

YOUTH DEVELOPMENT INSTITUTE ISSUE BRIEF

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Tax Credits for Families with Children in Puerto Rico

The child poverty rate in Puerto Rico has remained constant since 1999, a time in which Puerto Rico experienced economic growth, as measured by GNP.¹ To illustrate this point, the child poverty rate in 1999 was 58%, while in 2016 it was 56%. In between those years, the rate has not fluctuated by more than 2-3 percentage points. Tax credits, both at the Commonwealth and Federal level are an opportunity to raise the take home income of children and their families living in or near poverty in Puerto Rico. Currently, the local Puerto Rico legislature is discussing a tax reform that would include the creation of a local Earned Income Tax Credit. This policy was also included in Puerto Rico's Fiscal Plan. At the federal level the extension of the Child Tax Credit for families with 1 or 2 children in Puerto Rico has gained bipartisan political momentum and support. It has been included in 9 different bills in Congress, with the most recent one sponsored by senator Orrin Hatch [R-UT] on July 24, 2018. This issue brief includes an overview of tax credits and their importance, as well as a discussion of their status in 2018, and an estimate of the possible impact of their implementation in Puerto Rico.

About the local EITC and the Child Tax Credit

In simple terms, tax credits reduce the amount of tax an individual has to pay when filing taxes for the Internal Revenue Service (IRS). A refundable tax credit, like the ones we are observing in this issue brief, not only reduces the taxes an individual may owe, but could result in a refund.² These refundable credits target working families and their amount varies by household composition and reported taxable income for a natural year. Tax credits such as the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC) have proven to lift working families with children from poverty in the United States.³ An analysis of the new Census supplemental poverty measure, designed to include the effects of transfer programs on families' disposable income, indicates that income from refundable tax credits (primarily but not exclusively the EITC) reduces the number of people in poverty by over 15%.⁴

The Federal EITC was enacted in 1975 and since then states started to create their own version of the credit. Twenty-five states, the District of Columbia and New York City have a local EITC.⁵ Puerto Rico had a local EITC between 2007 and 2014, but eliminated due to fiscal reasons.

The empirical research over the last decade and a half provides robust evidence that the EITC increases the work effort of its recipients, especially among single mothers.⁶ Tax credits reduce poverty in two ways: (1) by encouraging work and (2) by supplementing the wages of low-paid poor or near- poor workers with a refundable credit. Moreover, studies have found that the size of the EITC has a statistically significant relationship with the improvement of student test scores in math and reading.⁷ In other words, the EITC has been found to also have a positive effect on children living in households that receive the benefit.

Similar to the EITC, the CTC offers a refundable credit specifically targeted for families with children. It was enacted in 1996 as a non-refundable credit and further expanded in 2001 as a partially

refundable credit for families with any number of children in the United States. For households with 1 or 2 children that earned all their income in Puerto Rico, this credit is not available because it is

calculated from Federal income taxes, which Puerto Rican residents don't have to pay. However, the portion of the CTC applicable to households with three or more children can be calculated as the excess of a taxpayer's payroll taxes, which Puerto Rican working households do pay.⁸ Hence, only families with 3 or more children are able to receive CTC in Puerto Rico, limiting its positive effects on the workforce participation rate and poverty.

The Puerto Rico EITC in 2018

The tax reform bill (P.C. 1544 section 1052.01) introduces the creation of a local EITC in Puerto Rico. According to the New Fiscal Plan certified by the Fiscal Oversight and Management Board (FOMB) this new version of the EITC has the objective to: increase the workforce participation rate, reduce poverty, increase the tax filer base, decrease the informal workforce participation and reduce dependence on social benefits programs.⁹ It is the component with the most robust scientific evidence of an otherwise limited approach to reducing poverty and increasing workforce participation proposed by the Fiscal Oversight and Management Board.

As noted earlier, Puerto Rico implemented a version of an EITC from 2007 – 2014 through the 2006 public law 117 (July 4, 2006). This tax credit was broad in its design with a maximum credit of \$450 by 2013. In its last year, the cost of the local EITC was around \$151.6 million dollars and about 48% of tax filers (505,962) claimed this refund.

According to a recent analysis by economist Maria Enchautegui, the design of this new local EITC is superior than the last one in at least 5 ways¹⁰:

