Changes in Refundable Tax Credits

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Key Findings

- Refundable tax credits add complexity to the tax code while favoring certain kinds of economic activity over others.

- For the year 2011, the IRS paid out $99.1 billion in refundable tax credits, down from a peak of over $120 billion in 2009.

- For comparison, the federal government spends more on refundable tax credits than it spends on the Department of Veterans Affairs ($63.5 billion) or the Department of Education ($71.2 billion).

- The largest refundable credits currently are the Earned Income Tax Credit, at $65 billion annually, and the Additional Child Tax Credit, at $30 billion annually.

- In the coming years, the dollar amount of refundable tax credits is projected to double due to the insurance subsidies in the Patient Protection and Affordable Care Act, which both the CBO and the JCT projects to cost about $100 billion annually by 2017.

- As the ACA subsidies come online, the total expenditures associated with refundable tax credits are projected to surpass $200 billion annually.

- The phaseout of refundable tax credits as income increases creates high implicit marginal tax rates, and, in some cases, can create infinite marginal tax rates.
Introduction

Tax credits are a form of tax expenditure in which a taxpayer can offset her tax liabilities in order to reduce them. Refundable tax credits differ from ordinary tax credits in that they can be used to generate a federal tax refund larger than the amount of money a taxpayer has paid throughout the year. In other words, they create the possibility of a negative federal tax liability, where a taxpayer receives a transfer from the government.

Refundable tax credits have become more and more significant over the last decade. This paper will track the way these tax credits have changed over time and the impact of recent legislation.

The largest refundable credits currently are the Earned Income Tax Credit and the Additional Child Tax Credit. They are given to eligible taxpayers who have income below specified thresholds. For both of these credits, the amount of the credit is based on income, filing status, and the number of qualifying children.

In the coming years, the dollar amount of refundable tax credits is projected to increase due to the insurance subsidies in the Patient Protection and Affordable Care Act (also known as Obamacare).

Stimulus Credits Extended

Several changes to refundable tax credits came with the American Recovery and Reinvestment Act of 2009 (ARRA), colloquially known as the stimulus bill. These tax changes were initially passed as temporary fiscal stimulus for years 2009 and 2010 only. However, they were extended through 2012 by the Tax Relief and Job Creation Act of 2010. They were then extended a second time, this time for five years, via the American Taxpayer Relief Act of 2012, which was passed in early January of 2013.

The extended ARRA changes are as follows:

• The Earned Income Tax Credit (EITC) was given a new category for families with three or more children. (Prior to 2008, all families with two or more children were treated alike.) The EITC's phaseout was also increased by $5,000 for married couples filing jointly, reducing the marriage penalty for families with two working adults. This $5,000 difference was indexed to inflation and has crawled upwards to $5,340.¹

• The minimum earned income required to qualify for the Additional Child Tax Credit was changed to $3,000. Before ARRA, this amount was set to rise to $12,550.² This change both increases the number of taxpayers eligible for the credit and increases the amount they may receive.

• The American Opportunity Tax Credit was a new refundable credit built into ARRA. It gives qualifying taxpayers up to a $2,500 credit for qualifying education expenses. It was one of the fastest growing tax credits between 2010 and 2011, and by 2011, its refundable portion represented $6.57 billion in outlays.³

Growth in Refundable Tax Credits

Refundable tax credit payments nearly doubled from 2006 to 2009 as a result of the new credits from ARRA. As some of them—such as the Making Work Pay Credit—expired, the amount of refundable tax credit payments began to decline again. For the year 2011, the IRS paid out $99.1 billion in refundable tax credits, with the majority coming from the EITC. This level is still elevated substantially from the pre-stimulus trend, largely due to the extension of the expanded EITC, the Additional Child Tax Credit, and the American Opportunity Tax Credit, as enumerated above.

For comparison, the federal government spends more on refundable tax credits than it spends on the departments of veterans affairs or education. For example, the White House’s 2014 budget allots $63.5 billion and $71.2 billion to those departments, respectively.⁴

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Patient Protection and Affordable Care Act

The big upcoming change in refundable tax credits comes from the Patient Protection and Affordable Care Act (ACA), which introduced a new form of transfer payment through the IRS—subsidies for its insurance exchanges. The purpose of the subsidies is to limit the percentage of income that taxpayers spend on healthcare purchased through the individual exchanges.

A unique feature of this credit is that individuals and families are able to apply for it when they sign up for insurance. The IRS will calculate the subsidy amount and send it directly to the insurance company. The taxpayer will then pay the remainder of the premium. There is an obvious issue with this system; the taxpayer has to estimate his or her income for the year before the year is over. This is likely to be especially challenging to those taxpayers who have uncertain income streams from multiple temporary jobs.

If the payments during the year turn out to be incorrect—for example, if a taxpayer underestimates his or her income—then the IRS will have to claw back the overpayment on the tax return by requiring repayment. These repayments, however, will be capped for taxpayers with income below 400 percent of the federal poverty level (FPL). For example, the most a family of four at 250 percent of the FPL can be asked to repay is $1,500, even if the amount of overpayment on the family’s behalf was above $1,500. This “repayment cap” effectively encourages taxpayers to underestimate their income in order to get larger subsidies.

