Excerpts From:

Federal Tax Reform

A Family Perspective

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II. Analysis of Specific Tax Reform Provisions Affecting Children and their Families

A PERSONAL tax system affects dependent children primarily through the taxes it imposes on their parents, guardians, or other caretakers. We have organized our discussion of the family-sensitive tax provisions affecting taxpayers with children — and, thus, children — into three general categories. The first category, addressed in Part II, A below, is made up of provisions that provide benefits for taxpayers who provide a home or other support for a child. Five such provisions are addressed here: (1) dependency allowances (exemptions or credits), (2) the earned income tax credit, (3) the child-care credit, (4) the head-of-household rate schedule, and (5) the taxation of the income of children at the marginal rate of their parents (the so-called "kiddie tax"*).

A. Provisions Relating to the Presence of a Child in the Home

1. Tax Relief for Dependent Children

The case for adjusting tax burdens for family size rests on the proposition that parents with dependent children have less ability to pay than other equal-income taxpayers because of the expenditures that parents typically make to support their children. Compare, for example, a family of four (husband, wife, two dependent children) with $50,000 of income with a family of two (husband, wife, no children) with $50,000 of income. If ability to pay is defined in terms of an individual's actual consumption and the family members are sharing resources in the expected fashion, it seems obvious that each individual family member in the family of four has less ability to pay than the individuals in the family of two. If income (consumption plus savings) is the appropriate measure of taxable capacity, it seems equally obvious that the individual members of the larger family have less taxable capacity, per capita, than the members of the smaller family.[1]

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[1] We have just presented in outline form the argument that a consumption tax should impose burdens with reference to the ability to pay of the consumer and that an income tax should impose burdens with reference to the ability to pay of the consumer or saver. See Michael J. McIntyre and Oliver Oldman, "Taxation of the Family in a Comprehensive and Simplified Income Tax," 90 *Harvard Law Review* 1573-1630 (1977).

Once a decision is made to provide tax relief[2] to parents with dependent children, three further tax policy issues must be confronted: (1) how much relief should be given, (2) what mechanism should be used to deliver that relief, and (3) which income groups should receive that relief. In addition, policymakers must concern themselves with the relationship between relief provided through the tax code and relief for poor families provided through various state and federal welfare programs. These issues are addressed in Sections II, A, 1, a through II, A, 2, c.

One possible reform of the various allowances for dependents (not discussed here in detail) would roll all of those allowances together into a single delivery mechanism. For example, a child credit, partially dependent upon work, might be designed as a unified mechanism that would substitute for a dependency exemption, child credit, and the EITC. The authors of this study, as well as Congressman Thomas E. Petri (R.-Wis.), have proposed or suggested such a combination in the past.[3] Under current law, these provisions have significantly different eligibility rules, reflecting somewhat different policy judgments about who should receive their benefits.[4] A single delivery mechanism would require more uniform eligibility rules, including a common definition of a "dependent child." Changes in those definitional rules would advantage some parents and disadvantage others.

a. Dependency Exemption

The dependency exemption is a major mechanism for adjusting tax burdens for the costs of supporting children, and is the only mechanism that provides tax benefits to all middle-income families with dependent children. The dependency exemption for 1996 is $2,550 per dependent child. Since 1987, it has been phased out for high-income taxpayers.[5] For tax year 1994, taxpayers claimed a total of approximately 70 million dependency exemptions.

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[2]We use the term "tax relief" generically to refer to a tax benefit conferred through the tax system, without reference to whether that relief is justified on tax policy grounds or on spending grounds (or is not justified at all).

[3]For a proposal for a unified credit, see C. Eugene Steuerle and Jason Juffras, "A $1,000 Tax Credit for Every Child: A Base of Reform for the Nation's Tax, Welfare, and Health Systems," *Urban Institute* (1991); "Child Credits: Statement of C. Eugene Steuerle before Senate Finance Committee," August 7, 1995. For a proposal for a unified deduction mechanism that was ultimately adopted by New York State, see Michael J. Mclntyre, "Tax Consequences of Family Sharing Practices Under New York Law: A Critique and a Proposal for Reform," 49 *Albany Law Review* 275-351 (1985) at 342.

[4]For example, current law allows a non-custodial parent to claim a dependency exemption but not an earned income tax credit.

