Tax Credits and Public Benefits: Complementary Approaches to Supporting Low-Income Families

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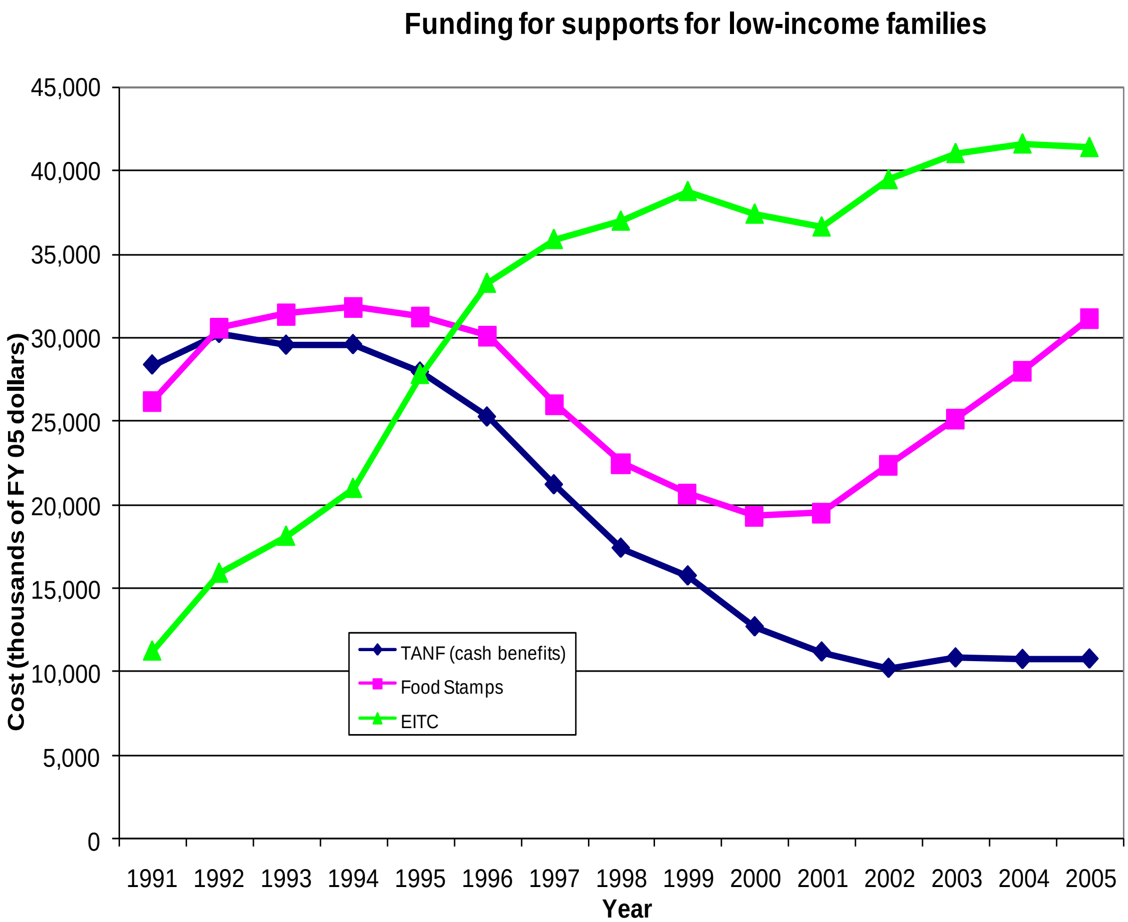
There is increasing recognition that a substantial fraction of the U.S. workforce is employed at jobs that do not pay enough to allow them to provide for all of their families' basic needs. Government can play an important role in bridging the gap between what these workers can earn and the necessities of life through work supports structured either as public benefit programs such as food stamps and child care vouchers, or as tax credits such as the Earned Income Tax Credit (EITC) and the dependent care tax credit.

