Investing in Middle Class Families:

The case for a much expanded child tax credit.

by James C. Capretta

As my Ethics and Public Policy Center colleagues, Peter Wehner and Yuval Levin, documented in an insightful Commentary essay last year, the United States has made substantial, if unheralded and under-reported, progress on a number of social indicators in recent years.[1]

For starters, violent crime is down – way down. The number of reported violent crimes was 1,656,100 in 1991, but only 1,190,600 in 2005 – a reduction of 28 percent.[2] Similarly, the use of illicit drugs by teenagers and children has fallen 24 percent just since 2001.[3] And, perhaps most stunning of all, the number of American families and children enrolled in the primary cash welfare program – now known as Temporary Assistance for Needy Families, or TANF – has plummeted. In 1996, there were more than 4.6 million Americans receiving cash benefits through Aid to Families with Dependent Children (AFDC) – the predecessor program to TANF. By 2002, state caseloads had been cut by more than half, to just 2.1 million people.[4]

Progress on these indicators didn't just happen. The much improved trend lines are the result of conscious changes in government policy, and particularly in federal policy.

Regarding crime, a bipartisan consensus emerged in the 1980s that the country was allowing too many violent criminals – a strong predictor of future criminal behavior – out of prison much too quickly. Tougher minimum sentencing requirements has swelled the population in prisons across the country, but it has also unquestionably contributed to the dramatic drop in violent crime – a decline much welcomed in many low-income, urban settings.

Similarly, progress on illicit drug use stems largely from a series of government initiatives aimed at reducing demand and disrupting supply. In the aftermath of the 1960s, many elites took a benign view of drug use, erroneously assuming its consequences were passing and insignificant. But attitudes changed with the Reagan era "Just Say No" campaign. Government-sponsored public service announcements have run in prominent media outlets with regularity ever since,

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hammering the point home that illicit drug use is not only dangerous and lethal, but also a dead end, leading to estrangement and loneliness. The message has largely gotten through to younger Americans, although this battle is far from over. Demand has ebbed somewhat, but the temptations remain strong as the flow of drugs into the country remains substantial.

The policy shift in the 1990s on welfare was particularly pronounced and consequential. AFDC was supposed to help poor single mothers and their children who had been abandoned by their fathers without a steady source of earned income. But the tragedy of AFDC was that, in trying to ease the consequences of counter-productive behavior, it only encouraged more of the same. Providing financial support to fatherless families without a bread-winner in the home effectively underwrote the formation of many additional such families. Out-of-wedlock births, already on the rise, soared, especially in minority communities, and work and self-reliance declined.

By the 1990s, a broad consensus emerged that reform was needed. The 1996 welfare reform program took the controversial step of terminating the previous federal entitlement to cash benefits, providing states instead with a limited block grant of funds, time limits on how long recipients could get cash assistance, and new requirements to encourage recipients to work their way off welfare dependency. These measures were coupled with a series of separately enacted expansions in the Earned Income Tax Credit (EITC) program, which provides a refundable tax credit to support low-wage households willing to forego government assistance for work.

Many predicted that this combination of policies would be calamitous for low income communities, with millions of children going without food or shelter once the entitlement to cash welfare assistance was time-limited.

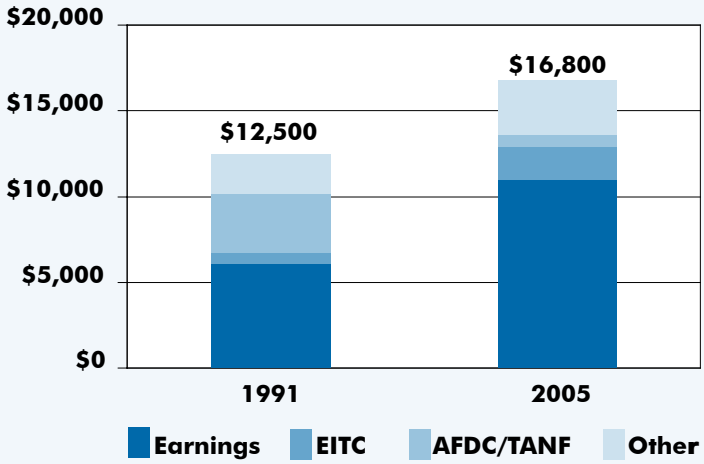
What happened?

Far from causing calamity, welfare reform and the emphasis on work has ushered in a new era of hope. Millions of American left welfare for paying jobs. Caseloads have plunged. And states have been able to use much more of their limited resources to provide child care and job training instead of subsistence.