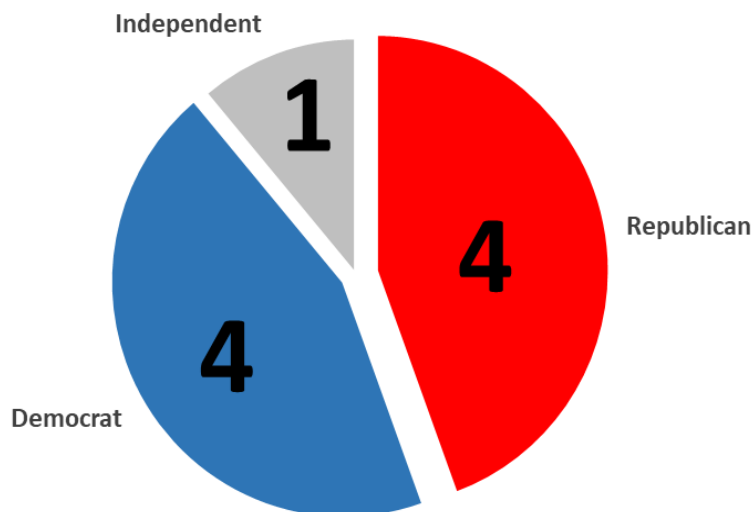
- It has a phase in and phase out rate, rather than a \$10,000 floor to receive the refund. For example, for single filers the range is \$6,000 - \$18,000 with a maximum refund of \$300.
- Considers the civil status and household composition of filers to determine the amount.
- It allows for a larger refund. For example, under the old EITC a single mother with two children making \$15,000 would have received a refund of \$350, or 2.3% of her reported income. With this proposed EITC this mother will receive a refund of \$1,500 or 10% of her reported income.
- It counts income from self-employment, when it is authorized by the Departamento de Hacienda. The old EITC did not have this provision.
- Eligibility can be determined by the earnings of each member of the married couple. The old EITC counted all the members of the household individually, meaning that at least 1 household member had to earn \$10,000 dollars.

The Child Tax Credit in 2018

At the Federal level, the extension of the CTC for families with one or two children in Puerto Rico has been part of nine bills in Congress. These bills were authored by four Republicans, four democrats and one independent senator proving that it is an issue with broad and strong support. Furthermore, 53 individual legislators have co-sponsored these 9 bills and 17 of them have done it in more than one occasion.¹¹ In addition to this, the Bipartisan Congressional Task Force on Economic Growth in Puerto Rico recommended to amend Section 24 of the Internal Revenue Code to authorize otherwise eligible families in Puerto Rico with 1 child or 2 children to claim the additional child tax credit, with the amount of the credit equal to the amount of annual federal payroll taxes paid by the family or \$1,000 per qualifying child, whichever is lower.¹²

Figure 1

Number of Bills that Include the Extension of the Child Tax Credit to Puerto Rico



Information from the 115th Congress Retrieved from: <https://www.congress.gov/>

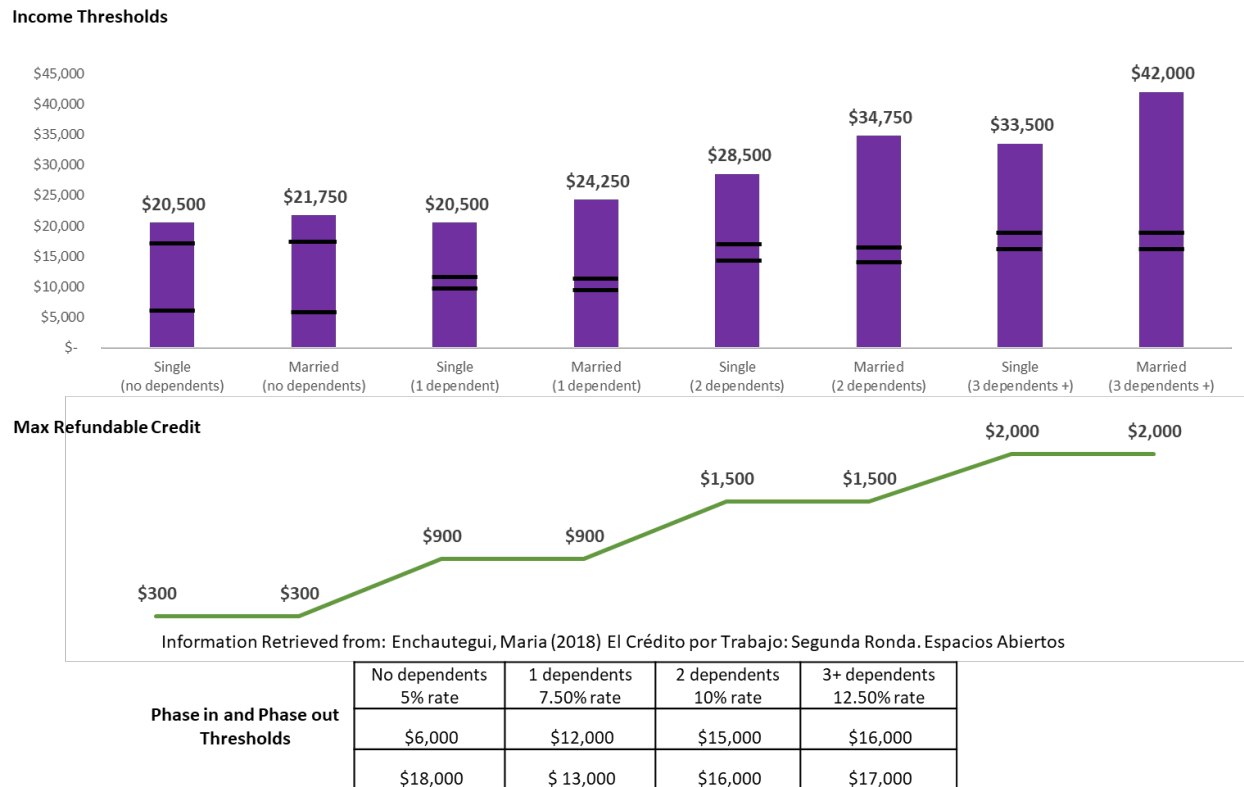
Potential Impact

The Puerto Rico Earned Income Tax Credit

If the local EITC is passed in this new tax reform will be claimed by 288,000 tax filers according to the new Fiscal Plan. This investment could effectively lift some families with children out of poverty and increase the economic security of others. As an example, if a single mother with two children earning