For those concerned about low-income families, tax credits have two significant advantages over public benefit programs. From a political perspective, it is often easier to win bipartisan support for expanding tax credits than for public benefits. And from the recipient's perspective, is it less time consuming and stigmatized to apply for and receive tax credits. However, public benefits are more responsive to families' changing circumstances and better meet immediate needs. It is also easier to target benefit programs based on non-financial factors.

By understanding the advantages and disadvantages of both mechanisms, advocates and policy makers can better choose the right tool for the job at hand, rather than adopting a one-size fits all approach. Tax credits and public benefits are complementary approaches to supporting low-income families; policy makers do not need to choose between them. Moreover, administrators of public benefit programs can learn important lessons from tax credits about how to ease the burden of applying for and receiving benefits.

Tax Credits Have Political Advantages

Over the past two decades, there has been a significant shift toward providing work supports for low-income families through the tax system, rather than as public benefits. In 1991, the EITC cost the federal government $11.2 billion and the Food Stamp Program cost $26.2 billion (in 2005 dollars). By 2005, after a series of expansions, the EITC had grown to cost $40.6 billion, while the FSP had grown more modestly, to $31.1 billion. Over this same period, spending on cash assistance under "welfare" (Aid to Families with Dependent Children and its successor, Temporary Assistance for Needy Families) declined from $28.4 million to $10.7 million. The EITC is now the largest single source of cash or near-cash assistance to low-income working families. In addition, the refundable portion of the child tax credit provided an estimated $14.6 billion to low-income families in 2005, and state earned income tax credits were worth more than $1 billion.



Sources: Christine Scott, *The Earned Income Tax Credit (EITC): An Overview*, Congressional Research Service Report R31768, Updated March 15, 2007. U.S Department of Health and Human Services, *Indicators of Welfare Dependence*, *Annual Report to Congress 2007.*

One main reason is that the budget process—and the sheer magnitude of tax policy—has made it easier to expand tax credits for low-income families than it would have been to create a comparable spending program. For most of this period, appropriations bills have been subject to tight spending restrictions, where expansions in one program must be offset by cuts in another program within the same appropriations subcommittee's jurisdiction. In such a context, funds for new activities are hard to come by. While this has not stopped presidents or Congress from proposing new programs, they have generally been enacted as relatively low-budget micro-initiatives.

While the budgetary rules over recent decades have often (although not always) required offsets for tax cuts as well, such offsets may be easier to find in the context of tax bills that control billions of dollars. Each of the major expansions of tax credits for low-income families has come in the context of a major tax bill. For example, the child tax credit expansion in the 2001 Economic Growth and Tax Relief Reconciliation Act law was estimated to cost the treasury $172 billion over 10 years (with most of this benefit going to middle- and upper-income families). However, this only accounted for about 13 percent of the total estimated cost of that bill (JCT 2001). Moreover, these massive tax bills are often presented to Congress as complete packages, with limited opportunity for amendments. Thus, tax expenditures are often enacted with far less scrutiny than benefit programs of comparable size (Toder, 2000).

Tax credits also benefit from being a more "mainstream," less stigmatized, approach to providing benefits. The overwhelming majority of tax expenditures go to middle-class families, through policies such as the exclusion of pension contributions and employer-paid health insurance premiums, the deduction for home mortgage interest, and the deductibility of state and local income taxes. Especially in the context of bills that would help middle- and upper-income taxpayers, it is a very strong political argument to say that we also need to include provisions that benefit less affluent taxpayers.

Finally, for most of the past decades, there has been divided government, meaning that only programs that appeal across party lines have had a chance of being enacted. Another political advantage of tax incentives as a means of achieving social policy is that such incentives can be described as tax cuts, rather than "new spending," or worse, "welfare." Tax incentives are a way for policymakers to do two things that are contradictory and yet both widely supported by the public—expanding the benefits provided by government and limiting government spending (Sammartino et al, 2002). In particular, Republicans who are opposed to "big government" have nonetheless often been willing to support policies that look like tax cuts (Gitterman, Cotton and Howard, 2003). Opponents of the EITC and CTC programs have tried to tar these programs with the welfare label, without much apparent success.