A recent Congressional Budget Office (CBO) documented the stunning reversal of previous trends. As shown in Chart 1, between 1991 and 2005, the incomes of those households representing the bottom fifth of the distribution went up 35 percent in real terms. This was the second largest percentage gain in income among the five quintiles, behind only the highest income group (which enjoyed a real income increase of 53 percent between 1991 and 2005).

What's even more encouraging is the change in the sources of income over that period. CBO estimates that work-related earnings for these households increased more than 80

Chart 1
Households with Children:
Sources of Income for the Lowest Quintile, 1991 and 2005
Constant 2005 Dollars



Source: Changes in the Economic Resources of Low-Income Households with Children, Congressional Budget Office, May 2007 (backup table to figure 3)

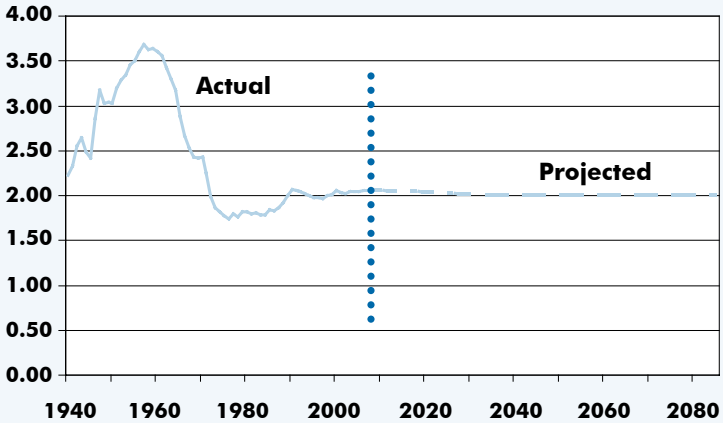
percent in real terms from 1991 to 2005, while cash welfare dependency plunged. In 1991, AFDC represented 30 percent of total income for the lowest income quintile of families with children. By 2005, TANF was contributing just 4 percent to total income for these families. Similarly, the participation rate in cash welfare dropped precipitously, from more than half of all families in the lowest quintile in 1991 to under 20 percent in 2005.

There are a couple of lessons that might be taken from these recent governmental successes. One is that a change in public policy can, under the right circumstances, make a difference. A key condition is clarity of purpose. If the goal is clear and widely supported, the federal government can marshal significant resources to achieve it.

Another important lesson is that financial incentives matter enormously. It is close to an iron law in public policy analysis that whatever the government chooses to subsidize will, in time, become more prevalent. Thus, changing the tax law to supplement earned income expanded dramatically the number of hours worked by those potentially eligible for the subsidy. Similarly, paying households, even when they don't work or take steps to join the workforce, induces more dependency.

And so, the question becomes, what societal challenge now requires concerted governmental attention? The answer is the broader, middle class American family. Despite progress in other areas, the American family has been showing signs of stress in two important ways for many years now: Families are much smaller than they used to be, and a growing number of American children are being raised outside intact, two-parent households.

Chart 2
U.S. Total Fertility Rate



Source: 2008 Social Security Trustees' Report, Intermediate Assumptions

Since the end of the baby boom generation in the mid-1960s, the birth rate in the United States has fallen well below previously observed levels. As shown in Chart 2, birth rates soared in the immediate post-war era, reaching 3.7 in 1957, only to fall precipitously as social standards and medical technology changed dramatically in the early 1960s. By the mid-1970s, U.S. fertility had fallen to about 1.7 births per woman, well below the population replacement birth rate of 2.1. It has since rebounded somewhat, going just above 2.0 in recent years (Social Security projections assume it will remain there for the foreseeable future). But even so, our population is set to age rapidly in the years ahead as births are not expected to keep pace with longevity.

The United States, of course, was not alone is this drop in birth rates. Falling fertility is a worldwide phenomenon, centered in the industrialized world, but now spreading rapidly to every corner of the globe. Indeed, in some sense, the U.S. is far better off than most of our developed partners. Several European countries and Japan have birth rates below 1.5, and some are as low 1.3, births per woman. Over the next 50 years, such low birth rates will contribute to an unprecedented shift in demographic conditions, with these countries populated much more heavily with elderly residents than with younger workers. Japan, for instance, is expected to lose about 40 percent of its working age population between today and 2050. Germany is expected to experience a similar trend.