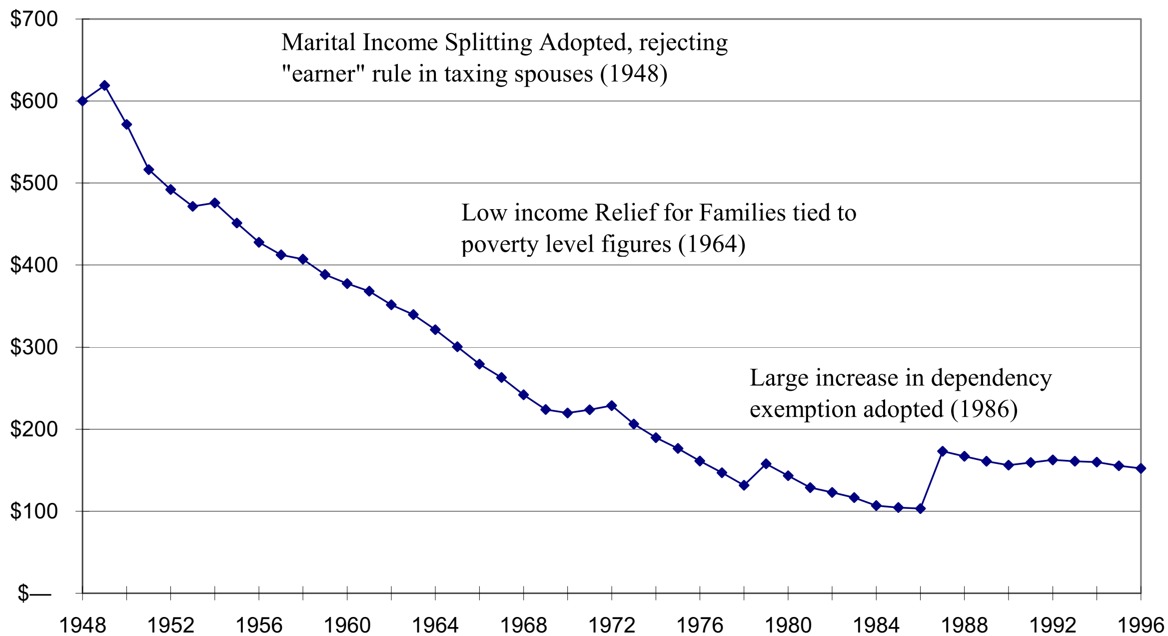
[5]One effect of the phase-out is to raise the top marginal tax rate for some high-income taxpayers with children above the top statutory rate (39.6%) in the rate schedules. In 1996, the phase-out begins for married couples at adjusted gross income of $176,950, for heads of household at $147,450, and for single individuals at $117,950. These phase-out thresholds are adjusted annually for inflation. As a result of the phase-out, tax burdens are not adjusted for differences in family size at high-income levels.

Historical Trends

Few changes in federal income tax laws over the past four decades have had as far-reaching effects on the distribution of federal tax burdens as the shift in the relative tax burdens from taxpayers without dependent children to taxpayers with dependent children. The increase in relative tax burdens has been particularly marked for middle-income taxpayers with children.[6]

The modern era of family taxation in the United States may be traced to 1948, when important changes (discussed in Section II, B, 2, below) were made in the taxation of married couples. At that time, middle-income families with dependent children were asked to shoulder a relatively small portion of the overall federal income tax burden. Their relative burdens have gone up steadily since then.

Figure 2.1 Value of Dependency Exemption Relative to Per Capital Income, 1948 to 1996



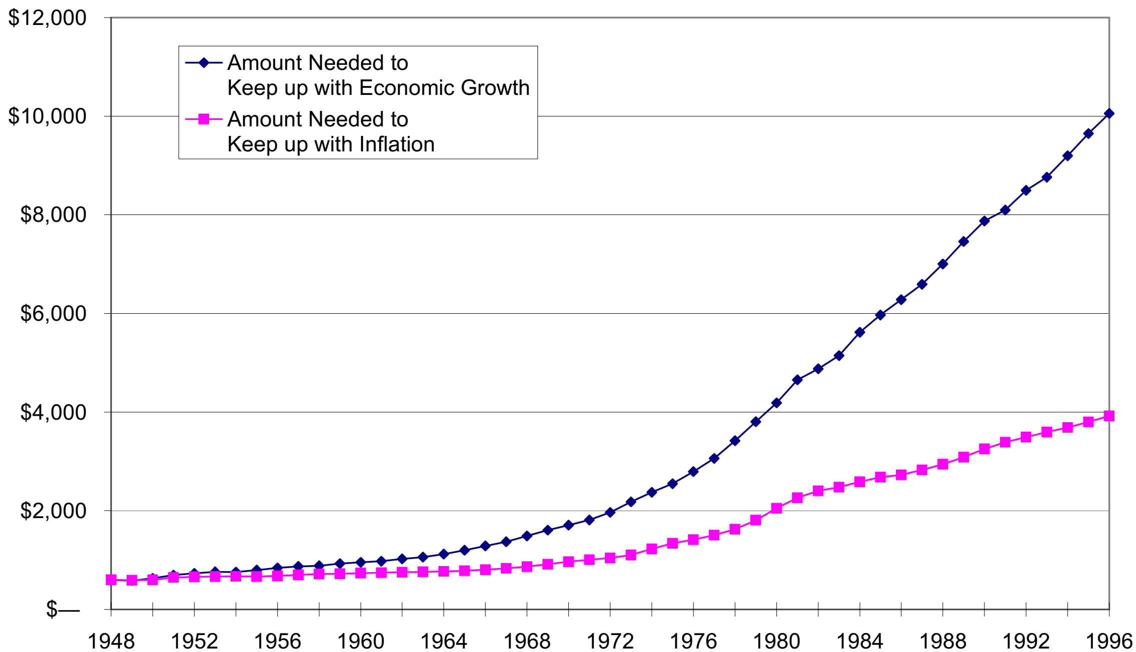
The change in relative burdens on families with dependent children did not occur because policymakers, after careful study, concluded that parents with dependent children were being taxed too lightly. Instead, it happened primarily because the chief mechanism for granting tax relief to families with dependent children — the dependency

[6]In addition to the shift in income tax burdens, the FICA (Social Security) payroll taxes also have risen substantially over this same period. The main impact of the FICA tax has been on middle-class workers, many of whom are supporting and caring for dependents. The FICA tax makes no adjustments for family size.

exemption — was not adjusted sufficiently to keep up with economic growth or with inflation.

