THE CHILD TAX CREDIT (CTC)

Increases and liberalizations of the Child Tax Credit (CTC) are among the most controversial provisions in the current budget reconciliation bill. The CTC provision is a significant part of the cost of the bill; in fact, assuming that it is intended to be made permanent, it is one-third of the total cost, and so must be an important consideration in the debate on the bill as a whole. The CTC is a part of current law, but the increases in benefit levels and liberalizations—such as removing the earnings requirement (making the benefit fully refundable) and paying the benefits out in monthly installments that would be extended in the reconciliation bill—are scheduled to expire at the end of this year, and so a resolution of this question is urgent. Furthermore, the reconciliation bill would extend those provisions, but only for four years, not permanently, which raises other issues. And finally, the mechanism through which the credit is distributed had never been tried before it was put into effect on short notice in the middle of this year. As a result of all of these issues, the CTC reconciliation provisions are debated hotly.

What Is the Child Tax Credit?

The CTC dates back to 1998, prior to which tax relief for families with children was delivered only through the personal exemption (then available to each taxpayer and dependent) and the earned income tax credit (EITC). The CTC is a tax credit (that is, an amount subtracted from tax liability rather than from taxable income) and is available for every dependent child. (The CTC is sometimes confused with the child and dependent care tax credit, which is a credit to offset in part the cost of care for a child or other dependent paid by a working adult.)

What Is the Status of the Child Tax Credit?

Since its creation, the CTC has been increased on several occasions.

In the current permanent law (subsequent temporary changes explained below), the CTC is $1,000 per child up to age 16. It is phased out by 5 percent of income in excess of $110,000 for a married couple (smaller amounts for other family units). A part of the credit may be refundable (that is, payable in cash to a taxpayer with no tax liability) in the amount of 15 percent of earned income in excess of $3,000.

In the 2017 Tax Cuts and Jobs Act (TCJA), the amount of the credit was increased to $2,000 per child, and it was made refundable, in an amount up to $1,400 per child, to the extent of 15 percent of earned income above a threshold of $2,500. The credit is phased out by 5 percent of income in excess of $400,000 of income for a married couple. However, all of these increases and liberalizations were temporary, with a sunset date of December 31, 2025, and thus will go away as of that date with no further change of law.

Then, the American Rescue Plan Act of 2021 (ARP), which was passed with no Republican support in either house of Congress, made further temporary increases for this year only (i.e., with a sunset date of December 31, 2021). These changes may be interpreted by some to be a temporary response to the pandemic; to others, they were first steps to permanent increases. The ARP increased the amount of the
credit to $3,000 per child, and to $3,600 for children under 6 years of age, with the increased amounts of the credit phased out for families with over $150,000 of income (but the previous amounts of the credit still phased out over $400,000). It increased the maximum age to 17. It made the credit fully refundable (i.e., in the wake of the pandemic and its substantial job loss, it waived the earnings test).

In addition, the ARP converted the refundable portion of the CTC from a once-a-year windfall at tax filing time—a kind of “Christmas Club,” for those of a certain age—to a monthly cash payment. Those monthly cash payments began in July, and with no change in current law they will end in December. According to the Department of Treasury and the IRS, the first monthly payment of the expanded child tax credit in mid-July paid $15 billion to families that included nearly 60 million children, or approximately 80 percent of all children in the United States.

Thus, the status of the credit today is quite complex. At the beginning of next calendar year, with no further change in law, the CTC will revert to the 2017 law. Then, again with no further legal action, it will revert to the pre-2017 law at the beginning of calendar year 2026.

What Is Proposed for the CTC in the Reconciliation Bill?

The reconciliation bill currently considered in the Congress is to all appearances under continuing negotiation. However, the House version of the bill, which has been passed out of the Budget Committee, would extend the CTC increases and liberalizations in the ARP through the end of 2025 (i.e., the expiration date of the TCJA provisions). The cost of the provision would be considerable—rising from an estimated $106 billion in fiscal year 2022 to $134 billion in fiscal year 2025. The total for the full 10 years would be $556 billion. However, if these tax cuts were built into people’s budgets and expectations over four years, there would likely be the strongest presumption that they would be made permanent. And with the annual costs rising on the trajectory that is estimated for the first four years, the cumulative cost for the last six years would surely be about $900 billion. That $900 billion additional cost would increase the cost of that provision to almost $1.5 trillion, and therefore (adjusting the total cost of the reconciliation bill by that same amount, to about $4.4 trillion) this single provision would be one-third of the entire cost of the bill. Alternatively, if one were to assume that the managers of the bill would react by holding the total cost to $3.5 trillion, the $1.5 trillion CTC provisions would be almost one-half of the cost of the bill. In other words, those who favor the reconciliation bill and its contents need to understand that the CTC necessarily will displace many of their other priorities.