There are many competing theories as to why fertility has fallen. A large part of the explanation is surely cultural and technological. Many Western nations have become more secular and less religious, which is strongly correlated with smaller families. In addition, the technology associated with regulating births is, of course, now widely accessible – and used.

But there are also reasons to believe economic issues have played an important role in suppressing birth rates.[5] In short, it simply does not pay to have children as it used to. In earlier times, children were viewed as an important source of economic security, particularly as parents aged. Families effectively "invested" in children because they knew, someday, the productive capacity of their children would provide important economic benefits for them as well.

But developed nations now generally have in place social insurance arrangements through which governments play a much more active role in financing retirement income and providing care for the elderly. And these programs require taxation. Therefore, families that have numerous children are essentially paying twice. They must invest in the costs of raising a child to adulthood, and they must also pay taxes for governmental programs. Moreover, the productive capacity of children is no longer captured by the families alone. Indeed, it is shared with society at-large. Of course, most people desire children for their own sake. But, as noted previously, financial incentives cannot be ignored. To the extent that today's modern welfare state effectively imposes a tax on child-rearing, it has contributed to smaller families.

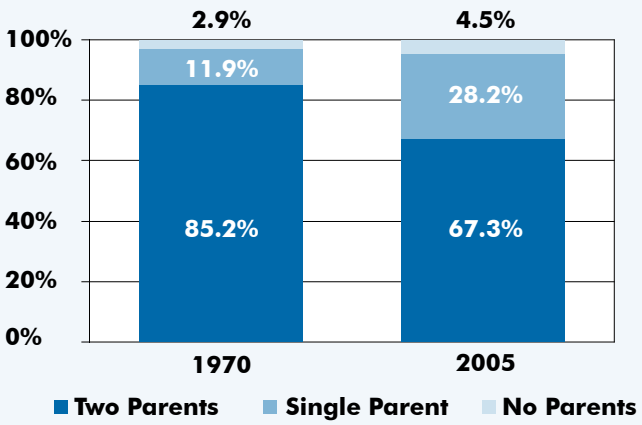
The irony is that, while families may need fewer children to sustain themselves, societies, including the U.S., are as dependent as ever on a growing workforce. Pay-as-you-go pension and health care systems require a constant stream of new taxpayers to pay for the costs of current generations of retirees. But with birth rates falling, the financial strains on governments will be pronounced indeed. For U.S. Social Security, the so-called dependency ratio of those aged 65 to the productive workforce is expected to increase from about .21 today to .34 in 2030.[6]

But it is not only a low birth rate that is of concern. It is also worrisome that so many children born today are being raised in households in which the parents are not married or do not stay together.

As shown in Chart 3, between 1970 and 2005, the percentage of children living in intact, two-parent households fell from 85 percent to 67 percent. Study after study shows that children raised in households with their married, biological parents fare better than children raised in alternative arrangements. The likelihood that a child will fall into low educational achievement, experiment with illicit drugs, engage in criminal behavior, and fall into poverty in adulthood are all elevated if their parents are not married and the family does not stay intact during their childhood. In sum, children raised outside intact, two-parents families are twice as likely to fall into behaviors that are problematic and self-destructive than children who are not.[7]

At this point, it might be reasonable to ask, "But what can the government do about any of this?" After all, the reasons for fewer births and family breakdown are long-standing and clearly related to profound change in social mores. In particular, out-of-wedlock births are now the norm, not the exception, in many minority

Chart 3
Living Arrangements of U.S. Children by Number of Parents Living in Household



communities, and reversing trends toward widespread, early, and unmarried sexual activity will not be easy, in large part because there is no broad-based societal consensus that such a reversal is even necessary, or that the government, at any level, should have much to say on the subject anyway.

But that does not mean the government cannot act. What can be done is to direct financial resources toward the desired objectives – formation of larger and stronger two-parent families raising the next generation of productive citizens. And the best way to do that is to increase the size of the Child Tax Credit (CTC) program.

The CTC was first put into federal tax law in the 1997 Taxpayer Relief Act. At that time, it was a pivotal provision in the bipartisan balanced budget compromise between President Bill Clinton and the then Republican-controlled Congress. The 1997 law originally set the credit at $400 in 1998 and $500 in 1999 and future years. It was subsequently raised to $1,000 through 2010 in the 2001 and 2003 tax laws.

