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Social Policy and the Tax System

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Social Policy and the Tax System

URBAN INSTITUTE

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PREFACE

To sort out the pros and cons of using the tax system to enact social policy goals, in particular to help low-income families, the Urban Institute convened a tax policy forum in Washington, D.C., on June 21, 2001. The discussion revealed that using the tax system as a social policy tool is a much more complex and subtle undertaking than would appear to be the case from many popular pronouncements.

Participants explored a range of issues from the ideological dilemmas involved in dramatically transforming the tax collection process to the administrative practicalities and obstacles such a switch would entail. And they considered specific examples, such as the benefits of using refundable tax credits to assist low-income earners and the likely pitfalls awaiting a proposed health care tax credit.

This publication draws on the forum discussion to present an overview of the issues involved in using the tax system to promote social goals.

SOCIAL POLICY AND THE TAX SYSTEM: AN OVERVIEW OF THE ISSUES

The system that has long been associated with perks for the rich can also be used to benefit the disadvantaged.

THE PROMISE AND THE HITCH

An image of the tax system as a money tree laden with ripe fiscal fruit just waiting to be plucked for a variety of social, economic, and political purposes has become increasingly popular in Washington policy circles in recent years. In theory, tax incentives can be employed to reduce taxes and direct government spending while supporting targeted programs, behaviors, or constituencies. The system that has long been associated with perks for the rich can also be used to benefit the disadvantaged.

In this view of tax spending, everyone wins. In the opinion of others, however, it's not that simple. Tax spending may work well for some programs and people, but not for all.

"We already have this mechanism by which people are making annual payments to the government, and which collects a lot of data about people," former Urban Institute Senior Fellow Eric J. Toder, now of the IRS, told participants at the June 2001 tax policy forum convened by the Urban Institute at its headquarters in Washington, D.C. "So it may be convenient to take this mechanism and turn it in the other direction and make reverse payments. However, this is a totally different use of the income tax system."

Two questions, at least, need addressing:

- When is the tax system a proper vehicle for promoting these activities?
- What are the overall effects of shifting from direct spending programs to tax spending programs?

By reducing the amount of income taxes owed, a tax cut can in effect put more money in the pocket of any category of taxpayer. And it can do that with a lot less bureaucracy, and fewer cumbersome rules and time-consuming hoops for the recipient to jump through than traditional means-tested transfer programs. There's a hitch, however. Traditionally, to benefit from a tax cut you had to owe income tax. Over the last 15 years, the tax laws have increased the income level at which a household, particularly a family with children, must begin to pay income tax. That has helped the poor, who no longer are burdened with onerous income taxes. But it has also meant that low-income families haven't been able to benefit from a variety of tax cuts.

Makers of tax policy have come up with a solution to that glitch. For those who don't owe taxes because their income is too low, a refundable tax credit allows the government to write them a check. For years, the Earned Income Tax Credit (EITC) was the only refundable tax credit that affected large numbers of people. In 1997, Congress enacted a new child credit and made it partially refundable for taxpayers with three or more children. Now the 2001 Tax Relief Act has made more of the child credit refundable for many eligible families and extended the refundable feature to families with one or two children. And the Bush administration and members of Congress are proposing additional refundable tax benefits.

But today's refundable tax credits only go so far. To enable them to work efficiently through the existing tax system, they are limited to people with positive earnings. This means that most credits go to people who already file tax returns, even if only to claim refunds on taxes withheld on their wages. They largely exclude both the non-working poor and many working poor without children; these groups will continue to depend on direct spending programs for assistance. Another downside of refundable tax credits for low-income households is that they typically are made as lump-sum payments at the end of the tax year. That's a long time for a needy family to wait for money crucial to meet day-to-day living expenses.

By reducing the amount of income taxes owed, a tax cut can in effect put more money in the pocket of any category of taxpayer.

The specific nature of the activity to be promoted through the tax system has much to do with the success of using a tax benefit.

The specific nature of the activity to be promoted through the tax system has much to do with the success of using a tax benefit. The EITC helps make work pay for low- and moderate-income earners. It does not add much to the number of tax returns the IRS must process. Most recipients would still need to file returns to recover taxes withheld from their wages. And since the desired result is simply additional income, the refundable benefit is able to provide that.

But, to take one example, the proposed health care tax credit is a very different matter. The U.S. health insurance system is extremely complex and most private insurance is offered through an employer. The provision of a tax credit, even if it is refundable, won't necessarily result in much of an increase in health care coverage for the uninsured. Some proposals could even backfire and end up reducing health care coverage by encouraging employers to drop their plans so that workers could be eligible for the credits. To take another example, the effects of proposals for a refundable child care tax credit are also unclear. Tax subsidies for child care may or may not be a more effective way to increase paid employment among mothers of young children than spending programs.