This raises a large part of the controversy. When the CTC increase was enacted in the ARP for one year, it was understood by some to be a temporary response to the pandemic, like many other provisions of that emergency relief bill. Making it permanent is an enormous impact on the budget. Doing so as a foot-in-the-door temporary increase (there is no conceivable rationale for enacting the provision for four more years and then allowing it to expire) grossly understates the price tag of the entire bill; another $900 billion of spending and tax cuts is allowed in because of this understatement, and the “fully paid-for” rationalization for the bill is totally undermined.
What Are the Pros and Cons of Extending the Child Tax Credit Enhancements?

**Child poverty.** A major argument currently used in support of the reconciliation provision is that it would reduce child poverty.

The conventional measure of poverty in use for more than half a century makes reference to cash income only, and therefore does not take account of many important government programs (food stamps, tax credits, and others) intended to increase the well-being of low-income households. An alternative, more comprehensive measure (the “Supplemental Poverty Measure”) includes such benefits (and incorporates other improvements, such as accounting for regional differences in the cost of living). Therefore, discussions of the benefit of the CTC (and other government programs that do not increase cash income narrowly defined) must make reference to the Supplemental Poverty Measure, not the headline poverty count.

Recent data have showed that the previous increase in the CTC (the one enacted in 2017) has already played an important role in keeping children out of poverty. In the pandemic year of 2020, in which low-income workers were often displaced, the Supplemental Poverty Measure showed a decline in poverty—indeed, the largest decline in the history of the metric—in which the CTC played a role. However, more important numerically were the economic impact and stimulus payments and the
enhanced unemployment insurance benefits, among other smaller programs which have expired. (But again, note that the CTC provisions that are proposed to be extended in the reconciliation bill were not yet in effect in 2020, and so had no impact on the 2020 measure of poverty incidence.)

But with the expiration of those other programs, the CTC would play a potentially more important role in the future. The Congressional Research Service has estimated that the ARP CTC expansion will reduce the percentage of children living in poverty by 40 percent, with the largest proportional reduction in the poverty gap among families of color.

**Monthly payments.** For many years, dating back to the creation of the refundable EITC, policymakers had been troubled that refundable credit amounts were available to cash-constrained low-income families only in lump sums, once each year upon filing income tax returns. However, with the enactment of the ARP liberalizations of the CTC, the Congress dictated that estimated refundable amounts (based on the prior year’s tax information) be paid to recipients in monthly installments by the Internal Revenue Service (IRS). Those payments began in July, 2021, and are scheduled to continue through December (the expiration point of the CTC liberalizations under current law). One justification for embarking on this initiative was the experience of the IRS in distributing cash rebates during the financial crisis, and in the earlier days of the pandemic. This required the IRS to search through its records of tax filers and to solicit applications from households that had not previously filed tax returns, to accept applications from other non-taxpaying households, and to send checks to all who were deemed eligible. The conclusion of that exercise was evidence that the IRS would be capable of this new assignment.

The positive side of this initiative is that it does make much more sense to deliver cash assistance to low-income cash-constrained families in real time, rather than in a lump sum once per year. Such families have current needs and cannot be expected to borrow and to manage such liabilities on an annual cycle.

There are negative sides, or challenges, to this approach, however.

The IRS had never, before July, been in the business of delivering cash benefits on a periodic basis, which is a different enterprise than distributing one-time cash rebates; an “ASAP” requirement is actually less rigorous than “on a date certain.” The time sensitivity of the CTC payments, which are often directed to households that are presumed to be in financial need, adds pressure to this administrative task.

