Proposal\***

	Single-parent family with one child and an income of \$10,000	Two-parent family with two children and an income of \$24,000	Single-parent family with one child and an income of \$40,000	Two-parent family with two children and an income of \$100,000
<b>Current Law</b>	\$ (2,427)	\$ (1,710)	\$ 3,153	\$ 14,788
<b>Bush Plan</b>	\$ (2,427)	\$ (1,710)	\$ 2,153	\$ 12,120
<b>New Proposal</b>	\$ (2,727)	\$ (5,227)	\$ 2,653	\$ 13,788

*\*All figures are calculated using 2001 tax parameters, and assume that families utilize the standard deduction rather than itemizing. An assumption is also made that child care expenses equal 10% of family income, and that income is comprised entirely of earnings. This table shows the net effect of the federal income tax, the Dependent Care Tax Credit, the Earned Income Tax Credit, and the Child Tax Credit. Numbers in parentheses represent refundable bonuses.*

third, it would further encourage marriage by explicitly reducing the very large marriage penalties that currently exist in the EITC.

As far as encouraging work is concerned, our earlier research—reported in “A Hand Up for the Bottom Third” (available at [www.brookings.edu/wrb](http://www.brookings.edu/wrb))—shows that the heads of poor families work only half as many hours per year, on average, as those who are not poor, and that encouraging work is a highly effective strategy for reducing poverty. In fact, if the heads of poor families worked as much as nonpoor heads, the poverty rate would be cut in half. Other researchers have shown that conditioning government benefits on work, as is done in the case of the EITC, has led to large increases in the employment rates of low-income single mothers. And conditioning such assistance on *full-time* work—as has been done in several demonstration programs—has even greater effects. Since the tax credits contained in this proposal are limited to families with earnings, and most of them to families with a full-time worker, they can be expected to further boost employment, and partially pay for themselves

as government revenues increase and benefit payments fall in response to higher earnings. (These offsets to the costs of the programs are not calculated here, but we believe they would be significant.)

In addition, the phase-in of the CTC could help to reduce the staggeringly high marginal tax rates often faced by low-income families. These high rates exist because many government benefits, such as the EITC, DCTC and food stamps, phase out as families earn more income. In combination with income and payroll taxes, families making between \$10,000 and \$30,000 in income may face an overall marginal tax rate of 70 percent or more. As the President has argued, these high marginal tax rates are the toll that low-income families must pay if they want to join the middle class.

A refundable CTC would substantially mitigate this problem. If, as we have proposed, benefits were limited to a certain percentage of earnings in the range where other benefits phase out, many families would gradually accrue CTC benefits over this same range, helping to offset their high marginal tax rates.

In addition to encouraging work, our proposal would also encourage marriage. Many low-income couples lose a substantial amount of EITC benefits when they get married, since the addition of a second earner to the family often causes a working mother to lose eligibility for the credit. One of the simplest and most cost-effective ways of reducing this penalty is by phasing out benefits for two-parent families at a higher income level than for single-parent families. Although proposals along these lines were introduced in the 106th Congress, the relief provided by them was modest. We suggest some stronger medicine, specifically raising the income level at which benefits begin to be phased out for two-parent families by \$5,000 (in addition to our proposed \$3,000 increase

in the phase-out point for *all* families with children, regardless of marital status). Under this proposal, then, the EITC phase-out point for two-parent families would be raised from \$13,090 to \$21,090 in 2001.

The arguments for reducing the EITC's marriage penalty are strong. Although there isn't much evidence that these penalties have had an impact on marriage rates in low-income communities, they are much larger as a percentage of income, and are therefore much more likely to matter at this income level, than among more affluent families. And changing the law in this way sends a message that society recognizes the value of raising children in two-parent, married families.

*The views expressed in this Welfare Reform & Beyond Policy Brief are those of the authors and are not necessarily those of the trustees, officers, or other staff members of the Brookings Institution.*

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**Table 3: Estimated Ten-Year Costs of the Bush Plan, a Possible Democratic Initiative, and the New Proposal**

<b>The Bush Plan</b>	\$1.6 trillion
<b>The Democratic Proposal</b>	\$72 billion
<b>The New Proposal</b>	\$394 billion

*Source: The Brookings Institution, based on an analysis of the 1999 Current Population Survey with costs adjusted for inflation.*

## Conclusion

This proposal is just one of many that could become part of an overall plan that a majority in the Congress as well as the White House could support in the current political environment. We suggest it as just one example of numerous ideas that should be considered before any legislation is enacted. Many of the details could be modified, and we recognize that compromise on the size and structure of an overall package will be inevitable. However, we believe that a modest tax cut is preferable to either legislative gridlock or a bidding war between the parties that throws fiscal caution to the wind.



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