Many factors go into a decision to go the tax system route rather than the direct spending route to achieve particular social or political goals. "Even if some tax credits are bad tax policy," Janet Holtzblatt, Deputy Director of the Individual Taxation Division in the U.S. Treasury Department's Office of Tax Analysis, told the forum, "they may achieve other policy goals more efficiently than alternative approaches."

THE RATIONALE AND THE GOALS

It may be politically and socially popular, but tax spending violates the basic tenets of classic tax policy: fairness, efficiency, and simplicity. But that has never stopped the nation's decisionmakers from granting tax relief to encourage home ownership, charitable giving, retirement saving, or the provision of group health insurance to employees. Historically, a substantial portion of tax expenditures promoted business investment and assisted selected industries. Over the past two decades, however, business tax expenditures have declined as a proportion of gross domestic product while tax expenditures for social purposes have grown, according to Toder's estimates.

Tax benefits come in a variety of shapes. Many of them—deductions and exemptions, for example—reduce the amount of income that is subject to tax and thus are worth more to higher-income taxpayers who pay a higher tax rate on their last dollar of income. In contrast, tax credits are subtracted from income taxes and can be designed in different ways to achieve the desired effects on the distribution of after-tax income.

Proponents have justified most tax benefits for families as a way to promote justice and fairness. An early aim of providing tax exemptions for children, for example, was to adjust for family size on the presumption that a larger family would have a harder time making ends meet on the same income as a smaller family. One rationale for refundable tax credits is to offset additional federal taxes, particularly payroll taxes, that impose a greater burden on those with lower incomes.

Proponents have justified most tax benefits for families as a way to promote justice and fairness.

The next step on this path would be to provide support through refundable tax credits for very low-income people who don't have earnings. But such a step is controversial. It requires disconnecting taxes from earnings. A refundable tax credit that offsets the payroll taxes collected from a low-income worker is one thing. Sending a check to a low-income person with no attachment to the workforce breaks the link to income and payroll taxes and steps over a philosophical line many tax experts are unwilling to cross.

Changes in the tax statutes that made tax benefits available to lower-income families ironically created a dilemma for policymakers who want to use the tax system to increase benefits to those families. Over the past 15 years, the threshold for paying income taxes has

By far the biggest winners as household tax relief has been expanded have been families with children—both married couples and single parents.

gone up. The good news, according to Holtzblatt, is that a family of four will not have an income tax liability before the EITC until their income is greater than $36,000, or about 200 percent of the federal poverty level. The bad news for policymakers who want to provide more assistance through the tax system is that families with incomes below 200 percent of the poverty level will not benefit from further increases in tax credits unless they are refundable because they do not have any further income tax liability to offset.

While tax benefits for low-income families have been increasing, the tax system has always had to confront issues of how to tax different types of families at all levels of income. In that regard, tax system designers must decide two main questions. The first question is how much extra tax benefit to give to families with more children. The second question is how to tax married couples compared with single individuals, with or without children.

By far the biggest winners as household tax relief has been expanded have been families with children—both married couples and single parents. The 2001 tax act continued the trend toward helping families with children but also reduced the so-called marriage penalty—the feature of the tax law that imposes more tax on many married couples than they would pay if they were single and had the same incomes.

Meanwhile, childless single adults have been left out in the cold. In 1970, a single individual with poverty-level income had to pay 8.3 percent of that meager income to the IRS, while a childless married couple with poverty-level income paid 5.6 percent and a married couple with two children paid 3.5 percent.