\$19,000 files for the local EITC, she would be eligible to receive a refund of approximately \$1,200 minus taxes. This would effectively lift this family above the federal poverty line set at \$19,337 for this household type. Below are more examples of impacts per households using the maximum eligible refund.¹³

Figure 2: Proposed design for the new local EITC in Puerto Rico



As Figure 2 illustrates, benefits begin with the first dollar of reported income. As income increases, the benefit also increase at the phase-in rate (different depending on household size), up to the maximum credit. When income reaches the phase-in cap, the benefit increase stops. Benefits remain constant at income levels that fall between the phase-in cap and phase-out cap start. When income reaches the phase-out stage, benefits begin decreasing at the phase-in rate for each additional dollar earned, until income reaches the income cap. Once the income cap is attained, the benefit is no longer available. As an example, a single parent with two children would receive the maximum benefit of \$1,500 when she is making between \$15,000 and \$16,000 a year, and would stop receiving the benefit once she reaches an income of \$28,500 or above.

Child Tax Credit

In terms of the extension of the CTC, the report from the Bipartisan Congressional Task Force on Economic Growth in Puerto Rico in 2016 estimated a total of 355,000 new eligible families and 404,000 newly eligible children will be able to access the credit. The report also estimates an average of \$770 average credit for all Puerto Rico families. However, since 2016 the CTC was revised under the 2017 Tax Revision (P.L. 115-97) expanding the income thresholds, the phase in caps, the maximum credit and the income cap by household. This would include the vast majority of the families with children in Puerto Rico.¹⁴ Using Census data from the Puerto Rico Community Survey, we would estimate that the size of the refundable credit for families with one or two children living under poverty would be around \$1,406.30 before tax liabilities.¹⁵

Conclusion

The EITC and the CTC would be one important step towards strengthening the economic security of families with children. In doing this, we could begin to see a reduction in child poverty rates, improved outcomes for children and youth, and hence, position the island for stronger economic and social development. It should be noted that in order to significantly reduce child poverty, a more comprehensive approach is warranted. This comprehensive approach should include two-generation policies that reduce barriers to employment for parents, and increased supports for families in the transition to employment.

References:

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³ Center on Budget and Policy Priorities (2017) Policy Basics: State Earned Income Tax Credits. Retrieved from: <https://www.cbpp.org/research/state-budget-and-tax/policy-basics-state-earned-income-tax-credits>

⁴ Ibid.

⁵ Internal Revenue Service (2018) States and Local Governments with Earned Income Tax Credit. Retrieved from: <https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/states-and-local-governments-with-earned-income-tax-credit>

⁶ Neumark, David, Shirley, Peter (2018) Long-Run Effects of the Earned Income Tax Credit on Women's Earnings. NBER Working Paper No. 24114, (National Bureau of Economic Research)

⁷ Chetty, Raj, Friedman, John N., Saez, Emmanuel (2012) Using Differences in Knowledge Across Neighborhoods to Uncover the Impact of the EITC on Earnings, NBER working Paper No. 18232, (National Bureau of Economic Research: Cambridge, MA, 2012), p.4.

⁸ Congressional Research Service (2018) The Child Tax Credit: Legislative History. Retrieved from: https://www.everycrsreport.com/files/20180301_R45124_2cd791dba88095e6e5dc9cff8342cb8ffd8b5872.pdf

⁹ Fiscal Oversight and Management Board (2018) New Commonwealth Fiscal Plan: Restoring Growth and Prosperity. June 30, 2018

¹⁰ Enchautegui, Maria (2018) El Crédito por Trabajo: Segunda Ronda. Espacios Abiertos

¹¹ Information Retrieved from: <https://www.congress.gov/>

¹² 114th Congress (2016) Congressional Task Force on Economic Growth for Puerto Rico Report

¹³ Enchautegui, Maria (2018) El Crédito por Trabajo: Segunda Ronda. Espacios Abiertos

¹⁴ The phase out threshold starts at \$200,000 for unmarried taxpayers and \$400,000 for married taxpayers. The phase in threshold is \$2,500 in both types of filers.

¹⁵ The Puerto Rico Community Survey does not include a separate count for families with one or two children. Using the available data and assuming that families will be taking the CTC out of their excess payroll taxes, the following formula was created [Number of families with one or two children living under poverty] \times [Average Income from poverty thresholds - average credit for families with one or two children] \times 7.65% percentage using the alternative calculation of the payroll taxes. We believe that this calculation would include the vast majority of children in Puerto Rico given high poverty levels but also recognize that is a sub-estimation.