Tax Credits Achieve Higher Levels of Participation

One study using 1999 data found that nearly all (93 to 96 percent) families with children who were eligible for the EITC participated in the program (Scott, 2007). (Participation rates are lower for childless adults, both because they qualify for a smaller maximum benefit and because more recipients would not have to file tax returns otherwise.) By contrast, only 60 percent of families eligible for the Food Stamp Program in 2004 participated—and only 51 percent of working poor families. For TANF, HHS estimates that only 42 percent of eligible families received benefits. As there is strong evidence that many non-participating families still have unmet needs, the low participation rates in public benefit programs are a matter of concern to many policymakers. Tax credits appear to be an effective means of reaching this population.

A primary reason for the higher participation rate of tax credits is that it is far easier to "apply" for the EITC by filling out the required forms on a tax return once a year than it is to apply for public benefits. No in-person interview is required and little documentation is needed. By contrast, one study found that the average food stamp applicant had to make two or three trips to the food stamp office or other places, and spent an average of five hours in applying. (Ponza, et al, 1999). TANF applications can be even more time consuming, as applicants often must attend orientations and prove that they have looked for a job before their application is processed.

For working families, the potential benefit for which they are eligible is usually small and the opportunity cost of the time involved in applying is high. Thus, for traditional benefit programs, participation rates are quite low among the families with the lowest potential benefits. However, onerous application procedures may also discourage the neediest families, who often have low skills, poor health, or other barriers that make it particularly difficult for them to navigate through bureaucratic obstacles (Orbach, 2005).

No one has ever suggested that an income tax return is easy to fill out, but if an individual has difficulty completing a tax return, there are many preparers ready to provide assistance. In 2003, 71 percent of all EITC recipients used a paid preparer to file their return, and an additional 2 percent used free preparers. Unlike welfare offices, tax preparers are routinely open evenings and weekends, and have multiple convenient locations. While this assistance does not come cheap—the typical fee paid for completing a state and a federal return exceeds $100—the fees are usually deducted from the refund, and thus do not require an out of pocket expenditure by filers (Berube, 2006).

Another reason why people do not apply for benefits for which they are eligible is the stigma of "welfare." Stigma can take many forms:

- Believing that it is shameful to take public support under any circumstances
- Believing that it is wrong to take public support if you can possibly get by without it
- Not wanting to be seen going into a welfare office, or using a food stamps card to purchase groceries.
- Not wanting to have to ask a caseworker for help, or to share intimate details of your living situation with a stranger.

How much of a role stigma plays in discouraging use of public benefits is not entirely clear. When directly surveyed, non-participants overwhelmingly (72 percent) say that they were not aware that they might be eligible, while very few say that they do not want to rely on government assistance (4 percent) or give other answers relating to stigma or the hassle of applying (Ponza, 1999). However, when people start receiving benefits when they hadn't before, they generally report that they experienced a recent increase in needs or decrease in income, not that they just learned about the programs (Orbach, 2005). There is also evidence that information campaigns alone do little to increase uptake.

There is virtually no stigma associated with receipt of tax credits. Tax credits do not require a trip to the welfare office, and once they are received, they are indistinguishable from other cash. Recipients know that other, more affluent families benefit from tax credits and deductions as well. As the EITC is conditioned on earnings from employment, it is often explicitly contrasted with welfare as "benefits that you've *earned*."

Finally, it is important to note that an important reason why eligible individuals may fail to receive public benefits is that these programs often limit participation due to lack of funding. In most states, meeting all the eligibility requirements for child care or housing assistance does not mean that a voucher will actually be available. Many areas have long waiting lists, while others do not even accept applications. By contrast, tax credits are generally available to everyone who meets the conditions of eligibility.