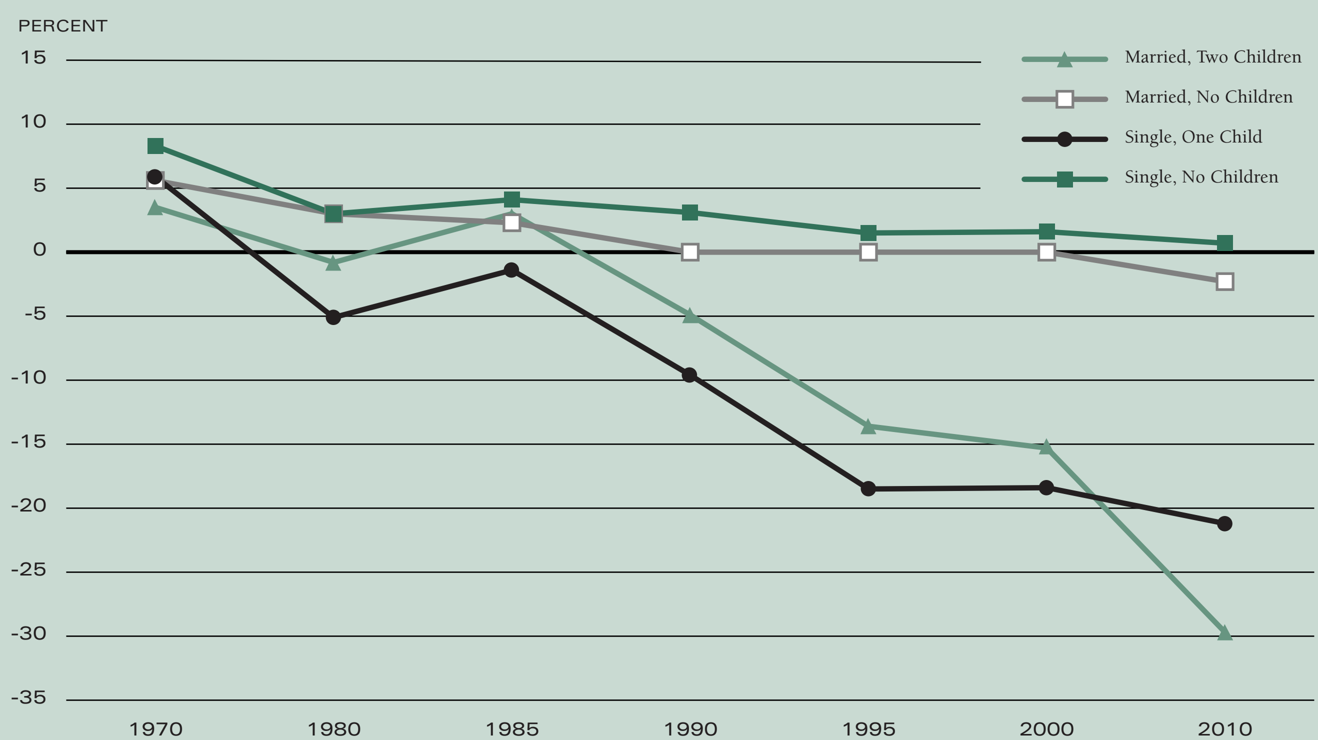
Tax relief over the past 31 years has eased the tax burden on all of these low-income households, but the gap between them has widened, with much larger benefits going to families with children. In 2001, a low-income single person must pay a little less than 1 percent of income. Married couples at the poverty level don't have to pay income taxes and actually get some money back from the IRS: a married couple without children gets a check equal to 2.3 percent of income, and a married couple with two children gets a refund equal to 29.7 percent of income. Children remain crucial to the equation. A low-income single parent with two children gets almost as much back (28.7 percent) as a low-income married couple with two children. (See chart, opposite page.)

Some advocates for the poor worry about the perpetual tilt toward married couples and children. Several participants in the tax forum warned that this continuing emphasis might further isolate and disadvantage single childless minority males, who end up with the short end of the stick whether government assistance comes as direct spending or tax spending.

Both the specific goal of assisting low-income families through tax spending and the general trend toward implementing government policy through the tax code got a big push from the Economic Growth and Tax Relief Reconciliation Act of 2001. Much has been made on the political stump and in the news media of the act's generous tax cuts for the wealthy. What received a lot less attention are the substantial benefits for those of little or moderate means.

The tax relief act doubled the child tax credit from the $500 per child provided in 1997 to $1,000 when fully phased-in in 2010. Perhaps more important, the act significantly expanded the child credit's refundability feature.

TRENDS IN INCOME TAX RATES FOR SAMPLE FAMILIES AT POVERTY LEVEL



Source: Urban Institute, 2001.

IT'S NOT JUST FOR THE WEALTHY: WHAT THE 2001 TAX RELIEF ACT DOES FOR LOW-INCOME HOUSEHOLDS

> *"We have crossed a kind of bridge with the 2001 Tax Relief Act. The Earned Income Credit used to be the only refundable credit. There was a little refundability with the child credit, but that applied to very few people. Now it is very broadly refundable to a large number of earners. There clearly is a need to rethink how the tax system is used given that the income tax is no longer for taxpayers only, with one asterisk for the Earned Income Credit."* Eric J. Toder, Director, National Headquarters Office of Research, IRS.

Provisions of The Economic Growth and Tax Relief Reconciliation Act of 2001 that benefit low- and moderate-income individuals, married couples, and families include:

- *The lowest **tax bracket** is reduced from 15 percent to 10 percent.* Effective this tax year, it applies to the first $6,000 of taxable income for a single filer, $10,000 for a head of household (often a single mom), and $12,000 for married couples filing joint returns. Beginning in 2008, the 10 percent rate will apply to the first $7,000 of taxable income for individuals and $14,000 for married couples.
- *The **Child Tax Credit** will be doubled in three steps* from the current $500 per child to $1,000 per child in 2010. More important, its refundable features have been liberalized and extended. Previously, the credit was only refundable for families with three or more children. Under the new law, the provisions for claiming a refund will also apply to taxpayers with one or two children. Under the old law, the maximum amount of refund was the difference (if positive) between the employee share of payroll taxes (7.65 percent of wages) and the refundable portion of any earned income credit amount that he or she received. Under the new law, the maximum refund will be equal to 10 percent of the difference between the taxpayer's earned income and $10,000. (This means that, if a taxpayer earned $17,000, the maximum refund will be $700). The maximum refund percentage will increase to 15 percent in 2005, while the $10,000 amount will be indexed to changes in the price level after 2002. Taxpayers with three or more children will be able to use either the new limit on the amount of refund or the prior law limit.

