TAX CREDITS FOR WORKING FAMILIES: THE NEW AMERICAN SOCIAL POLICY

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EXECUTIVE SUMMARY

In a policy environment averse to direct spending on programs dedicated to income support, a variety of federal tax credits have emerged as key vehicles for providing assistance to low-to-moderate income families. Indeed, the two largest individual income tax credits—the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC)—will represent over $75 billion in tax expenditures in 2003.

Looking for ways to expand the constituency for tax credits to include more "working families" with low-to-middle incomes, this paper reviews the current regime of tax credits, their design, and the political dynamics behind their appeal and finds that:

- **Tax credits for working families have expanded rapidly in recent years.** Voter attitudes, congressional partisanship, budgetary rules, and shifting viewpoints among public finance experts have all helped fuel a rise in tax expenditures. However, large tax cuts enacted in 2001 and 2003 will likely constrain near-term efforts at the federal level to expand income support for working families.

- **Tax expenditures are more significant for lower-income and higher-income families than for middle-income families.** Lower-income families benefit from a number of income-targeted credits , while upper-income families benefit from deductions for mortgage interest and state and local taxes, as well as the exclusion of employer-paid benefits from income. Those families in the middle can be said to face a "middle-class parent penalty."

- **Tax credits designed to provide income security for working families have grown much larger than other types of credits.** While the EITC and CTC combined provided over $75 billion to working families in 2003, tax credits tied to the consumption of particular goods and services totaled only $11.6 billion, and general business tax credits designed to benefit low-income workers and communities totaled only $5.4 billion.

- **A new income security tax credit or a combination of the existing EITC and CTC could broaden support for, and understanding of, federal investments in working families.** Such a credit should be available to working families with up to $75,000 in adjusted gross income. A combined credit, seamless for taxpayers applying for it, would also reduce errors in the EITC program by reducing complexity.

Though some might argue that a combined tax credit could dilute support for separate existing programs, a streamlined credit for low-to-middle income working families seems one of the few politically viable ways to expand support for these families in a tight budget environment.

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TAX CREDITS FOR WORKING FAMILIES: THE NEW AMERICAN SOCIAL POLICY

I. INTRODUCTION

In recent years, some analysts have criticized American social policy for slighting working individuals and families (Skocpol 2000; Graetz and Mashaw 1999). This reinforces an existing perception that the federal government assists only the poorest Americans at the margins of the labor market, as well as elderly Americans who have already left the workforce. Meanwhile, they assert, workers and families in the lower and middle tiers of income distribution receive little support.

We believe that by focusing on only the most visible programs, this line of argument mischaracterizes American social policy. Federal cash assistance programs for the poor, such as Temporary Assistance for Needy Families (TANF), and universal insurance programs for older Americans, such as Social Security and Medicare, have high profiles. By contrast, much of what the federal government does for low-to-middle-income families—whom we refer to in this paper generally as "working families"—goes unnoticed. For working families, the federal government offers the bulk of its income support more indirectly, through the income tax code.

This paper examines the growing role of federal tax credits that provide support to families with annual incomes up to $75,000. We argue that policymakers could harness these credits to build a more powerful constituency on behalf of continued federal investments in America's working families.

We proceed in three sections. The first background section explains why we chose to examine tax credits versus other types of tax benefits, discusses the growth in their political appeal over time, and identifies how tax credit design varies (along dimensions such as refundability, eligibility, and indexation). The second section offers a typology of major individual tax credits with social policy objectives, noting briefly how they work, their background and history, and their size and growth over time. We also briefly compare these individual credits to social-policy-related general business tax credits. The third section discusses how integrating multiple income support credits into a "working family tax credit," in both policy and political terms, could reap the benefits of greater simplicity in the income tax code, while also broadening the constituency for tax credits to include more middle-income families.

II. Background

A. The Growing Prominence of Tax Expenditures

Congress, for the better part of the twentieth century, employed federal tax expenditures to encourage particular consumption and investment activities. Tax expenditures, as defined in the 1974 Budget and Impoundment Control Act, are "revenue losses attributed to provisions of federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." In that act, Congress required that a list of all tax expenditures be included in the federal budget. Typically, official government documents (OMB, JCT) divide tax expenditures according to function (e.g., income support, national defense, agriculture), reporting the respective portions of the total revenue loss/budget outlay effects that arise under the individual and corporate income taxes (OMB 2003).