Tax Credits Not a Universal Solution

Tax credits thus have many attractive features, for both policy makers and recipients. Because of this, most recent proposals for expansions of work supports have taken the form of tax credits, and some have even suggested that existing benefit programs should be folded into a comprehensive tax-based system of subsidies. However, there are downsides to tax credits that need to be considered.

Tax credits are not responsive to short-term changes in income

Eligibility for tax credits is based on annual income (or spending), while most benefits are based on monthly income. If a worker loses her job in the middle of the year, she can apply for unemployment insurance, food stamps, or TANF and start receiving benefits almost immediately. There is no practical way to qualify for immediate assistance through the tax system.

This matters a great deal, because low-income families tend to have high levels of income volatility. Low-wage jobs are often seasonal or temporary, and it is common for hours of work to fluctuate widely from month to month. Thus, for example, while 33 percent of single mothers were poor in 2001 based on their annual incomes, 54 percent had family incomes below the poverty line for at least one month (Moore, Rangarajan, and Schochet, 2007). Since low-income families have minimal savings and little access to credit, this results in real hardships, such as food insufficiency, during periods of low income (Bania and Leete, 2007).

Tax credits require recipients to spend money up-front and may not provide a sufficient subsidy to help the lowest income families.

For tax credits that are intended to pay for specific activities, such as education tax credits and child and dependent care tax credits, individuals must generally lay out the full cost of the activity up front, and only get reimbursed through the tax credit when they file their taxes the following year. If the spending occurs in January (as is often the case for spring term tuition payments), the taxpayer may have to wait 15 months or more to receive the credit. Few low-income individuals have the resources to take advantage of such a credit. Thus, in 2003, fewer than 8 percent of families with children claiming the EITC received the child and dependent care tax credit, and just 2.7 percent of EITC recipients claimed an education tax credit.

Moreover, the value of such tax credits is typically a fraction of family's spending on that activity. This is often not a deep enough subsidy to affect very low-income families. For example, a tax credit that reduced the cost of health insurance by 25 percent would probably have virtually no effect on low-income households, as even 75 percent of the cost of health insurance would consume their entire budgets. By contrast, benefit programs like housing vouchers and child care subsidies typically provide a deep subsidy to participants (although funding limitations mean that many eligible families are not served).

This problem could be overcome by making the credit itself progressive—e.g. lower-income households would receive a higher percentage of their spending back as a credit (Furman, Summers and Bordoff, 2007). In theory, the existing child and dependent care tax credit follows that model, with families with incomes under $15,000 eligible for a 35 percent credit, and families with incomes over $43,000 eligible for only a 20 percent credit. (In practice, almost no low-income families receive this credit, as it is non-refundable.) However, such tiered credits add to the complexity of the tax code, and may increase the political visibility (and vulnerability) of the benefits for low-income families.

Policymakers continue to worry about high error rates

From policymakers' perspective, the primary criticism of the EITC in recent years has focused on its high error rates, at least as compared to traditional benefit programs. An early IRS study using 1985 data found an overclaim rate of 39.1 percent. More recent studies have produced lower estimates of overpayments—23.8 to 25.6 percent in 1997 and 27 to 31.7 percent in 1999 (Scott, 2007). These rates are far higher than for TANF or the Food Stamp program. While no national error rate is calculated for TANF, the error rate for AFDC in the last year for which it was calculated (FY 1994) was 6.11 percent. In FY 2005, the Food Stamp program overpayment rate was 4.5 percent.