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- *The **Dependent Care Tax Credit** is increased beginning in 2002, but not made refundable.* The credit helps pay for employment-related childcare. The amount of childcare expenses that can be used to compute the tax credit rises from $2,400 to $3,000 for one child and from $4,800 to $6,000 for two or more children. In addition, the maximum credit rises from 30 percent of those eligible expenses to 35 percent. The income level to claim the maximum credit rises from $10,000 to $15,000, after which the percent of expenses that can be claimed phases down.

- *Several provisions ease the so-called **marriage penalty*** that resulted in many two-earner married couples paying higher income taxes than two single taxpayers with the same combined income. In five annual steps between 2005 and 2009, the law raises the standard deduction for married couples to twice the standard deduction for singles. Similarly, in four annual steps between 2005 and 2008, the law increases the income level covered by the 15 percent income tax bracket for married couples to make it twice the size of the bracket for singles.

- *The **Earned Income Tax Credit** increases for many married couples and is simplified.* Up until now, the phaseout of the EITC began at the same income levels for both unmarried and married individuals. (In 2000, the EITC phaseout began at $5,770 for taxpayers with no children and $12,690 for taxpayers with one or more qualifying children.) The result was to create some large marriage penalties for some two-earner couples. For example, in 2000, a woman with two children and an income of $12,690 would receive the maximum EITC in that year of $3,888. If the woman married a man with no children and the same earnings, the EITC of the couple would drop to $1,215 because the additional income of the couple would cause much of the credit to be phased out. The new law reduces the marriage penalty by increasing the start of the phaseout range for married couples by $3,000 in three $1,000 steps between 2002 and 2008. In addition, the law simplifies several important definitions, including what constitutes income and who can be claimed as a child for the EITC. It modifies the so-called "tie-breaker" rule that required the taxpayer with the higher adjusted gross income (AGI) to claim a child for EITC purposes when two taxpayers were otherwise eligible to claim the same child. Previously, this rule was the source of a large number of errors and thus disqualification and denial of the tax credit.

Very low-income people who have no attachment to the workforce need assistance desperately, but extending that assistance through a refundable tax credit may not be helpful to them.

STRUCTURAL BENEFITS AND ADMINISTRATIVE HURDLES

The tax code is attractive as a social policy tool because, among other advantages, it seems to minimize the bureaucracy and the frequent congressional reviews inherent in direct spending programs. And tax benefits appear to be a more certain and permanent form of assistance because many of them are exempted from the annual congressional appropriations process.

The new thinking also fits into current IRS efforts to change its image from the heavy-handed tax collector to a benign financial services agency like the Social Security Administration. But the tax system was set up to collect taxes, not to administer social programs. Some tasks are simply beyond its current scope of operations. Other procedures that work well for tax collecting are cumbersome for providing benefits. And because they were not intended to be social programs, tax benefits aren't coordinated with spending programs for low-income households.

Very low-income people who have no attachment to the workforce need assistance desperately, but extending that assistance through a refundable tax credit may not be helpful to them. These individuals may receive more hands-on assistance and services through a direct spending program than through a tax credit.

In fact, the EITC is now the largest single source of federal support for low-income families. It far exceeds the amount on any other federal program, including Food Stamps and Temporary Assistance for Needy Families (TANF).

One of the most politically attractive features of using the tax system rather than direct spending programs for social policy is the lack of bureaucracy—government funds go directly to the poor. But that, too, has a downside. Tax forms can be formidably complicated. The IRS—unlike state welfare offices—doesn't have an army of conveniently located social workers to help fill them out. So, low-income families have to dip into their meager resources to hire paid tax preparers. Indeed, a greater proportion of EITC recipients (62 percent) use paid tax preparers than the rest of the tax-filing public (53 percent of all filers).

On balance, despite some administrative obstacles that make the tax code less attractive for certain forms of support, tax spending appears to hold out substantial opportunities as a tool of social policy.

TAX CREDITS THAT WORK AND ONES WITH DRAWBACKS

When it comes to deciding which route to take to assist low-income families, generalizations about the overall virtues of tax spending versus direct spending are probably less useful than the details of the specific kind of help envisioned. A comparison of how the EITC and the food stamp programs actually work suggests that the EITC might have some advantages. An analysis of proposals for a health care tax credit, conversely, indicates it might have major drawbacks. And the findings on child care credits are inconclusive.