The nation's growing collection of tax expenditures with social policy objectives continues to be a topic of debate as well as an important area of policy research. A number of policy scholars—primarily public finance specialists—have analyzed federal tax expenditures. We seek a middle ground between broad generalizations about all tax expenditures (Surrey and McDaniel 1985; Witte 1985) and detailed case studies of specific tax expenditures with social welfare objectives (Howard 1997). Our focus only on individual tax credits is in a similar vein as a number of recent analyses focusing on the impact of the federal income tax code and child tax benefits on "working" families (Ellwood and Liebman 2000; Sawhill and Thomas 2001; Dolbeare 2001; Sammartino, Toder, and Maag 2002). We are interested, however, in explaining the political appeal and design of tax credits, their origins and evolution, and future political sustainability. Most importantly, we want to highlight the importance of tax expenditures for middle-income families as well, and to include them within a broader definition of "working families."

For historical reasons, policymakers and scholars have tended to associate federal assistance for low-to-moderate-income families and places with income transfer policies targeted toward low-income individuals, such as TANF and child care, or grants targeted toward economically distressed geographic areas, such as the Community Development Block Grant (CDBG). Because these social programs operate on the expenditure side of the budget, they have attracted a great deal of political and policy attention during times of fiscal stress or shifting federalism.

Yet because of their large size and significant local economic impacts, federal tax credits such as the Earned Income Tax Credit (EITC) should also be of interest to state and local policymakers. For example, according to Berube and Forman (2001), the EITC provided working poor families and places within the 100 largest metropolitan areas with a $17 billion stimulus in 1998. There is growing recognition that these individual tax credits carry a spatial or geographic impact, as well as an impact on taxpayer income.

Policymakers and policy watchers at the state and local level may find it difficult to monitor historical and contemporary trends in federal tax expenditures. Different researchers with different

social policy expertise (income security, education, housing, health, and community economic development) often focus on tax incentives in isolation rather than in a comparative way or in terms of aggregate fiscal impact. This fragmentation is due in part to a professional division of labor, and in part to Congress's case-by-case treatment of tax expenditures. Thus, the broad range of expenditures is not always rationally integrated, or easily explained as a policy package—let alone administered that way. Each is rooted in varying underlying social and economic objectives, and in differing legislative origins and development.

B. Current Context

Individual tax expenditures, particularly tax credits, have expanded rapidly in recent years and represent growing vehicles for providing federal dollars to low-to-middle-income families. Two of the largest individual income tax credits—the EITC and Child Tax Credit (CTC)—will represent $35.4 and $40.1 billion investments, respectively, in 2003.

Notwithstanding this growth, current budget and tax trends do not bode well, at least in the short term, for efforts to provide additional income support to working poor families. The major tax bill passed by Congress and signed into law in May 2003, the Job Growth and Tax Relief Reconciliation Act (JGTRRA), contains little support for lower-income families (Lee and Greenstein 2003). Further, the enormity of the tax cuts adopted in JGTRRA and the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) will severely constrain the federal government's ability to provide additional income support to working families for several years to come. In all likelihood, they will force significant cutbacks in direct expenditure programs that benefit these same families.

Not coincidentally, the latest round of tax cuts follows on the Council of Economic Advisers' (CEA) Economic Report to the President, released in February 2003, which made the case that low- to moderate-income families do not shoulder a fair share of the income tax burden. The document lays the intellectual groundwork for policies that would greatly simplify the tax system, but that would arguably raise the federal tax burden on lower-income workers, while reducing that on the affluent (Weisman 2002). In keeping with this, Treasury Department economists are drafting new ways to calculate the distribution of tax burdens among different income classes, and those results are expected to highlight what administration officials view as a rising tax burden on the rich and a declining burden on the poor (Weisman 2002).

Despite all this, or perhaps because of it, political strategists and scholars are working to imagine coalitions that might rekindle support for government social policy initiatives, forming new partnerships as a way to connect with the "missing middle" of American working families, or building new bridges between urban and suburban constituencies (Greenberg and Skocpol 1997; Page and Simmons 2000; Teixeira and Rogers 2000; Skocpol 2000; Borosage and Hickey 2001; Dreier, Mollenkopf, and Swanstrom 2002).

We are sympathetic to these efforts, to the extent that they draw policy and analytical attention to income support and other issues affecting millions of working families, including the high

cost of child care, higher education, housing, and health care. We do not think that either the general public or policymakers have lost interest in using government tools to address the problems of working families. Rather, the way in which the government intervenes in these areas has evolved in recent decades, characterized by an increasing reliance on subsidies and incentives that operate through the tax code.

