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**MEMORANDUM**

**TO:** CONGRESSMAN CHARLES B. RANGEL AND  
CONGRESSMAN HENRY A. WAXMAN

**FROM:** LEONARD E. BURMAN, URBAN INSTITUTE  
JOHN KARL SCHOLZ, UNIVERSITY OF WISCONSIN – MADISON<sup>1</sup>

**SUBJECT:** Should the refundability threshold for the child tax credit be indexed for inflation?

This memorandum responds to your letter of September 14 requesting our analysis of the effects of indexing the threshold for refundability of the child tax credit on low-income working families.<sup>2</sup> We estimate that in 2005 over 4 million families will be affected by this provision, which reduces the value of the credit for many low-income households. We conclude that, in this case, indexation does not remove the effects of inflation from the tax system, as intended. Instead, for many low-income families whose earnings have not kept pace with inflation, the provision actually magnifies the damage done by inflation. We consider several policy options that could reduce or eliminate the perverse interaction between inflation, stagnant wages, and the child tax credit.

**Child credit rules**

Under current law, families with children under the age of 17 may claim a tax credit of \$1,000 per child against their federal income tax. The credit phases out for high-income households—those with adjusted gross incomes over \$110,000 for married couples and \$75,000 for singles and heads of household. Certain low-income households may claim a refundable child tax credit—that is, a refund in excess of tax liability--of up to 10 percent of earnings over a certain threshold. The threshold, which was originally set at \$10,000 in 2001, is indexed for inflation. The current threshold is \$10,750. In 2005, the refundability rate is set to increase to 15 percent, while the credit per child drops to \$700 under the phase-in schedule set in place in 2001.

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<sup>2</sup> The views expressed in this memo are ours alone and should not be attributed to any of the institutions with which we are affiliated.

The credit will gradually increase to \$1,000 in 2010, but fall to \$500 in 2011 and the refundability provision will also expire with the expiration of the 2001 legislation that implemented those provisions. Neither the credit itself, nor the income at which it phases out, is indexed for inflation.

### **Inflation and the tax system**

In general, we believe that indexing the parameters of the tax system is a good idea whenever practical. Households should not face higher effective tax rates simply because inflation increased the nominal value of income. Indexing the *phase-in* threshold for the child tax credit, however, does not make the credit neutral with respect to inflation, and it harms those whose earnings fail to keep up with inflation. The main impetus for indexation is to eliminate bracket creep—the phenomenon whereby taxpayers’ liability increases in real terms when inflation pushes up price levels. In every other case we are aware of, indexation reduces tax liability or increases tax credits to avoid this phenomenon. In the case of the child tax credit, however, indexation actually *reduces* the value of the credit for those with earnings in the phase-in range. If the household’s earnings keep up with inflation, their *real* credit will not decline, but many low-income households’ earnings have not kept up with inflation during the recent recession.

### **Indexing of the child tax credit has resulted in substantial tax increases on working families with children**

The minimum wage is not indexed for inflation, and has not increased since 1997. Currently set at \$5.15 per hour, a single parent working full time at the minimum wage would not qualify for the refundable child tax credit, because her annual earnings of \$10,300 is below the phase-in threshold. (Note that this was not true in 2001 when the \$10,000 threshold was put in place.) A married couple, both working full time at the minimum wage, with two children would qualify for a child credit refund—of up to \$1,010 in 2003. But that is lower than the credit they would have received in 2001, assuming the same amount of earnings. In 2001, when the threshold was \$10,000, their income of \$20,600 would have qualified them for a credit of \$1,060, five percent more than in 2003. In real terms, the value of their credit has declined by almost 10 percent, at the same time that the value of their minimum wage earnings had fallen by 5 percent in real terms. In other words, the indexation of the child tax credit threshold for inflation has the perverse effect of reducing the real child tax credit for low-income working families at the same time their real earnings fell.

The example using hypothetical families earning the minimum wage illustrates the potential problem that arises with child credit indexing. But assessing whether this is indeed a serious policy problem requires us to examine data on the earnings of low-skilled workers in recent years. The best data for making this assessment come from the Survey of Income and Program Participation (SIPP) – a data set that follows the incomes of roughly 40,000 families over time in the last few years.

Data from the 2001 SIPP indicate that the typical household headed by someone with less than a high school diploma actually saw their earnings decline in nominal terms (that is, before adjusting for inflation) between 2001 and 2003.<sup>3</sup> The typical married couple's earnings fell by 0.6 percent. The typical (or median) single parent's earnings declined by 4 percent! That household saw a decline in earnings from an annual rate of \$11,088 in early 2001 to \$10,080 two years later. Based on those annualized earnings, that single parent could have claimed a child tax credit of about \$109 in 2001, but nothing in 2003—at the same time that her earnings had fallen.

The Tax Policy Center estimates that 4.4 million households will receive a smaller tax credit (or none at all) in 2005 because of indexation of the threshold.

## **Policy Options**

The only way to make the credit completely neutral with respect to inflation would be to make it fully refundable—that is available in full to any household regardless of tax liability, index the credit amount for inflation, and also index the phase-out threshold. But making the credit fully refundable might make the tax system more difficult to administer or be too expensive. A second-best option might be to reduce the threshold for refundability to zero. This would still allow the credit to decline in real terms when a household's earnings did not keep up with inflation, but the stagnation would be no faster than the decline in real earnings. This option, too might be undesirable because of its cost or because the current phase-in has the effect of mitigating some of the high marginal tax rates that affect lower-income households, particularly due to the phase-out of the earned income tax credit.

A less expensive option that would mitigate some of the unintended tax increases on low-income working families would be to restore the nominal threshold for child credit refundability to \$10,000.

Finally, increasing the refundability rate from 10 percent to 15 percent, as will occur starting in 2005, will help many low-income households, but it will do little to help those with the lowest incomes (the single-parent SIPP family would still receive no tax credit unless her earnings increased above the threshold). Moreover, the higher phase-in rate will do nothing to abate the underlying problem that arises from stagnant income growth at the bottom of the earnings distribution. Low-income households with earnings that grow slower than inflation will see their child tax credit erode in real terms every year, and at a rate that is even faster than their decline in real earnings.

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<sup>3</sup> To ensure the analysis is not affected by changes in fertility or marital status, we limited the sample to parents with at least one child under the age of 18—that is, potentially eligible for the tax credit—with no change in marital status and no childbirths over the two years.