EITC vs. Food Stamps: The EITC is the oldest and largest attempt to use the tax code to assist low-income households. It is the only refundable tax credit with a track record. The EITC was enacted in 1975 and has been expanded dramatically in the intervening 26 years. In 1998, it provided $32 billion in tax relief and refunds to nearly 20 million recipients. The Food Stamp program, adopted in 1964, assisted 8 million households at a total cost of about $20 billion in 1998.

In a comparison of the two programs, Holtzblatt found that the EITC is cheaper and easier for both the government to administer and the recipient to use. About one-fifth of the Food Stamp budget—$4 billion—is consumed in administrative costs. The IRS hasn't broken out the total costs of overseeing the EITC, but the total agency budget for handling 122 million individual taxpayers and 5 million corporations was only $7.3 billion in the 1998 fiscal year.

For the recipient, the food stamp hassle comes mostly up front. To apply for food stamps, the prospective recipient must make a personal trip to the state office, fill out a 12-page form, and provide a large stack of documentation. While on average the process takes about 5 hours, many applicants have to take a day or two off from work. And then they have to go back and get recertified periodically, in some states as often as every three months. It's no surprise that only 47 percent of eligible low-income workers participate in the food stamp program, compared to 70 percent of the nonworking poor.

Participation in the EITC is much higher. According to one study, 80 to 86 percent of those eligible submit claims. One reason is that the EITC is less cumbersome, although it is not free of all hassle for the recipient. The inconvenience comes at the other end. About 95

EITC is cheaper and easier [than food stamps] for both the government to administer and the recipient to use.

percent of EITC recipients file tax returns anyway, so claiming the credit is just a matter of filing an additional schedule. But the forms are complicated. Until simplifications were written into the 2001 Tax Relief Act, even the definition of who is a qualifying child was very difficult to understand. And making a simple mistake like forgetting to write in a child's correct Social Security number could result in being disqualified. For the overwhelming majority of EITC beneficiaries, the refund comes at the end of the year. To speed up payment, 45 percent of them file their returns electronically. For all these reasons, most claimants pay for a professional tax preparer. And because the money still doesn't get to them very fast, many pay an additional sum to arrange for a refund anticipation loan.

Until simplifications were written into the 2001 Tax Relief Act, even the definition of who is a qualifying child was very difficult to understand.

Another consideration, which to some extent evens the score between EITC and food stamps, is the cost of noncompliance. The up-front costs to the IRS of administering the EITC may be minuscule compared to the costs to the Department of Agriculture and the states for administering food stamps. But a recent IRS study discovered that 25.6 percent of claims paid in 1997 were erroneous. The error rate for food stamps was about 7.6 percent, which when added to the 19 percent administrative cost of food stamps, brings the two programs into a kind of balance.

In recent years, the IRS, the Department of Agriculture, and the states have been working to lower administrative and compliance costs of both programs and to make each program more user-friendly. Also, the IRS has been developing a dependent database that uses administrative records, including state child custody records, to verify EITC claims before refunds are paid out.

According to Holtzblatt and others, targeting refundable tax credits to those with earnings builds on the strengths in the tax system relative to those in spending programs. But spending programs still serve an important role—providing assistance to nonworking poor families as well as meeting certain needs of working families in a timelier and more cost-effective manner than refundable credits can.

Health Care Tax Credit: President Bush and some members of Congress want to use the tax system to help some of the 43 million people who don't have health insurance to purchase coverage. The idea is politically attractive but, according to Linda Blumberg, Urban Institute researcher, and others, it is fraught with difficulties.

Unlike the EITC, which simply gives people cash, a health care tax credit would be used to purchase a specific product. Because the credit is linked to a purchase, consideration must be given to what people are going to be able to buy with the subsidy. Answering that question is complicated because there's no such thing as a standard health insurance policy.

The price tag for health insurance policies varies tremendously according to the state or geographic area in which the purchaser lives, the buyer's age and health status, and family structure, particularly in the nongroup market. Most people with private health insurance purchase it through an employer group. Individually purchased policies—the kind that would be subsidized by a tax credit—are much more expensive for the same set of benefits due to high administrative loads. Insurers in most states can still refuse to sell nongroup coverage to individuals that they deem to be poor risks. And even individuals with fairly minor past health conditions may be refused insurance altogether or have coverage for related problems excluded from the policies that they are offered.