Many amendments have been made in the tax code since 1948 to keep low-income families off the tax rolls. The preferred technique for raising tax-free levels in the 1960s and early 1970s was an increase in the standard deduction. That approach provided a cheaper means of raising tax-exempt levels than raising the dependency and taxpayer exemptions, because such an increase was of no benefit to middle-and high-income taxpayers who itemized their deductions. Since 1975, the earned income tax credit has been used to target relief at low-income families with children.

Figure 2.2
Amounts Required to Preserve Value of Dependency Exemption at its 1948 Level, 1948 to 1996



Our comparisons of current relief for dependent children to the level of relief provided in 1948 are not meant to suggest that generous relief for dependents is required now because it was given back in 1948. The year 1948, nevertheless, is an interesting point of departure, because that was the year that the federal government adopted marital income splitting as a national policy. The basic premise underlining that policy is that the income earned by one family member and spent for the benefit of another should be tax-able to the person who enjoys the benefits of the income and not necessarily to the earner. This premise also underlies the case for generous dependency exemptions and for many other types of relief provided to families with children.

Over the 48-year period from 1948 to 1996, the dependency exemption has grown from $600 to $2,550 — slightly more than a four-fold increase. During that same period,

per capita personal income has grown from $1,425 to $23,882, which is more than a sixteen-fold increase. As a consequence of economic growth, the dependency exemption fell from about 42 percent of per capita personal income in 1948 to less than 11 percent by 1996. Figure 2.1, on page 3, shows this historical trend. That figure also marks the changes in the dependency exemption from 1964, when Congress began to set relief for families with children by reference to poverty-level statistics, and from 1986, when Congress moved in the direction of more generous relief for such families.

The dependency exemption for 1996 would need to be set at approximately $10,000 for it to represent the same percentage of per capita income as it represented in 1948. Simply to adjust the dependency exemption for post-1948 inflation would require that it be increased to nearly $4,000. The dependency exemption is now indexed for inflation, but indexing did not begin until after 1988. The increases in the dependency exemption that would have been required to keep pace with economic growth and inflation from 1948 to 1996 are shown in Figure 2.2, above.

The tax policy case for large allowances for children rests on the proposition that children are properly viewed as taxpayers in their own right and that income earned by their parents and spent to finance their consumption should be taxed to them rather than to the parents.[7] The size of the allowances for children under this theory would depend on estimates of the typical sharing patterns within the family. In our view, sharing within the family is adequate to justify rather large dependency allowances.

The current level of dependency allowances appears to be grounded on the theory that the income spent to satisfy the basic subsistence needs of children should be exempt from tax. It is unclear whether this theory is based on tax policy considerations or welfare considerations. If the former, then the dependency allowances should not be phased out at high-or middle-income levels. If the latter, they should be phased out at fairly low income levels.

b. Tax Credit for Dependent Children (Child Credit)

A child dependency credit, generally referred to as a child credit, is a possible alternative mechanism for delivering tax relief to parents with dependent children. The credit might be a fixed amount per dependent child, or the amount of the credit might vary with family size. It could be fixed in amount at all income levels, or it could be phased out at middle-or high-income levels.

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[7]The view that income spent for a child should be taxable to the child is not necessarily inconsistent with the view that having children constitutes a consumption choice. Assume, for example, that one individual chooses to have a child and another individual chooses to acquire a racehorse. Both individuals have made what can be characterized as a consumption choice. Assume that the child and the horse both earn income. The owner of the horse is taxable on the horse's earnings, whereas the earnings of the child are taxable to the child. Once children are recognized as taxpayers in their own right, then the question arises as to whether they or their parents should be taxable on income spent for their benefit.

Both the leadership of Congress and the Clinton Administration have recently offered proposals for granting a child credit. An omnibus tax bill containing a credit of $500 per child was passed by Congress in late 1995, but the bill was vetoed by President Clinton.[8] The Clinton Administration also proposed a child credit in 1995, and its budget proposal to Congress for 1997 contains a slightly revised version of that proposal.[9]

A child credit is worth more to a taxpayer, dollar for dollar, than a dependency exemption, because the dependency exemption is subtracted from the amount subject to tax (whether income or consumption), whereas the credit is subtracted from the amount of the tax otherwise payable. Leaving aside special features of current law, a dependency exemption of $10,000 would offset exactly $1,500 in taxes for parents in the 15-percent tax bracket — the lowest bracket provided under current law. It would offset $2,800 in taxes, however, for parents in the 28-percent bracket. In contrast, a credit of $1,500 would provide the same dollar benefits to taxpayers in the 15-and 28-percent brackets, and, of course, to taxpayers in the higher brackets.[10] In comparing child credits to dependency exemptions, therefore, the credit may be viewed as an exemption that is automatically reduced as taxpayers move into higher tax brackets.[11]