C. Defining "Working Families"

Taxpayers can benefit from tax expenditures in one of two primary ways: through a deduction, which reduces the amount of income on which taxes are levied, or through a credit, which provides a dollar-for-dollar reduction in tax owed. For decades, tax expenditures have been indicted for distributing most of their benefits to more affluent families (Howard 1997). This criticism derives from the fact that historically, most tax expenditures have been tax deductions. Because deductions occur pre-tax, the value of a deduction rises as a taxpayer's income—and marginal tax rate—go up. Tax credits, in contrast, are deducted dollar for dollar directly from taxes owed and not from taxable income, so that a $500 credit can be worth the same amount to a family earning $25,000 as a family earning $250,000. Because the recent policy trend has been to enact tax credits rather than deductions, the benefits also have been distributed more evenly across income groups—at least those credits available to individuals.

The bulk of the tax credits on which we focus in this paper are available primarily to families with children, and these credits have multiplied in number and value in recent decades. Even so, the federal income tax code has long offered extra tax benefits for families with children, primarily in the form of the dependent exemption (Ellwood and Liebman 2000). Working families with children today are eligible to benefit from three major individual tax credits—the EITC, the Child Tax Credit (CTC), and the Child and Dependent Care Credit (CDCC)—in addition to the dependent exemption. Unmarried families with children also benefit from the single head-of-household filing status (Carasso, Rohaly, and Steurle 2003).[1]

Ironically, the income-targeted, refundable EITC and other deductions and exemptions have created a situation where tax expenditures are larger for lower-income and higher-income parents than for middle-income parents. Upper-income families with children continue to benefit significantly from social policy-related tax expenditures, including the exclusion of employer-paid health insurance premiums from income, and the deductibility of state and local income taxes and mortgage interest paid on owner-occupied homes. At the same time, many more individual tax credit dollars today, primarily in the form of the EITC and CTC, go toward low-to-moderate-income families than in past decades (Sammartino, Toder, and Maag 2002). These credits have greatly increased the progressivity of the tax and transfer system in the United States. In light of these trends, some policy scholars have recently argued that middle-income parents, who earn too much to qualify for the EITC, and who earn too little to benefit much from other deductions or exemptions

[1] The personal exemption, applied to dependents, is $2,900 per child and is indexed for inflation. Tax brackets and standard deductions are more beneficial for head of household filers than for single filers without children (Carasso, Rohaly, and Steurle 2003).

in the code, might be said to face a kind of "middle-class parent penalty" relative to their lower- and higher-income counterparts (Ellwood and Liebman 2000).

Because we believe that the economic fates of both lower-income and middle-income families deserve greater attention, we expand previous definitions of "working families" (e.g., Berube and Forman 2001) to include those with adjusted gross income (AGI) of up to $75,000 per year.[2] These individuals often face the same problems of paying for child care, saving for college, and buying their first home. Thus, we focus primarily on low- to middle-income families, who derive the majority of their income from earnings, as claimants of federal individual tax credits.

How does our definition of "working families" fit the distribution of family incomes in the U.S. today? The median U.S. family income in 2001 was $51,407 (just below 300% of the official poverty level).[3] Thus, in addition to only those working poor families who qualify for the EITC, we also include those moderate- to middle-income families who benefit from other individual credits—using just less than 150 percent of median family income as our "working families" income standard. Table 1 illustrates the extent to which middle-income families benefit from many of the same child-targeted individual tax credits as low- and moderate-income families. For the CTC, the Hope Scholarship/Lifetime Learning credits, and CDCC, benefits were split fairly evenly among "working poor" families ($15,000 to $30,000), moderate-income families ($30,000 to $50,000), and middle-income families ($50,000 to $75,000). The EITC, by contrast, is heavily weighted towards low-income and working poor families.

[2] Adjusted gross income (AGI) represents total income reduced by certain "above-the-line" deductions known as "adjustments," but before a taxpayer takes an itemized deduction or standard deduction, and before a taxpayer takes the deduction for exemptions.

[3] Family median income is the amount that divides the income distribution into two equal groups, half having incomes above the median, half having incomes below the median. http://www.census.gov/prod/2002pubs/p60-218.pdf.

Table 1. Distribution of Selected Tax Credits by Adjusted Gross Income, Tax Year 2000

Tax Expenditure	*Total Amount* *(In Billions of $)*	*Percentage of Total Dollar Amount Claimed*				
		<$15K	*15K-30K*	*30K-50K*	*50K-75K*	*75K+*
EITC (Revenue Loss & Outlay)	$32.30	62.8%	37.1%	0.1%	0%	0%
Child Tax Credit*	$20.67	2.0%	22.0%	29.3%	27.1%	19.6%
Education Credits*	$4.85	6.4%	22.9%	27.7%	27.0%	16.1%
Child & Dependent Care Credit	$2.79	0.8%	20.3%	23.0%	24.7%	31.4%

Source: IRS Individual Tax Statistics Table 3.3, Individual Income Tax, All Returns: Tax Liability, Tax Credits, and Tax Payments, by Size of Adjusted Gross Income.
* Percentages may not total 100% because of rounding. Child Tax Credit figures include Additional Child Credit for families with three or more children in TY2000. Education credits include the Hope Scholarship and Lifetime Learning credits.