The end-of-the-year lump-sum-payment problem that dogs the EITC would be exacerbated in a health care tax credit. Recipients are required to pay for their health insurance throughout the year, while tax credits are generally received after filing tax returns after the end of the year. This would create a cash flow problem for low-income people who want to purchase coverage. If the credit were paid out in advance, that advance payment would be based upon a prediction of the year's income. But if the actual amount of the credit is reconciled with annual income at the end of the year, individuals may be uncertain about the actual amount of the credit that they would be due. This uncertainty is likely to decrease participation. The challenge, according to Blumberg, is not just to make the subsidies accessible in a timely manner but to do so in such a way that the recipients won't feel they're incurring costs they may find out later they really cannot afford.

Studies by Blumberg and others show that low-income people shy away from purchasing insurance if they have to pay significant amounts of the premiums out-of-pocket. Another problem would be designing a tax credit that doesn't backfire and cause employers to drop the health insurance they already provide to their workers.

Studies by Blumberg and others show that low-income people shy away from purchasing insurance if they have to pay significant amounts of the premiums out-of-pocket.

CAN TAX BENEFITS SUBSTITUTE FOR SOCIAL PROGRAMS?

"Tax benefits as they currently exist are not a substitute for the expenditure safety net for the very lowest-income families." Frank Sammartino, Principal Research Economist, Joint Economic Committee's Democratic staff.

Frank Sammartino, Joint Economic Committee, compared benefits received by households whose incomes were only half of the poverty level. He found that payments from spending programs such as Temporary Assistance for Needy Families (TANF), food stamps, Social Security, and Supplementary Security Income nearly tripled the incomes of these families, while tax benefits barely raised their incomes at all.

Although many low-income working families do receive both transfer payments and the EITC, the spending programs and the tax benefits are not well coordinated. Elaine Maag of the Urban Institute calculated different benefit levels for families in Pennsylvania. Initially, she found that the Earned Income Credit is phasing in while the transfer programs are phasing out, helping ease the burden for those affected. But once the threshold is crossed between an income equal to 125 percent of the poverty level and one equal to 150 percent of the poverty level, there is no gain. At higher income levels individuals actually see less in their pockets.

Maag had done the calculations for a hypothetical single mom with two kids in Pennsylvania who earned about $16,400 and was at 125 percent of the poverty level. This low-income worker wasn't eligible for TANF but did get about $2,500 in food stamps. When she added to that the net benefits from the EITC and the child tax credit, her total spending money turned out to be about $20,600. Then Maag figured out what would happen if this hypothetical mom got a $3,300 raise to $19,700 (equal to 150 percent of the poverty level). The result: She would end up with $200 *less* to spend! That's because she would no longer be eligible for food stamps and her EITC would decrease. Even though she would get more money from the child tax credit, she would have to pay more in income taxes. (See chart, opposite page.) When the 2001 tax relief act is fully implemented, however, her plight will be somewhat eased because of adjustments to the EITC and the expanded refundability of the child tax credit. But inconsistencies between tax benefits and spending programs will persist.

Even for those families that get the biggest benefits from refundable tax credits, there are administrative hitches. Tax benefits are designed as lump-sum reimbursements at the end of the tax year. Low-income families need money throughout the year. It is difficult for them to come up with the cash to pay for necessary items even if they know they'll get the money back at the end of the year. Workers expecting an EITC refund can ask for a cash advance from their employers. But that option is limited and few recipients take advantage of it—about 150,000 recipients out of 20 million, according to an estimate by Janet Holtzblatt of the U.S. Treasury Department's Office of Tax Analysis.

MARGINAL TAX RATES—SINGLE PARENT FAMILY, 2 DEPENDENTS IN PENNSYLVANIA
BY PERCENT OF POVERTY LEVEL

	50%	100%	125%	150%	175%	200%	225%	250%	275%	300%
Earnings	$6,567	$13,133	$16,416	$19,700	$22,983	$26,266	$29,549	$32,833	$36,116	$39,399
+ Employer's SS Tax	502	1,005	1,256	1,507	1,758	2,009	2,261	2,512	2,763	3,014
= Total Earnings	**$7,069**	**$14,138**	**$17,672**	**$21,207**	**$24,741**	**$28,275**	**$31,810**	**$35,345**	**$38,879**	**$42,413**
Cash and in-kind transfers										
+ TANF	4,380	0	0	0	0	0	0	0	0	0
+ Food Stamps	3,876	3,444	2,571	0	0	0	0	0	0	0
Total Transfers	$8,256	$3,444	$2,571	$0	$0	$0	$0	$0	$0	$0
Taxes										
+ Federal EITC ('98 rules)	2,627	3,572	2,881	2,189	1,498	806	115	0	0	0
+ Federal Child Tax Credit ('98 rules)	0	0	0	0	398	800	800	800	800	800
+ Child and Dependent Care Credit	0	0	310	803	897	987	960	960	960	960
- Federal Income Tax	0	0	310	803	1,295	1,787	2,280	2,772	3,265	3,757
- SS Tax—Employee	502	1,005	1,256	1,507	1,758	2,009	2,261	2,512	2,763	3,014
- SS Tax—Employer	502	1,005	1,256	1,507	1,758	2,009	2,261	2,512	2,763	3,014
Total fed income and payroll tax	**$1,623**	**$1,562**	**$369**	**$–825**	**$–2,018**	**$–3,212**	**$–4,927**	**$–6,036**	**$–7,031**	**$–8,025**
= Cumulative Net Income	**$16,948**	**$19,144**	**$20,612**	**$20,382**	**$22,723**	**$25,063**	**$26,883**	**$29,309**	**$31,848**	**$34,388**
Change in Earnings		7,068	3,534	3,535	3,534	3,534	3,535	3,535	3,534	3,534
Sum of Benefit Losses, Tax Increases		4,872	2,066	3,765	1,193	1,194	1,715	1,109	995	994
Incremental Tax Rate		**69%**	**58%**	**107%**	**34%**	**34%**	**49%**	**31%**	**28%**	**28%**