In general, taxpayers can claim the CTC for children under the age of 17 who are dependents in their household. In 2004, some 26 million households received some benefit from the CTC.[8]

Originally, the child credit was not refundable, which meant it could be claimed to reduce income tax liability, but could not be fully claimed if a household was already paying no federal income tax. In other words, the child tax credit could not be used to provide direct cash assistance to households. In the 2001 and 2003 tax bills, partial refundability was provided for households with earned income exceeding a threshold, set at $12,050 in 2008.[9] This "refundability threshold" is indexed annually to inflation.

The child credit is phased out for upper income households. Married couples filing jointly with adjusted gross income exceeding $110,000 get a $50 reduction in their credit for every $1000 in income above the threshold. The $110,000 is not indexed to inflation. Consequently, the number of households eligible for the credit will shrink over time as more taxpayers exceed the upper income limit.[10]

The most direct way to expand the credit, and thus put more resources into the hands of parents raising children, is to increase the amount of the maximum credit over time. For instance, one approach would be to add $250 to the credit beginning in 2010, until the credit per child reached $2,500 in 2015. At that point, the credit could be indexed to keep pace with inflation.

Without question, such a proposal would be costly in terms of lost revenue. There were approximately 45 million children eligible for the tax credit in 2005, according to the Brooking-Urban Institute Tax Policy Center.[11] Assuming the eligible population remained relatively fixed over time, the cost of this expansion could be as much as $60 to $70 billion per year, more than doubling the current program.

What could American taxpayers expect to get from making this investment in middle class families? First, there would likely be a rise in the birth rate, although it may be modest given the headwind of other cultural changes. One major flaw in the current CTC program is that it is not a permanent feature of the tax law (the increase from $500 to $1,000 is set to expire after 2010). It would be important to make an increase in the CTC a permanent feature of the tax law so that families choosing to expand could do so with some certainty regarding their future tax liability.

Other countries, such as France, have successfully implemented pro-natalist policies, with modest improvements in their birth rates. A large expansion of the CTC would have the virtue of devoting substantial resources to raising a child, but, unlike provisions in other countries, it would not direct the resources to child care or education or any other expense. That decision would be left with the parents, who are in the best position to know what is most needed in their household.

The other major benefit of a large CTC expansion would be increased financial security for some struggling families. The hope would be that these resources would allow more parents to get and stay married, which would greatly improve the prospects for their kids.

Some may argue that this proposal is unaffordable, given the other budgetary pressures facing the country. But, in a certain sense, that is the point. Helping parents, ideally two parents, raise their children has to be a public policy priority because the success of the country in the future depends on it. And, in a certain sense, we have little choice. If the U.S. birth rate falls as it has in Europe, there would be almost no way to avoid a steady decline in world leadership and global influence, not to mention economic prosperity.

There are ways to offset the revenue loss from an expanded CTC. The current tax law is highly unstable, with many important provisions set to expire at the end of 2010. In addition, there is widespread interest in scrapping the alternative minimum tax, reforming the corporate tax law, and revising the tax treatment of employer-based health insurance. All of these changes can and should be pursued in a larger reform aimed at broadening the base and keeping rates as low as possible. But as the pieces are assembled, it will also be critical for the new president and Congress to realize that the most important aspect of reform is its treatment of middle class families with kids. As they go, so goes the nation.

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[1] See "Crime, Drugs, Welfare – And Other Good News," *Commentary Magazine,* December 2007.

[2] Bureau of Justice Statistics, U.S. Department of Justice (http://www.ojp.usdoj.gov/bjs/glance/tables/4meastab.htm).

[3] "Youth Drug Use Declines," White House Office of National Drug Control Policy, December 2007.

[4] "A Decade of Welfare Reform: Facts and Figures," The Urban Institute, June 2006.

[5] See, for instance, "Fertility and Social Security," Michele Boldrin, Mariacristina De Nardi, and Larry E. Jones, National Bureau of Economic Research, Working Paper 11146, February 2005.

[6] *The 2008 Annual Report of the Board of Trustees of the Old Age and Survivors Insurance and Disability Insurance Trust Funds,* p. 82.

[7] "Family Structure and Child Well-Being," Kristin Anderson Moore, Ph.D., presentation to the Children's Rights Council, July 17, 2003.

[8] *2004 Individual Income Tax, All Returns: Tax Liability and Tax Credits,* Tax Policy Center.

[9] "Improving the Refundable Child Tax Credit: An Important Step Toward Reducing Child Poverty," Aviva Aron-Dine, Center on Budget and Policy Priorities, May 19, 2008.

[10] "Who Gets the Child Tax Credit?", Leonard E. Burman and Laura Wheaton, *Tax Notes,* October 17, 2005.

[11] Burman and Wheaton, October 2005.