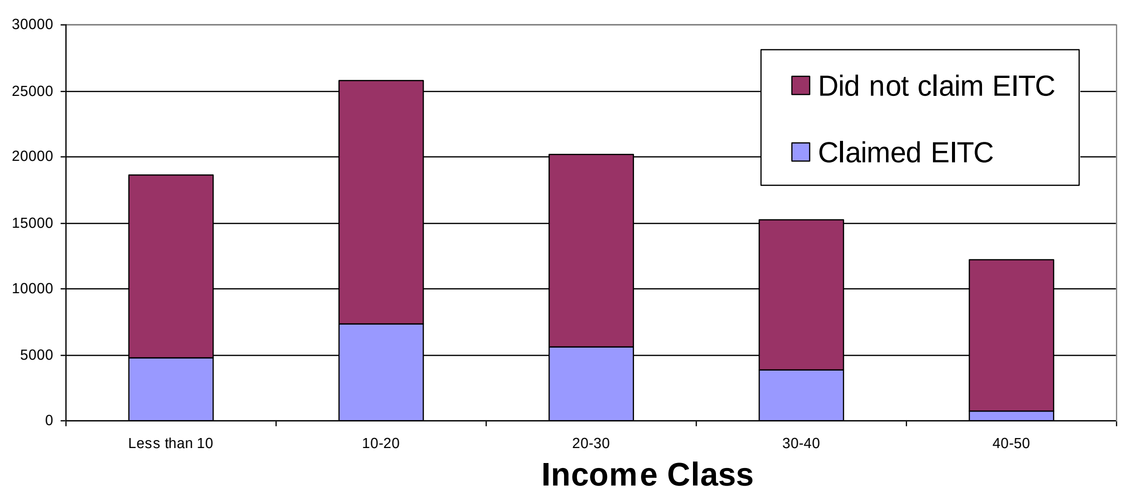
However, there is little evidence that suggests that the EITC is more prone to errors than the tax collection system as a whole. The type of error most often made in returns that included EITC claims—incorrectly claiming a child—is also common among other returns. And it is well-established that taxpayers often fail to report income that is not independently reported to the IRS through W-2s or 1099s (Burman, 2003). These are inherent risks to a "voluntary" tax compliance system—one that does not independently verify the accuracy of every return that is filed. What is clear is that the EITC gets enforcement attention far disproportionate to its share of errors. While EITC overclaims represent just 2.8 percent of the total "tax gap", the IRS has devoted 3.8 percent of the compliance budget to it—and nearly half of the new resources made available for enforcement (Burman, 2003).

This voluntary system is a large part of the reason why the administrative costs of the EITC and other tax expenditures are low. To the extent that the recipients of overpayments are still quite needy, some have suggested that it makes sense to allow some level of erroneous payments—especially when they are due to confusion rather than deliberate fraud—rather than to spend an equivalent amount of money on administration and enforcement (Zelenak, 2005).

Tax credits are harder to target

In most cases, more of the benefits of a tax credit go to less needy families. By definition, non-refundable tax credits provide no benefit to families that do not have enough income to owe income taxes. Credits that are a fixed portion of expenditures on education or child care will also tend to benefit those who can afford to spend more. The EITC avoids these problems by being refundable, and targeted to low-income workers. However, because of the long phase-out range, 3.87 million tax units with incomes between $30,000 and $40,000 receive the EITC. While their average benefit is modest—only $306—because there are so many of these families, the total cost of providing these families with the EITC is $1.2 billion.

Distribution of Tax Units, 2007



Source: Tax Policy Center, Distribution of the Tax Benefits of the Earned Income Tax Credit (EITC) by Cash Income Class, 2007, Table T07-0109.

The ease of application accentuates the contrast between tax credits and benefit programs. If a program was designed that provided the exact same dollar value of benefits as the EITC, it is likely that relatively few families with incomes above $30,000 would bother applying for a benefit of only $306. But because they have to file tax returns anyway, almost all of these families will apply for, and receive, the EITC.