Notes: Excludes value of Medicaid, housing subsidies, and state taxes. Assume $3,900 in child care costs for families under 200 percent of poverty level, $4,800 for others.
Source: Urban Institute, 2001.

Health care tax credit advocates argue that the availability of the credit will help create a market for cheap health insurance plans for individuals.

Health insurance is expensive and most of the tax credit proposals are meager. The president's fiscal year 2002 budget proposal—a credit of $1,000 for individuals and $2,000 for families—is one of the most generous offers. But it would fall far short of paying for comprehensive coverage. A national survey showed that employer-provided group insurance on average costs $2,400 for an individual and $6,500 for families in the year 2000. Nongroup insurance premiums would be higher for similarly comprehensive benefits. These amounts would put such insurance way beyond the means of a poverty-level family. Even a family whose income is 200 percent of the poverty level would be faced with a post-credit premium bill that is 20 percent of their income, by the time the program is fully phased-in in 2004.

Health care tax credit advocates argue that the availability of the credit will help create a market for cheap health insurance plans for individuals. Blumberg and others disagree, noting that there is nothing stopping such policies from being sold in the current market. Clearly more people could afford them today without a credit than can afford the more comprehensive policies offered in the nongroup market. The reason such policies are not being sold is that high-deductible, limited-benefit plans are not attractive to many low- or modest income people. In addition to all the other drawbacks of a health care tax credit, they pose many administrative difficulties for the IRS, which has had little experience administering this type of health care subsidy.

Nonetheless, a health care tax credit could be fashioned in a way which is likely to expand insurance coverage, according to Blumberg. It would require a subsidy that approximates the cost of an available policy, and the cost and subsidy would, therefore, need to vary by state and probably also by the health status of the targeted individuals. Everyone would need to be guaranteed access to a policy of reasonable quality for which they could use the credit. Eligibility would not be contingent on employer behavior or past insurance status. And effective administrative mechanisms would be required.

Even if all this could be achieved, the question remains: Why do it? The answer, according to Blumberg, Urban Institute Senior Fellow Leonard Burman, and others, is that tax credits are the only game in town, so it is worthwhile to see what can be accomplished with this vehicle. That is, there seems to be a general agreement to spend money on tax credits and maybe deductions for health insurance, but there's no more money on the spending side for that purpose.

Child Care Tax Credit: Low-income single parents need a job to attain self-sufficiency, the dominant welfare-reform policy rationale goes, and to get a job they need assistance in paying for child care. The federal government currently subsidizes child care in two different ways: directly through a $2.4 billion a year block grant to the states for child care assistance; and indirectly through about $3.5 billion in nonrefundable tax credits to parents who pay for child care.[1]

Which approach is more likely to get more mothers into the labor force? Phillip Levine, an associate professor of Economics at Wellesley College, used econometric models to analyze the issue. Based on some conjectures about the way people react to different forms of compensation, he concludes that direct expenditure programs are going to give you much more bang for your buck.

As currently configured, the tax credit is not very helpful to low-income parents because it is not refundable. It offers the biggest tax break to parents with incomes below $10,000 and the smallest break to those whose incomes are above $28,000. Levine found, however, that few parents whose income is below $30,000 have sufficient tax liability to take advantage of the tax credit. The 2001 tax act will make the tax credit somewhat more useful to some parents with modest incomes. It will raise the maximum credit rate from 30 to 35 percent, raise qualifying child care costs from $2,400 to $3,000 per child (up to a maximum of $6,000 for two children), and raise the income level at which the 35 percent rate begins to decline to $15,000. This will raise the maximum credit for a family with two children to $2,100. But the new law does not make the credit refundable, so most low-income families will not benefit much, if at all, from the increase in the credit amount.

As currently configured, the tax credit is not very helpful to low-income parents because it is not refundable.