**Inaccurate payments.** An associated issue is the likely inaccuracy of many of these distributions. The actual amount of CTC due will be based on calendar year 2021 income, which of course is not known as of July or even December of 2021. The monthly payments are based on 2020 tax information, which is the most reasonable guide available; but some monthly payments will be too high, and some will be too low. This is particularly sensitive for a provision like the refundable portion of the CTC, which is received by households of modest means. If a family has somewhat better circumstances in 2021 and the payments prove to have been too large, the IRS finds itself in the painful position of trying, by law, to get the money back from a household that is still financially fragile and that cannot have been expected to do the necessary tax projections in real time to avoid the problem in the first place. An alternative is to provide forgiveness for such overpayments, but that raises questions of equity in the treatment of the affected families versus others (and of course costs revenue, albeit in extremely modest amounts). A mechanism to reclaim any overage over time would be complicated and costly.
Refundability (i.e. no earnings test). Further, there is controversy about making the credit fully refundable to all households. Pre-pandemic, the law implemented an obligation to work to receive refundability (the refundable amount was equal to 15 percent of earnings above a low floor amount; in other words, there was a possible rationale as a compensation for payroll tax liability). In the pandemic, when millions were involuntarily out of work and struggling to feed and house their children, waiving this requirement was not widely raised as a point of dispute. But there will be debate as the pandemic eases over whether the credit should be available to households in which no member works, given the uneven progress of the economy and the slow recovery of employment in the low-paying service sector; there are strong views on both sides.

Missing beneficiaries. An associated challenge is identifying all legal recipients. Because eligibility for a refundable credit under the pre-2021 law required work, virtually every eligible adult recipient was employed and known to the IRS. With full refundability, households with no employment relationship and no legal obligation to file returns become eligible. If they are not well enough informed to seek out the IRS, then the onus falls upon the IRS to find them. There is no telling exactly how many households may be missed; if households have not been identified to receive the credit, they have not been identified to be counted. However, a comparison of the numbers of recipients for various public assistance programs suggests that there may be 4 million children whose households are not receiving payments. But it is an arguable question whether policy should repeal refundability for the legally eligible vulnerable households that have been identified because some others have not. Given the enormous cost of the provision, this component should be considered carefully.

Fraud. A further associated issue is potential fraud. Analysts of the IRS are quick to note that the agency has traditionally been in the business of collecting money, not giving it away; and its capabilities have been developed in keeping with that mission. But in this instance, the IRS has been charged to be a lifeline for large numbers of financially fragile households. As the IRS struggles to deliver important support quickly, there are more than a few unscrupulous individuals who will represent themselves as needy households through digital connections that involve little risk of discovery, using stolen identity information including social security numbers that are required by law for the receipt of the credit. If any evidence of surveillance should emerge, these grifters will disappear into the shadows. We will know only in the fullness of time the extent to which such fraud has been attempted or achieved, but we will need to decide in real time whether that risk is sufficiently serious to tilt the balance against providing aid to truly struggling families with children.

It is not a question of fraud technically defined, but some express upset that some of the CTC dollars may be used for unattractive purposes, or may not address true poverty. Apart from the question of whether such complaint is appropriate when it could be applied to any other federally spent dollars, there is evidence that many of the monies paid out under the CTC have been saved or used to pay down debt. Some would interpret that as an indication that CTC recipients are being prudent; others would counter that those who could afford to save the money cannot be truly poor. That having been said, it is impossible to determine, given the fungibility of money, whether any particular dollars of income for any household are used for any particular purpose. And the Census Bureau reported, admittedly based on only one month of data, that food insufficiency and trouble paying household expenses declined after receipt of the July checks.
Higher-income beneficiaries. Finally, there has been public reaction even dating back to the 2017 law at the receipt of the child credit by higher-income families, with the phaseout of the credit beginning at $400,000 for couples with children. The delivery of the credit through monthly payments has highlighted the incongruity of families with solid six-figure incomes receiving small federal checks every few weeks. There is an associated technical issue. Phasing down such a credit involves what is in effect a higher marginal tax rate in the phaseout income zone. So, for example, a family that earns an additional $20 will lose $1 of its child credit in addition to paying the income tax (and payroll tax) that is otherwise due; in effect, the family’s marginal tax rate is increased by 5 percentage points to phase down the CTC. This implicit increase in the tax rate can lead to confusion, and possibly underwithholding. Criticism of receipt of any amount of CTC by upper-income households sometimes elicits recommendations that the credit should be phased down faster; but that requires an even higher implicit additional tax rate, with even worse side-effects. Alternatively, the credit could be phased down at the same 5 percent rate, but the phaseout could begin at a lower level of income. However, given that there are several government benefits or incentives that are phased out, all of those need to be coordinated so that several phaseouts do not coincide and increase implicit marginal income tax rates by several times that 5 percentage points (or whatever rate applies in any particular program).

