

Fiscal Fact

Case Study #9: The Child Tax Credit

By

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These results are part of an eleven-part series, *The Economics of the Blank Slate*, created to discuss the economic effects of repealing various individual tax expenditures. In these reports, Tax Foundation economists use our macroeconomic model to answer two questions lawmakers are considering:

1. What effect does eliminating these expenditures have on GDP, jobs, and federal revenue?
2. What would be the effect on GDP, jobs, and federal revenue if the static savings were used to finance tax cuts on a revenue neutral basis?

Key Points:

Eliminating the Child Tax Credit would:

- Increase tax revenues by \$47 billion on a static basis;
- Increase GDP by \$14 billion; and
- Increase revenues by \$50 billion on a dynamic basis;
- Increase employment by the equivalent of approximately 110,000 full-time workers; and
- Produce little change in hourly wages.

Eliminating the Child Tax Credit and trading the static revenue gains for individual rate cuts would:

- Allow for an across-the-board rate cut of 4.8 percent;
- Increase GDP by \$90 billion per year; and
- Increase federal revenues by \$21 billion on a dynamic basis;
- Increase employment by the equivalent of approximately 536,000 full-time workers; and
- Increase hourly wages by 0.1 percent.

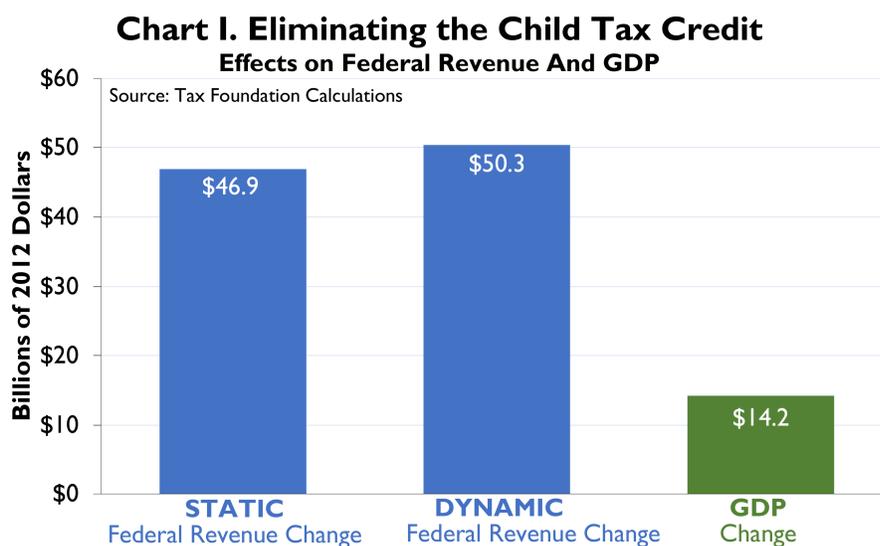
The Child Tax Credit was enacted in 1997 and in its current form provides a tax credit of \$1,000 for each eligible child under the age of seventeen. If the credit exceeds the filer's tax liability, it may be partially or entirely refundable depending on the filer's earned income. The credit lowers the marginal tax rate on very low incomes. In particular, at very low income levels, the credit may create a negative marginal tax rate of 15 points because each extra dollar of earned income makes 15 more cents of the credit eligible for refund. By contrast, the credit phases out at a 5 percent rate per eligible child over an adjusted gross income (AGI)

range of \$75,000-\$95,000 for single filers and heads of households (\$110,000-\$130,000 for joint filers). The phase-out produces a marginal tax rate spike of 5 percentage points for each eligible child. For instance, if a couple has two eligible children, their AGI is \$115,000, and their AGI rises to \$116,000, they will lose \$100 of the credit. That is an effective marginal tax rate of 10 points on top of what the couple's marginal rate would be otherwise.

The Joint Committee on Taxation classifies the Child Tax Credit as one of the larger tax expenditures, costing \$56.8 billion in 2012 including the refundable portion. When the Tax Foundation's model runs a conventional static revenue estimate that assumes taxes have no effect on growth, it estimates the added federal revenue from repealing the credit would be \$47 billion in 2012.

Eliminating the credit would have growth effects pulling in opposite directions, and the net effect is positive. Ending the phase-in of the refund would increase marginal tax rates for some filers with very low incomes. But abolishing the credit would end the income-based phase-out and would lower marginal tax rates for the many filers within the phase-out zone. Based on the taxpayer information in the IRS Public Use File, our dynamic model

estimates that the rate spike due to the phase-out is the dominant effect, and that labor and capital supplies would be slightly greater without the credit than with it. Our model predicts that eliminating the credit would raise GDP by \$14 billion and lift federal revenue by \$50 billion, which is slightly higher than the static estimate due to the positive growth feedback. (See Chart 1.)



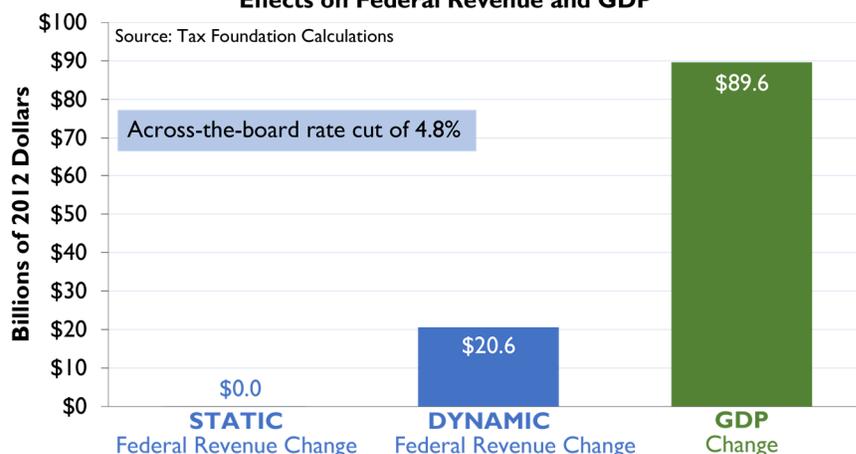
Suppose the assumed revenue gain is based on the conventional static estimate and used to pay for an across-the-board reduction in individual income tax rates.¹ As indicated in Chart 2, rates could be lowered 4.8 percent (for example, the 15 percent bracket would become 14.3 percent). The lower marginal rates and higher after-tax returns on labor and capital would lead to a larger economy and the positive economic feedback would offset some of the revenue cost of the tax reduction. The model

estimates that trading the Child Tax Credit for lower tax rates would boost GDP by a net \$90 billion and federal revenue by a net \$21 billion, once the economy had fully adjusted. The higher GDP and pre-tax incomes would partially offset the loss of the tax credit for low-income households, although the net effect would be less redistribution.

Growth is just one of the factors to consider when evaluating the Child Tax Credit and may not be among the main factors. Nevertheless, it should not be ignored.

Finally, we determined the impact of these scenarios on employment and wages. We found that eliminating the Child Tax Credit would increase employment by the equivalent of about 110,000 full-time workers with little change in the hourly wage. With the rate cut offset, employment would increase by the equivalent of about 536,000 full-time workers and hourly wages would rise by 0.1 percent.

Chart 2. Using the Static Revenue Gain from Eliminating the Child Tax Credit to Pay for an Across-the-Board Rate Cut
Effects on Federal Revenue and GDP



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About the Tax Foundation

The Tax Foundation is a 501(c)(3) non-partisan, non-profit research institution founded in 1937 to educate the public on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.

¹ We assume proportional cuts in all of the ordinary income tax bracket rates but no cuts in the lower tax rates on capital gains and qualified dividends.