[1]States also spend a large share of their Temporary Assistance for Needy Families (TANF) block grant on child care for low-income families. Child care accounted for over $5 billion of TANF expenditures in fiscal year 2000.

Levine's econometric analysis found that lowering child care costs makes going out into the workforce more attractive to mothers than raising their potential wages.

Even if the tax credit were made refundable, Levine's study shows it might be less effective than direct spending in prodding low-income mothers into the workforce. Logically, he reasons that the form of assistance shouldn't be all that important. Basically, both a direct spending program and a tax expenditure are just more money to spend. But people don't always behave the way they should in theory.

Levine's econometric analysis found that lowering child care costs makes going out into the workforce more attractive to mothers than raising their potential wages. His conjecture: a direct spending program is more like a reduction in child care costs, while a tax cut is analogous to a raise in wages. If this conjecture holds up, a direct spending program would prod more mothers into going out into the labor force than a tax credit.

Not everyone at the conference agreed with this line of reasoning. Roberton Williams, of the Congressional Budget Office, suggested that a child care tax credit isn't analogous to a wage increase because the parent must spend the money on child care. A wage increase can be spent on anything. Isabel Sawhill of the Brookings Institution also questioned the conclusion and suggested it might reflect the limitations of our econometric techniques. Others noted that the statistics are further skewed by the fact that only about one-third of working mothers spend money on child care. Eric Toder suggests a much bigger practical difference between direct spending programs for child care and the tax credit that is not accounted for in the econometric models. The spending programs subsidize most of the cost of child care for a very limited number of parents, while the tax credits cover a small fraction of the costs for a much larger proportion.

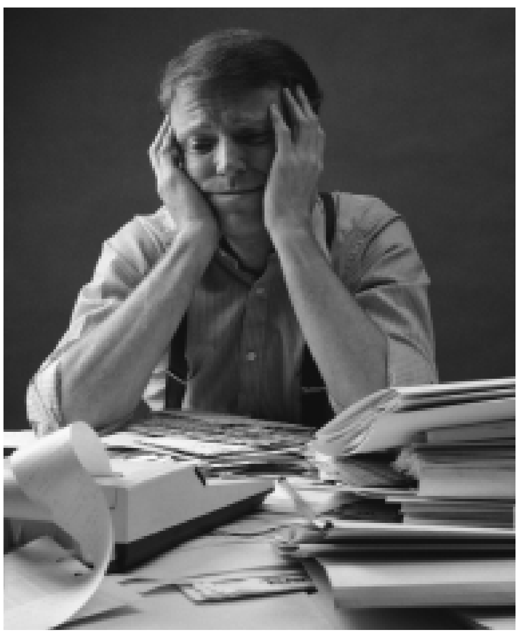
If there is a conclusion to be drawn about direct spending versus tax credits for child care it seems to be that no firm conclusion is possible now.

THE BOTTOM LINE AND THE CHALLENGE

The tax system is being used to achieve some goals of social policy and is likely to be employed for others. The political attractiveness and overall popularity of this approach would seem to make that inevitable. The challenges for policy analysts are to help decision-makers distinguish between potentially effective and counterproductive uses of the tax system and to help fashion techniques to target assistance—whether through the tax system or direct spending—on the people who are in most need of the assistance.

Although there are persuasive arguments on both sides, some conclusions are possible at this juncture about the effective use of the tax system. To benefit low-income families, tax credits must be refundable. Refundable tax credits may be a practical way to assist low-income working families, but the nonworking poor may have to continue to rely on direct spending programs. As currently configured, even refundable tax credits have some drawbacks, such as being lump-sum payments at the end of the year. The utility of any tax credit program will depend on the specifics of the program. General support for the working poor, such as the Earned Income Tax Credit, seems to work well; a tax credit for health care may have so many obstacles to surmount as to make it ineffective in achieving its objective of extending health insurance coverage to many more low-income families. Similarly, tax credits for child care may be less effective in encouraging labor force participation by low-income women than direct spending alternatives. Policymakers, however, might find a way around these barriers and come up with better tax-spending vehicles. One thing is clear: Both analysts and policymakers will continue to seek new ways of using the tax system to assist low-income families and to widen their access to health care coverage, paid child care, and labor market opportunities.

Refundable tax credits may be a practical way to assist low-income working families, but the nonworking poor may have to continue to rely on direct spending programs.



P A R T I C I P A N T S

SOCIAL POLICY AND THE TAX SYSTEM: WHAT ARE THE ISSUES FOR LOW-INCOME FAMILIES?
Urban Institute, June 21, 2001

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Leonard Burman, Urban Institute

Christina Smith FitzPatrick, National Women's Law Center

Joel Friedman, Center on Budget and Policy Priorities

Janet Holtzblatt, U.S. Department of the Treasury

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