The child credit proposals of the Clinton Administration and the Congress have become enmeshed in the debate over the proper means of reducing or eliminating the federal budget deficit. Much of that debate has centered on whether or not tax relief for the middle classes is appropriate in the middle of a deficit reduction effort. In the

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[8]H.R. 2491, The Balanced Budget Act of 1995, would have granted taxpayers a nonrefundable tax credit of $500 for each qualifying child under the age of 18. The credit is phased out, beginning at $110,000 for married taxpayers filing joint returns, and at $75,000 for taxpayers filing single or head-of-household returns. Neither the credit amount nor the threshold for the phase-out rules would be indexed for inflation.

[9]The proposal would provide taxpayers with a nonrefundable tax credit of $300 for each qualifying child under the age of 13 for taxable years 1996, 1997, and 1998, with the amount of the credit increased to $500 for subsequent years. The credit would lapse if certain deficit reduction targets were not met. It would be phased out ratably for taxpayers with adjusted gross income (AGI) over $60,000, and would be fully phased out at AGI of $75,000. Beginning after calendar year 1999, the maximum credit and the beginning point of the phase-out range would be indexed annually for inflation.

[10]It is sometimes argued that a credit is more progressive than an exemption, because an exemption is worth more at higher tax rates. This point is obviously correct if the only feature of the tax system being changed is the credit or exemption. In the context of a reform that might include rate changes, however, the use of a credit combined with an increase in tax rates could be exactly as progressive as the use of an exemption, assuming that progressivity is measured by reference to the burdens imposed on various income classes. Unless all taxpayers were receiving the credit or exemption or were of the same family size, however, the impact on particular taxpayers within each income class would not necessarily be precisely the same under the two mechanisms.

[11]As suggested above, a dependency exemption of around $10,000 would be needed to replicate the benefits that the exemption provided to parents of dependent children in 1948. A child credit of $1,500 would not be enough to fully replace those benefits, in part because the bottom rate in 1948 was higher than 15 percent, and in part because the 1948 tax rate schedule had steeply graduated rates, with a top rate over 90 percent. A credit of less than $400 would be needed to provide the benefits that low-income parents and most middle-income parents obtain from the dependency exemption under current law.

context of a revenue-neutral major tax reform, deficit issues can be side-stepped. Of course, any liberalization of dependency allowances in a revenue-neutral context would require an increase in the relative tax burdens imposed on taxpayers without dependents. If the ground rules of the reform proposal require revenue neutrality, however, the debate can focus on the trade-offs between the fairness claims of parents with children and the fairness claims of other taxpayers without concern that a victory for one side or the other would have adverse effects on the deficit.

We do not believe that a child credit should simply be added to the current list of relief mechanisms for families. We see significant simplification gains in providing tax relief to families with dependent children through one mechanism that integrates the benefits of current law and any new benefits that policymakers are prepared to give to families with dependent children. Under current law, relief is now targeted at families with children through the dependency exemption and, for low-income families, through the earned income tax credit (EITC). Adding a third relief mechanism with a different set of eligibility rules appears to us to be needlessly complex. We recognize that rolling two and perhaps all three mechanisms into a single mechanism will require some changes in policy — for example, a uniform definition of "dependent" would probably be required. Such changes may create some additional winners and losers in order to achieve gains in administrative economy.

We do not have strong views as to whether, in tax theory, the combined mechanism should be a credit or a deduction. Assuming the continuation of the EITC and the cash payments in welfare programs, however, the use of a unified credit would seem to be the preferred approach. In addition, we believe that a credit mechanism that combined the benefits of the EITC and the dependency exemption could be coordinated better with various rules for phasing out welfare benefits than is possible under current law. That coordination issue is addressed in Section II, A, 2, b, below.