The system described above comes with obvious drawbacks but is not the only option for taxpayers. The traditional route for delivering refundable tax credits remains available for eligible taxpayers—those with income below 400 percent of the poverty line—who choose to pay their premiums in full. They will then be able to claim the subsidy amount on their tax returns instead.
By the Joint Committee on Taxation’s February 2013 estimate, these subsidies will quickly approach $96 billion in spending by 2017. The CBO has an even higher projection of $118 billion in its most recent economic outlook. Below is a projection of how the largest refundable tax credits are expected to grow under current law using the more conservative estimates from JCT.

The number could rise even faster than expected with the recent delays of the employer mandate. Employers of low-wage workers, absent a mandate, will find it sensible to shift those workers onto the exchanges so that the workers can receive the subsidies.

**Overpayments**

Overpayments are an issue with refundable tax credits. The eligibilities and formulas for refundable tax credits are complex enough that the benefit payments are often inaccurate. The CBO’s January 2013 report on refundable tax credits cites an overpayment rate of 25 percent for the EITC and explains that

overpayments are generally higher for refundable tax credits than for subsidies operated through spending programs, primarily because the Internal Revenue Service (IRS) cannot verify that applicants meet all eligibility requirements before benefits are paid. However, additional verification steps raise the administrative and compliance costs of spending programs relative to those of the tax system.

In total, the improper payments on the EITC exceed $11 billion per year. Given the complexity of the insurance subsidies in the ACA, and the fact that they are paid in advance, we should expect overpayment to continue to be an issue in the future.

**Subsidies’ Effects on Implicit Marginal Rates**

The subsidies phase out as income increases, creating higher implicit marginal tax rates on eligible taxpayers and a potentially infinite marginal tax rate at 400 percent of the FPL. The former is a well-known tradeoff associated with means-tested benefits. The latter—an infinite marginal tax rate—is simply poor policy.

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7 The years prior to 2012 come from the IRS Statistics of Income data. The data from 2012 on comes from the estimates by the JCT.
10 An implicit marginal tax rate is the cost of earning an additional dollar of income when considering all factors, including transfer payments such as the EITC, SNAP, housing assistance, etc.
The exchange subsidies are based on three variables: the FPL, the filer’s income, and the price of the second cheapest Silver plan in the filer’s area.\footnote{The ACA classifies insurance plans as Bronze, Silver, Gold, Platinum, and Catastrophic based on the quality of the plan. See HealthCare.gov, \textit{How do I choose Marketplace insurance?}, https://www.healthcare.gov/how-do-i-choose-marketplace-insurance/.} The “cap” ensures that—if the filer were to purchase the second cheapest Silver plan—he or she would spend no more than that percentage of his income on the plan (see Table 1).

Table 1. Exchange Subsidies Insurance Price Cap as a Percentage of Income

<table>
<thead>
<tr>
<th>Income (as percentage of federal poverty level)</th>
<th>Insurance Price Cap (as percentage of income)</th>
</tr>
</thead>
<tbody>
<tr>
<td>100-133%</td>
<td>2%</td>
</tr>
<tr>
<td>133-150%</td>
<td>3-4%</td>
</tr>
<tr>
<td>150-200%</td>
<td>4-6.3%</td>
</tr>
<tr>
<td>200-250%</td>
<td>6.3-8.05%</td>
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<tr>
<td>250-300%</td>
<td>8.05-9.5%</td>
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<tr>
<td>300-400%</td>
<td>9.5%</td>
</tr>
<tr>
<td>400% or more</td>
<td>No cap</td>
</tr>
</tbody>
</table>

As income rises, the cap increases as a percentage of income. For example, a single individual at 100% of the FPL ($11,490) would only pay $19.15 per month for the silver plan, while a single individual earning three times as much could pay up to $272.89 per month before receiving any subsidy. The increased out-of-pocket costs represent an increase in implicit marginal tax rates. The CBO Budget and Economic Outlook report estimated that this would have large adverse effects on labor supply. In total, workers would cut back their hours, reducing aggregate compensation by about 1 percent in total over what would have occurred in the absence of the ACA.\footnote{Congressional Budget Office, \textit{Budget and Economic Outlook 2014 to 2024}, http://www.cbo.gov/publication/45010.}

The infinite marginal tax rate arises when people lose eligibility for the insurance cap at 400 percent of the FPL. Consider a middle-aged married couple earning $62,040, 400 percent of the FPL for a two-person household ($15,510.) If the second cheapest Silver plan in their area costs $1,200 per month, they would receive a subsidy of $8,506 in order to cap that plan’s price at 9.5 percent of their income. However, if they earned $62,041—only a dollar more—the entire subsidy would evaporate. This constitutes an infinite marginal rate, a hallmark of poor policy.

Implicit marginal tax rates are not unique to the ACA. Almost all refundable tax rates create high implicit marginal tax rates for taxpayers who benefit from them.
Conclusion

The primary purpose of the Internal Revenue Service is to collect revenue. Refundable tax credits represent a form of mission creep, in which the IRS dispenses revenue instead of collecting it. Recent acts of Congress, particularly ARRA and the ACA, have dramatically increased the scope and breadth of these credits. As the ACA subsidies come online, the total expenditures associated with refundable tax credits will surpass $200 billion.

Refundable credits add complexity to the tax code and favor certain kinds of economic activity over others. Both of these characteristics are faults to be avoided. The IRS should not capriciously dole out payments based on people's personal decisions. Instead, it would be best to move the functions of refundable tax credits outside the tax code to spending programs.