ISSUE BRIEF

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Congress Should Be Cautious About Expanding the Child Tax Credit

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Members of Congress have renewed the discussion of increasing the Child Tax Credit (CTC) to help the beleaguered middle class. Their desire to help the middle class is laudable. The slow recovery and President Barack Obama's faulty economic policies have hit the middle class hard, but increasing the CTC is not the best way to deliver relief. The better approach would be tax reform that reduces disincentives to engage in economically productive activities.

Tax Reform Is the Best Way

Tax reform is vital to invigorating the sluggish economy. The current tax code stifles growth by creating strong disincentives against engaging in economically productive activities, such as working, saving, investing, and taking risk. As a result, the economy is growing more slowly than it should, and Americans, especially the middle class, have less economic opportunity.

The best way to reduce these disincentives is to reduce the high marginal tax rates that created them in the first place. Tax reform should reduce both individual income tax rates and the rates on businesses and investment.

The CTC is currently $1,000 per eligible child and refundable if the credit is greater than a taxpayer's tax liability. Taxpayers also received a $3,900 exemption per dependent. Increasing the credit would be a targeted tax cut that would put more money in the pockets of people who qualify for the expansion. However, it would not improve economic growth like rate reductions would because a CTC increase would not reduce those disincentives on productive activities.

Instead, it would greatly increase the number of tax filers that pay no federal income tax, which is already close to 50 percent. It would also greatly increase the number of taxpayers who receive cash payments from the IRS because the credit is refundable. Taxpayers who already receive refundable payments could see larger payments if the credit rose.

In contrast, tax reform would help the middle class without the downsides of expanding the CTC. Lowering marginal tax rates would increase productivity because it would lower the cost of capital, which would raise wages. Lower rates would increase the incentives for investors and businesses to take on risk, creating new jobs and opportunities for middle-class families to find better paying positions. Lower rates could also tip some families' decisions in favor of a second worker entering the workforce, if they choose, which could improve their financial well-being.

Assuming the increase of the CTC was a fixed amount, the enhanced benefit to the middle class is capped at that increase unless Congress expands it again. However, tax reform that unleashes the economy to grow at a higher potential would have no such ceiling on its benefits to the middle class. Better yet, incomes would likely grow much higher than with an increased CTC.

This paper, in its entirety, can be found at
http://report.heritage.org/ib4241

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Reducing the Tax Rates on Investment Is Key

In past tax reform efforts, lowering the individual income tax rate had the greatest impact on growth. For instance, from 1981 to 1986, the top tax rate fell from 70 percent to 28 percent, which was the main driver of the subsequent period of robust growth. Lowering the current 43.4 percent rate would certainly promote higher economic growth, especially because many businesses pay the individual rate.

However, unlike in the past, the strongest growth effects from modern tax reform would come from reducing taxes on businesses and investment because this is where the tax code is furthest out of step in the highly competitive global market. The tax rate on businesses is more than 39 percent when the average state tax rate is included. That is almost 15 percentage points higher than the 25 percent average rate of other major industrialized countries in the Organization for Economic Co-operation and Development (OECD). This high rate is negatively affecting investment, thereby destroying jobs and suppressing wages.

Double taxation further hampers investment. After businesses pay high tax rates on their earnings, investors pay another layer of tax on their capital gains and dividends. Those rates are 23.8 percent today. Accounting for both layers of taxation, the combined rate on investment is over 53 percent.

Reducing that combined rate by lowering the rate on businesses and reducing, or better yet eliminating, the rate on capital gains and dividends would positively affect economic growth, increase wages, and create new jobs.

Although the middle class would not perceive these hefty positive impacts in the same way as they would an increased CTC, they would greatly benefit from them nonetheless—and likely to a greater degree.

The Danger of Further Tying Payroll Taxes to Old-Age Benefits

Other than directly aiding the struggling middle class, the intellectual argument behind increasing the CTC is that old-age entitlement programs such as Social Security and Medicare reduce fertility because they reduce the need for children to care for parents in retirement.

This argument further holds that these programs need new workers to pay the payroll taxes that fund them. As a result parents pay twice compared with non-parents: once with their own payroll taxes and again for the cost of raising children who will become the future workers who will pay the cost of the programs.

According to this line of thinking, lowering payroll taxes on parents to reduce the cost of children makes sense. This would both neutralize the disincentive to have children[1] and equalize the cost of old-age programs between parents and non-parents. Increasing the CTC is a way to reduce payroll taxes for families who have no income tax liability because of its refundability.

However, perpetuating the link of payroll taxes to Social Security and Medicare benefits is dangerous. Both programs badly need reform to make them more affordable and effective. Otherwise, they will either necessitate massive, economy-crushing tax hikes or drive government debt to unsustainable levels.

One major hurdle to reform is the belief that workers pay for their entitlement benefits by paying taxes during their working years. In fact, current workers pay for current beneficiaries. Convincing the American people that the programs are not pay-in, get-out programs is a key to achieving long-overdue reforms.

Justifying an increase of the CTC on the grounds that it would reduce payroll taxes to offset the supposed extra cost that parents pay for the programs

1. Fertility has been declining in Western civilization since the Industrial Revolution for a myriad of reasons. The advent of entitlement programs in old age could be one of the many. The literature on its effect is scant at present. Yet, even if Social Security and Medicare do depress fertility, the degree of this effect will be incredibly difficult to determine in relation to all the other factors causing the decline. Assuming that reducing taxes will undo that negative effect is also problematic because little evidence suggests that people choose to have more children when governments attempt to reduce their costs. For example, many governments in Europe and Southeast Asia give generous payments to parents with children, yet fertility rates have remained low. For more information, see Jonathan V. Last, *What to Expect When No One's Expecting: America's Coming Demographic Disaster* (New York: Encounter Books, 2013).

would go in the opposite direction. It would *strengthen* the connection between payroll taxes and entitlements, making reform more difficult.

Keeping Focused on Tax Reform

Congress is slowly coming around to the idea that it should not use the tax code to alter the decisions of families, businesses, and investors. For instance, the appetite for creating new tax incentives for particular energy sources has dissipated significantly. This is a positive development because the tax code should raise the minimum amount of revenue necessary for the federal government to carry out its prescribed duties. Non-tax policy objectives should be achieved outside the code.

Increasing the CTC would run contrary to improving how Congress perceives taxes. Rather than stop this positive momentum, Congress should remain focused on tax reform that lowers marginal rates. It remains the best tax policy option for improving the prospects of middle-class families. Because the benefits of tax reform will be less obvious to the middle class than an expanded CTC, lawmakers and others will need to explain to the middle class the benefits of the wage increases and renewed opportunity that will come from pro-growth tax reform that lowered marginal tax rates.

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