2. Tax Relief for Low-Income Families with Children

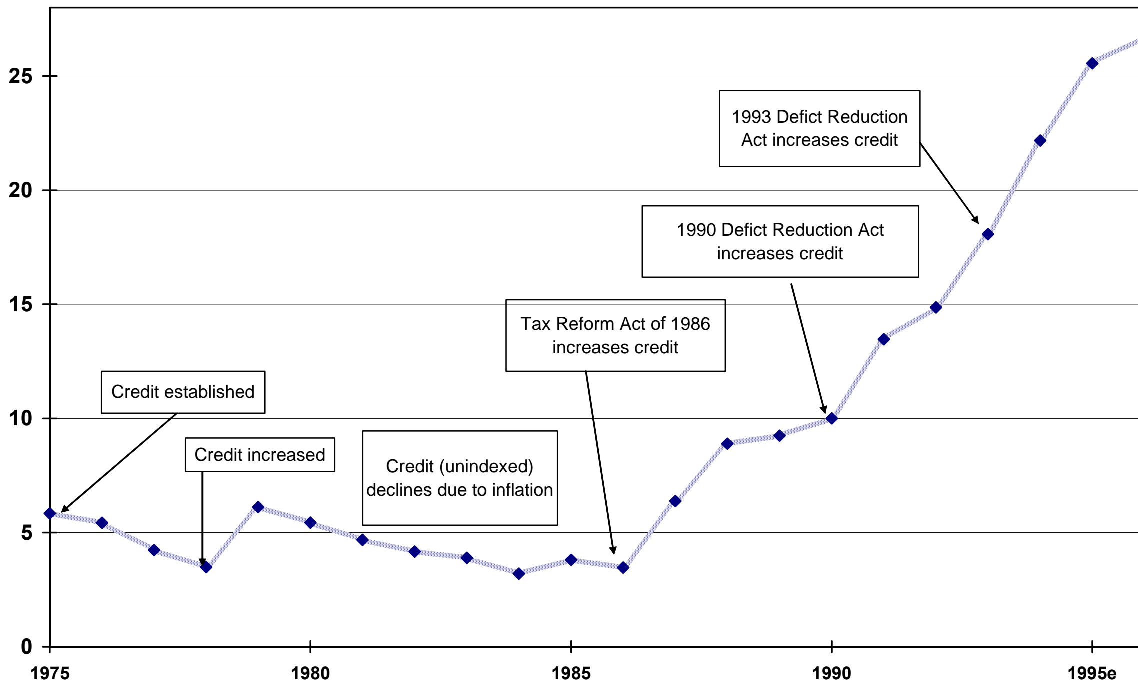
In Section II, A, 2, a, below, we discuss the effectiveness of the earned income tax credit (EITC) of current law in providing both tax and welfare benefits to low-income families with children, and suggest how its repeal would disadvantage those families. Section II, A, 2, b discusses the need to coordinate the various tax and welfare measures targeted at low-income families with children.

a. Earned Income Tax Credit

Current law provides low-income workers with a refundable tax credit — that is, besides reducing the tax liability for low-income families, the government sends a check to the taxpayer for any amount by which the allowable credit exceeds the taxpayer's liability for taxes payable on his or her income tax return. This earned income tax credit (EITC) provides significant benefits to low-income families with dependent children and more limited relief to other low-income individuals. Taxpayers with income over specified income thresholds are not eligible for the EITC.

Figure 2.3

Earned-Income Tax Credits, 1975 to 1996



The EITC began as a limited program in 1975 during the Ford administration and has been expanded several times since then, with large increases enacted in 1986, 1990, and 1993. The 1993 additions only became fully effective in 1996.

According to preliminary IRS data, the EITC was claimed by approximately 18 million families in 1994, with average benefits exceeding $1,100 per family. Around 80 percent of the approximately $20 billion in credits claimed for 1994 represented amounts refunded to taxpayers.

For 1996, individuals with two or more qualifying children and wage income between $8,890 and $11,610 may claim the maximum EITC credit of $3,556 (40% of $8,890). Individuals with one child receive a maximum credit of $2,152 (34% of $6,330) in the income range from $6,330 to $11,610. Individuals with no children receive a maximum credit of $323 (7.65% of $4,220) at a wage level between $4,220 and $5,280. Relatively few taxpayers eligible for the EITC fall within these narrow income ranges. Thus, most taxpayers receive only a fraction, and sometimes a small fraction, of the maximum credit. The EITC is fully phased out for two-, one-, and no-child families at, respectively, $28,495, $25,078, and $9,500. All of the income-level amounts are indexed for inflation.

Historically, the EITC has been promoted as a useful mechanism for lowering income taxes and offsetting FICA (Social Security) taxes for low-income individuals with dependent children, as well as offsetting the work disincentives associated with welfare. Both of these goals continue to be invoked to justify the EITC. Today, the EITC probably

should be considered primarily as an extension of a combined welfare/tax system. That is, it has important tax and welfare features that to some extent are inseparable.

A major goal of many federal welfare programs — e.g., Aid to Families with Dependent Children (AFDC), food stamps, and housing vouchers — is to lift families with dependent children out of poverty. Such programs typically provide the highest benefits to parents who do not work in the labor market, thereby creating serious work disincentives. An important goal of the EITC has been to counter those disincentives by providing help to low-income parents who work in paid employment outside the home.

The EITC has been a major topic of discussion during the contest between Congress and the Clinton Administration over the 1996 budget. Revision of the EITC is likely to be a topic on the public agenda for some time. The EITC has received political support from many sources, including, at various times, from the leadership of the two major political parties. It has been favored because of the work incentives that it provides, as well as the relief that it delivers to low-income families. Some supporters have seen it as a politically viable alternative to an increase in the minimum wage. The EITC has also received criticisms from a range of sources, partly because of problems with its implementation and partly, as discussed below, because it is not well integrated with income-tested welfare programs. Congress and the IRS have attempted to deal with the problem of ineligible participants receiving the credit by reforming eligibility criteria and by checking more closely with taxpayers over the existence of dependents.