Conclusion

There has been a child tax credit (CTC) in the tax law for almost a quarter century. Over that time, circumstances and technology have changed. In quite recent years, the CTC has been liberalized substantially, including major changes earlier this year. But all of the recent changes are only temporary, and like all temporary tax cuts, they attract strong advocates to make them permanent. The most recent changes, enacted as part of the American Rescue Plan (ARP), were effective for only one year, and so there is considerable pressure to resolve their status before December 31.

In the context of the several enormous pieces of pandemic relief legislation, the one-year CTC changes enacted in the ARP did not appear all that large. But now, as part of a 10-year reconciliation bill, the cost of the CTC expansion is becoming clearer, and must be taken into account in the consideration of the full reconciliation bill. The considerable cost of the CTC expansions makes all of the decisions about the reconciliation bill more complex.

As policymakers consider the status of the CTC, the following steps would be constructive and important:

Face up to the cost. The current CTC provision grossly understates the cost of making the changes on a permanent basis. When those same changes in law were recommended for one year in the ARP, many interpreted them as a temporary part of an emergency response to the pandemic. Today, there is no reason whatever to believe that these changes in the reconciliation bill are actually intended to be effective only for precisely four more years; this is a foot in the door to make them permanent. And if they were scored as permanent, they would constitute virtually half of a $3.5 trillion bill—and would dominate a bill under any lower topline constraint. Policymakers must face up to the true cost, recognize the tradeoffs between this provision and all of the other priorities in the reconciliation bill, including all of the other provisions related to children (and all other purposes), and choose accordingly. Assumptions that “we’ll find the money later” are not justifiable in the current environment of runaway budget deficits and debt.
Make a choice on a work requirement. Prior to the pandemic, the CTC was refundable only to the extent that earned income exceeded a floor amount. The floor was waived in response to the pandemic because so many low-wage parents lost their jobs. Now it is proposed to make that unconditional refundability permanent. That would unquestionably provide relief to many low-income families. It also entails a cost—as do others of the CTC provisions (including the higher topline amount of the credit, and the higher age of eligibility). Policymakers will need to weigh these benefits against other priorities in the reconciliation bill, the availability of legitimate offsets to the cost (including the current phaseout of some benefits only over $400,000 of family income), and the underlying budget problem.

Recognize the unavoidable inaccuracy of administration. Important questions have been raised as to whether the IRS is finding the most needy CTC-eligible households to send monthly payments. Nor can the IRS foretell the future, and send monthly payments in amounts that will prove precisely accurate when the calendar (tax) year ends. Policymakers must decide whether the current system’s missing some of the neediest eligible beneficiaries, and whether sending monthly payments that prove excessive, are damning flaws that require cutting back or terminating some features of the credit, or whether they are unfortunate but acceptable costs of delivering support to most of the worthy recipients. And if the latter, policymakers should seriously consider funding the IRS to do the best possible job of delivering that support.

Face up to fraud. There are bad actors who will try to exploit the availability of a refundable CTC. (Just as those same bad actors try to claim income tax refunds using other people’s wage withholding and their stolen identifying information, they use stolen identification to try to claim CTC money.) And some may take issue with how some CTC beneficiaries spend their tax credits. But again, policymakers must decide whether the prospect of fraud is concerning enough to remove the CTC from other worthy beneficiaries. And regardless, the IRS must have funding strong enough to build a robust firewall against bad actors, with respect to the CTC and to every other provision of tax law.

Consider comprehensive tax reform. The current tax law includes the CTC, the child and dependent care tax credit, and the earned income tax credit, all of which go to households with children under varying circumstances, and all of which are phased out at higher income levels. These provisions have been added and modified in uncoordinated steps. The phaseouts in particular raise issues, because they can subject low-income working families to significant marginal effective tax rates on their incremental income should they add or drop a job, get a raise or suffer a loss of pay, or encounter any number of personal developments. In this and many other policy areas, going back to the beginning and building a tax system on purpose might give people both a clearer understanding of, and more trust in, the workings of the tax system. It could be both fairer and more efficient, providing greater incentives. It could reduce the unintended consequences of changes in the tax system such as in the current debate over the CTC, and provide clear benefits for all.