In addition, many benefit programs distinguish between families based on criteria other than annual income. For example, many programs have asset limits, to prevent families that are well-off, but have temporarily low incomes from taking advantage of them. Others are conditioned on disability status, or compliance with work requirements. It is very difficult to apply conditions to the receipt of tax benefits that are based on anything other than the information that is already collected by the IRS, and attempts to do so often have unintended consequences.

For example, when the EITC for childless individuals was created, Congress decided that it should not be available to college and graduate students from middle- and upper-class families who have temporarily low incomes, but high expected lifetime incomes. Congress therefore made this credit only available to workers aged 25 or older. However, this age limit is a crude mechanism for targeting the benefit. In particular, it cuts out many of the most disadvantaged disconnected youth, whom policymakers might otherwise want to target a work incentive toward (Aron-Dine and Sherman, 2007).

Similarly, policymakers and advocates have sometimes suggested that EITC receipt should be conditioned on hours of work, rather than annual earnings; or compliance with child support order. While these proposals are highly appealing as a way to incentivize desired activities, they would require IRS to collect additional information that is not otherwise needed. This would increase administrative costs. Moreover, IRS sees such proposals as outside of its mission, and is institutionally resistant to taking on such responsibilities.

Conclusions

Tax credits have many advantages, but are not a perfect substitute for benefit programs

This examination of the tradeoffs between tax credits and benefit programs shows that tax credits have significant appeal from the perspectives of policymakers and recipients. In the context of an economy that provides large numbers of low-wage jobs, there will continue to be many working poor families that need assistance to bridge the gap between what they can earn and the income needed to achieve a decent standard of living. Including support for low-income families in the context of tax bills that affect broader populations is an effective political strategy.

The ease of application and lower stigma means that tax credits reach many recipients who are less likely to apply for benefit programs.

However, this review shows that tax credits are not a perfect substitute for benefit programs, and that there will continue to be a role for both types of supports for the foreseeable future. From the recipient's perspective, tax credits are not immediately responsive to changes in circumstances. In addition, tax credits are far better suited to providing flexible income support than to meeting specific needs, especially for low-income families. Both the up-front payments and the need to track and document all eligible expenditures are quite burdensome on participants, and reduce low-income families' ability to benefit from a credit. From the policymakers' perspective, it is important to recognize that just turning benefits into tax credits is not a silver bullet for overcoming political opposition. Moreover, tax credits are harder to target than benefit programs, on both financial and non-financial criteria.

Implications for improving access to work supports

The main disadvantage of a hybrid system that provides work supports through a combination of tax credits and benefit is that the policies are often uncoordinated. Participation in multiple programs, each with its own phase-out schedule, can result in extremely high implicit tax rates that can even leave families worse off as the result of an income gain. While it is challenging for policymakers to think across programs, and often across committee jurisdictions, it is critical that they do so. Tools like the National Center for Children in Poverty's Family Resource Simulator are an important way to begin this process (Cauthen, 2006).

On the tax side, there needs to be a shift toward providing universal incentives through refundable tax credits, rather than deductions. There is no ethical justification for providing greater subsidies for housing and health care to higher-income families than to lower ones (Batchelder, Goldberg and Orszag, 2006). At the same time, when opportunities are available to expand the existing tax credits that are targeted at low-income working families they should be taken.

On the benefit side, there are many lessons to be learned from tax credits. Policymakers should look for ways to simplify eligibility rules and eliminate asset tests. This improves access for recipients and reduces administrative costs. Services should be available outside of standard working hours, and in places like grocery stores or Laundromats that are convenient to busy families. Several states are already moving in the direction of accepting applications for benefits by phone and online. Unfortunately, this has sometimes been accompanied by a withdrawal of in-person assistance in completing the application process. Community-based organizations that are enlisted to facilitate enrollment should be paid for their services.

Finally, some of the issues related to access to work supports can only be solved with more funding. While the application process for child care subsidies could be simplified, no amount of process improvements will change the fact that current funding levels only provide vouchers to about one in seven eligible families.

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