An additional problem remains to be addressed: the ability of taxpayers to over-declare income to receive higher credit amounts. This problem, which one of us has deemed a "superterranean economy," does not require cheating. Two neighbors could baby-sit for each other and generate significant EITCs as a consequence.[12]

b. Coordination of Tax Provisions with Implicit Taxes Embedded in Welfare Programs

In some important respects, an individual with a dependent child who is receiving welfare payments may be viewed as being subject to a "negative" income tax. The welfare check is roughly equivalent to a refundable tax credit for a dependent child. If that individual should begin to work, the welfare rules provide that the welfare payment is phased out. For example, for each additional $10 over some amount that the individual earns, the welfare check might be reduced by $3, for an effective "tax" rate of 30 percent. At the same time, the income that the individual is earning is taxable under the federal and state income taxes and under the FICA payroll tax. In this simple case, the effective

[12] C. Eugene Steuerle, "The IRS Cannot Control the New Superterranean Economy," 59 *Tax Notes* 1839-1840 (June 28, 1993). The IRS apparently has not yet detected significant evidence of a superterranean economy. The risk appears to be serious enough, however, that the Clinton administration developed a proposal in 1995 to reduce the incentive for inflating self-employment income.

marginal "tax" rate that the individual would face may easily exceed 50 percent. In real life, various additional factors may combine to raise the effective rates even higher.[13]

An important objective of public policy — whether characterized as tax policy or welfare policy — should be to substantially reduce the high marginal "tax" rates that welfare recipients typically face when they attempt to enter the workforce. A reduction in those rates presumably would encourage welfare recipients to enter the workforce and avoid a long-term dependence on welfare. The current tax system, operating in tandem with various welfare programs, is said to create "poverty traps" because it discourages welfare recipients from taking the steps into the workforce — steps that offer them the only realistic hope of avoiding long-term poverty for themselves and their children. We suggest that the avoidance of such poverty traps should be an important objective of any major tax reform.

A child credit provides a means of linking together the welfare system and the tax system. Just as a welfare payment operates as a refundable tax credit that is *phased out* as income increases, so also a child credit could be designed to operate as a welfare payment that would be *phased in* as income increases. The phase-in rules of one set of credits can be designed to offset, wholly or in part, the phase-out rules of the other credit, thereby reducing implicit marginal tax rates considerably. Once the credit is fully phased in, it would remain constant throughout the low-and middle-income ranges, thereby avoiding the implicit taxes that result under current law from the phase-out of the EITC or welfare credits.

Another potential advantage of a unified approach to tax and welfare issues is the opportunity thereby provided for reducing marriage penalties resulting from the implicit taxes imposed by the welfare system. Those marriage penalties can be extraordinarily high under current welfare policies.

Consider, for example, a female welfare recipient with a dependent child who is considering marriage to a male wage earner whose wages are somewhat above the threshold for receiving welfare. Prior to marriage, they would each be considered for welfare by reference to their own earnings — one would receive welfare benefits and the other would not. After marriage, their eligibility for welfare would be a function of their combined incomes. The likely result would be that neither of them would be eligible for welfare if they married — with a drop in their combined income of 30 percent or more in many cases. A potential loss of income of that magnitude would be a strong financial impediment to their marriage.

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[13]One recent study of AFDC recipients indicates that members of those households frequently face combined "tax" rates under the welfare and tax systems in excess of 70 percent. See Linda Giannarelli and C. Eugene Steuerle, "The True Tax Rates Faced by Welfare Recipients," 1995 *NTA Proceedings* 123-129 (88th Annual Conference). These implicit tax rates are derived not only from the individual income tax, but also from Social Security taxes, state and local income taxes, the phase-out of the EITC, and the phase-out of various welfare benefits such as AFDC, Food Stamps, Medicaid, and housing subsidies. But see Janet Holtzblatt, Janet McCubbin, and Robert Gillette, "Promoting Work through the EITC," 48 *National Tax Journal* 591-607 (1994) (suggesting that the EITC changes in 1993 generally reduced marginal tax rates facing many families with children).

In the example above, a generous child credit could reduce the marriage penalty resulting from the introduction of income into the household by marriage. The introduction of wage income into the household would trigger a drop in welfare payments to the wife and mother. The marriage, however, would automatically activate a child credit that would offset, in whole or in part, the taxes otherwise due on the wage income of the husband. With full coordination — which, we fully concede, would be a difficult political achievement — the high marriage penalties of the welfare "tax" system could be eliminated entirely. They can be substantially reduced even with limited coordination.

What analysts should realize is that individuals in the welfare system are implicitly subject to "tax" on their incomes even if the explicit tax system is consumption-based and provides them with generous exemptions from the explicit tax.[14] In addition, the proponents of a consumption tax should realize that their goal of eliminating the need for individuals to report their nonwage income may not be achievable as long as their reform is not coordinated with the income-based welfare system that would remain in place.

3. Other Provisions Affecting Families with Dependent Children

The sections below discuss the child-care credit, the special rate schedule for heads of household, and the so-called kiddie tax, which requires young children to pay tax at the marginal tax rate of their parents. Although these provisions are very important to the families to whom they apply, they affect only a modest percentage of families with dependent children.

a. Child-Care Credit

Parents with one or more children under age 13 may claim a tax credit under current law for a portion of the expenses for child care and household services that they incur in pursuing gainful employment outside the home. The allowable credit is a percentage (30 percent at Iow4ncome levels, phased down to 20 percent) of qualifying expenses. Qualifying expenses are capped at $2,400 (one qualifying dependent) or at $4,800 (two or more qualifying dependents). In the case of a two-job married couple, the expenses eligible for the credit generally cannot exceed the income of the lower-earner spouse. Taxpayers claiming the credit must provide the Internal Revenue Service with the name, address, and taxpayer identification number of their provider.

A deduction for child-care expenses was introduced in 1954, during the Eisenhower administration, primarily as a mechanism for encouraging mothers on welfare to work outside the home. The deduction was capped at $600 and was phased out at rather low income levels. The allowance has been expanded several times and was converted into a credit in 1976. As shown in Table 2.2, the child-care credit was claimed in 1995 by just over 6 million taxpayers for total credits of under $3 billion. For a taxpayer with adjusted

[14] To a modest degree, the EITC of current law operates to reduce poverty traps.

gross income of $10,000 or less and two qualifying dependents, the maximum credit is $1,440. The maximum credit is $960 for parents with income of $30,000 or more.[15]

Opponents of the child-care credit have not made an overwhelming case on administrative economy, efficiency, or fairness grounds for its repeal. The child-care credit is moderately difficult to administer, due to the intricacy of some of its qualifying rules. Thus, repeal would provide some simplification gains.

The case for repeal on efficiency grounds is at best mixed. An initial and continuing purpose of a child-care allowance has been to mitigate the tax and welfare disincentives that some parents face in taking a job in the labor market. The efficiency problem arises because self-performed child-care services are not taxed, whereas cash income spent for child care would be taxable in the absence of a child-care allowance. Maintaining the credit would cause some modest increase in the tax rate, which could have some efficiency costs. Those costs would need to be balanced against the possible efficiency gains from granting the credit.

The child-care credit is available to all taxpayers with qualifying dependents, not just those eligible for welfare. The efficiency case for granting a child-care allowance for middle-and high-income taxpayers is difficult to assess, due to the significant likelihood that child care provides parents and other guardians with some consumption benefits. Indeed, some commentators assert, albeit without supporting evidence, that the child-care credit creates a positive incentive for women to work outside the home. Some political opposition to the credit is grounded on this possible effect.

Table 2.2
Child-Care Credits Claimed, 1995

Income Class* ($000)	Returns (000)	Amount ($000,000)
Below $10	—	—
$10 to $20	452	166
$20 to $30	864	402
$30 to $40	1012	446
$40 to $50	826	335
$50 to $75	1545	672
$75 to $100	900	415

[15] A recent article argues that the child-care allowance is progressive with respect to income, measured over a short- and a medium-time period. See Rosanne Altshuler and Amy Ellen Schwartz, "On the Progressivity of the Child-Care Tax Credit: Snapshot Versus Time-Exposure Incidence," 49 *National Tax Journal* 55-71 (1996).

Income Class* ($000)	**Returns (000)**	**Amount ($000,000)**
$100 to $200	494	247
$200 and over	84	43
Total	6177	2724

* The income concept used to place tax returns into classes is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, and (8) excluded income of U.S. citizens living abroad.

SOURCE: Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1996-2000, JCS-21-95 (1995)

The case for a child-care credit on fairness grounds also is mixed. One argument for a child-care allowance is that it constitutes a legitimate cost of earning income and ought to be deductible in a tax system seeking to measure net income (or net consumption). Those arguing that child-care expenses constitute a business cost can show that the costs of child care are closely analogous to certain expenses, such as the costs of travel away from home, that are deductible as a cost of earning income.[16] On the other hand, those costs are also analogous to certain other expenses, such as the cost of most types of personal clothing, that are not deductible, notwithstanding a close relationship to business. Because child-care costs arise from the quintessentially personal decision to have and raise children, a case for the deduction on business-expense grounds can never be conclusively made.[17]

A second fairness argument for a child-care allowance is a variant of the argument we endorsed above for granting generous dependency allowances. According to that argument, amounts spent for the benefit of a child ought to be taxable to the child in a tax system that taxes consumption to the consumer and, in the case of an income tax, income to the beneficiary. Amounts spent for child care clearly fall within the category of amounts spent for the benefit of a child. In a tax system that is already granting generous allowances for dependent children, a child-care allowance would be justified only if child-care expenses generally represent an above-average level of spending on children.[18] The

[16]See C. Eugene Steuerle, "Tax Credits for Low-Income Workers with Children," 4 *The Journal of Economic Perspectives* 201-212 (1990). See also Michael J. McIntyre, "Evaluating the New Tax Credit for Child Care and Maid Service," 5 *Tax Notes* 7-9 (May 23, 1977).

[17]Both the proponents and critics of the child-care credit agree that some of the technical features of the child-care credit, including the use of a credit rather than a deduction, are inconsistent with a business-expense rationale for the allowance. Of course, these features of the credit do not undermine the case for some allowance for child-care expenses.

[18]See Michael J. McIntyre, "Fairness to Family Members Under Current Tax Reform Proposals," 4 *American Journal of Tax Policy* 155-192 (1985) at 174, note 40.

premise that parents paying substantial child-care expenses spend more money on their children than other parents is a plausible premise, but we are not aware of any organized data on this point.[19]

Repeal of the credit for household and dependent care services would raise approximately $2.7 billion in revenue, according to the tax expenditure budget prepared by the Joint Committee on Taxation. That amount is not unimportant, but it is too small to affect the overall tax rate significantly.

Related Provisions

Under current law, taxpayers may receive child-care benefits from their employer, subject to some limitations, without paying tax on those benefits. That exclusion from income is similar in effect to the child-care credit. The technical rules governing the exclusion, however, are not coordinated with the related provisions of the child-care credit. For example, the exclusion is limited to child-care services valued at $5,000, whereas the comparable limit under the credit is $2,400 for one child and $4,800 for two or more children. The cost in forgone federal income tax revenue of the exclusion for employer-provided child-care services is estimated by the Joint Committee on Taxation at around $700 million for 1996.

Alternatives to Child-Care Credit

Some analysts have criticized the child-care credit on the ground that it provides benefits only to single parents who work and two-earner married couples and not to families in which one of the parents remains at home as a full-time caretaker. They have suggested that the tax code should provide an enhanced dependency deduction or a general child dependency credit in place of the child-care credit. Extending the benefits of the child-care credit to all parents with dependent children, however, would cost many times more than the existing child-care credit in terms of forgone federal tax revenue. In addition, such an allowance would fail to address the differential treatment between, on the one hand, one-earner couples and, on the other hand, two-earner couples and one-earner heads of households, that many analysts believe is the basic purpose of the credit.[20]

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[19]An additional argument sometimes made for a child-care allowance is that such an allowance is allegedly an effective measure for indirectly taxing the parents in a one-earner, two-parent family on the imputed income they derive from the child-care services performed by the stay at-home spouse. For a lengthy discussion of the implicit premises of this argument and a rejection of them, see Michael J. McIntyre and Oliver Oldman, "Taxation of the Family in a Comprehensive and Simplified Income Tax," 90 *Harvard Law Review* 1573-1630 (1977) at 16(^9-1620.

[20]For example, assume that a head of household has $10,000 in wages and $2,000 in child-care costs. That individual's net additional income from work clearly is not $10,000. Nor is there a spouse at home generating nonmarket income.

b. Head-of-Household Rate Schedule

The head-of-household rate schedule is available under current law to unmarried individuals with a qualifying dependent, most typically a minor child. The tax rates contained in the head-of-household schedule under current law are the same as the rates on the schedule for other single individuals, but its tax brackets are wider. This change in bracket widths has no impact on heads of households who would be subject to the 15-percent bracket under the single schedule (income of $24,000 or below for 1996). Those with income above that level, however, obtain a tax benefit from using the head-of-household schedule. For example* under 1996 tax rates, a single parent with taxable income of $30,000 and filing as a head of household would save $780 in taxes from using that schedule instead of the singles schedule. For a head of household with taxable income of $50,000, the tax savings would be $1,060. The maximum tax savings of $2,467 is available to heads of household with taxable income of $263,750 and above.

The head-of-household schedule was introduced into the tax code in 1951. Its purpose was to extend to one-parent families some portion of the tax benefits that two-parent families received under the marital income splitting regime adopted nationally in 1948. Under that regime, marital partners were allowed to report one-half of the total income of their marital partnership on the same rate schedule used by single individuals. In contrast to the head of household schedule, the benefits of marital income splitting were available to all marital couples, whether or not they had dependent children.

The purpose of the head-of-household schedule is to take account of the differences in ability to pay of heads of households relative to equal-income single individuals due to the difference in their support obligations. In effect, the head of a one-parent family is allowed to split income with a dependent child, with the child's portion of the parent's income being taxed at a low or zero rate. The head-of-household schedule operates like a dependency exemption that increases in value with increases in the total income level of the one-parent family.

The special rate schedule for one-parent families creates the potential for a marriage penalty because a husband and wife with children could reduce their taxes under current law by getting a divorce, using the deduction for alimony to equalize their individual incomes, and then having one former spouse file as a head of household and the other spouse file as a single person. The former spouses cannot both file as a head of household under current law and still live together, because a head of household is defined as a person providing *more than half* of the cost of maintaining the household. It does not appear that significant numbers of married couples have availed themselves of this tax-avoidance opportunity.

c. Kiddie Tax

Under current law, as amended in 1986, children under the age of 14 are taxable on their unearned income at the marginal tax rate of their parents. This rule is popularly, if inexactly, referred to as the "kiddie tax." Its point is to prevent parents from avoiding the

bite of the graduated rate structure by shifting investment income to their children.[21] Its adoption has reduced the tax planning benefits obtaining from establishing certain family trusts, thereby reducing the complexity for the taxpayer and the tax authorities that is associated with such tax planning.[22] Earned income — e.g., income that children earn from babysitting or delivering newspapers — is not subject to the kiddie tax rule.

[21]To simplify compliance with this rule, parents may elect to include the investment income of their children on their own tax return.

[22]However, an adjunct to the kiddie tax — the denial of a taxpayer exemption to a child who is declared as a dependent on someone else's tax return — has increased filing complexity significantly. Some analysts defend the so-called double exemption, whereas others oppose it.