III. THE POLITICS OF SOCIAL POLICY IN THE TAX CODE

A. Electoral Pressures

Why have individual tax credits become a favorite political and policy tool in recent decades? The first reason we posit relates to electoral pressures and incentives. Put simply, tax credits help policymakers reconcile seemingly contradictory electoral messages from the public. On the one hand, the public seems to support activist government. In the 1990s, large majorities wanted to spend more on health care, education, and childcare (Smith 2001). The levels of public support for such spending were comparable to those for one of the largest and historically most popular federal programs, Social Security. When respondents say they want more done about these problems, they appear to want government to take the lead. A Pew (1998) survey found that 80 percent of respondents thought that government should have the primary responsibility for ensuring that every citizen has access to affordable health care, compared to 8 percent who thought that the private sector should be responsible. Likewise, a majority thought that government should have the primary responsibility for ensuring that every citizen can afford to send their children to college, and for providing a decent standard of living for the elderly.[1]

On the other hand, several signs point toward popular opposition to activist government. First, Americans do not seem to trust government. Although the level of distrust went down during the 1990s, and even more sharply in the immediate aftermath of the terrorist attacks of September 11, 2001, distrust has still remained high for many years. Most respondents do not trust the government to do the right thing most or all of the time, and most people agree that policymakers do not care what they think. Second, Americans are more likely to say that the national government is too powerful rather than too weak. More citizens think of themselves as conservative than liberal (though most call themselves moderate or don't respond).[2] These findings dovetail with the Republican gains in the House and Senate for much of the period since 1994, and the GOP White House victory in 2000.

At first glance, these patterns reinforce an Americans preference for low taxes and a limited government that still provides valuable goods and services. One might wonder how this ambivalence is connected to the recent popularity of credits. The answer, we believe, is that ambivalence is greater now than in the past. The gap between what Americans want government to do, and what they trust it to do, has grown. To resolve these conflicting electoral pressures, policymakers are motivated to look for ways to address policy problems without using the more traditional forms of spending and regulatory authority. They have turned to indirect tools like individual tax credits, in which the government uses carrots rather than sticks to encourage certain behavior, and which rely on existing bureaucracies (the IRS) and existing routines (tax collection) rather than the creation of new public programs and agencies.

[1] By "government," we mean national, state, or local government.
[2] These figures include "leaners" for each party and come from the National Elections Studies web site (www.umich.edu/~nes/nesguide/toptable/tab2a_2.htm).

B. Partisanship in Congress

A second influence involves the changing composition of Congress. Partisan control has become far more tenuous than in previous decades as the two major parties have achieved rough parity. The majority party in the Senate switched from Republican to Democrat to Republican between 1986 and 2002, and not once did the majority have the 60 votes needed to end a filibuster. Republicans gained control of the House in 1994 but failed to generate a large electoral cushion. If they had lost an additional ten races in any election since 1996, they would have lost control of the House. In contrast, Democrats enjoyed a 50- to 100-seat margin in the House during the 1970s and 1980s. Whereas House Democrats used to enjoy a 5 to 10 percentage point margin in the total number of votes won in each election, House Republicans now have a 1 to 3-percentage point advantage (Ornstein, Mann, and Malbin 2002).

Each house of Congress has also become more polarized ideologically. Political scientists have estimated that the ideological gap separating the two parties in Congress increased by more than 50 percent in just two decades.[3] Combined with the razor-thin majorities that have characterized recent Congresses, this suggests that power in Congress is now wielded by two factions, both roughly equal in size, one quite liberal and the other quite conservative. If each party insisted on championing its own ideal policies, gridlock would result. Policymakers would then risk running for reëlection as part of a "do-nothing Congress" (a label most famously ascribed to the 105th Congress in 1995).

Most of the time, however, the two sides have compromised on policies each viewed as less than ideal, thereby bringing tax credits into play. Congressional Democrats looking to increase expenditures on lower-income families had to find a policy tool more acceptable to their GOP adversaries than traditional forms of direct spending. One alternative was to selectively lower tax liabilities for these families, which Republicans could justify as tax cuts. A range of general business tax credits targeted at third-party providers—such as employers who hire the poor, or developers that build low-income rental housing—could be portrayed as tax subsidies by Republicans, while Democrats could still claim to deliver tangible benefits to low-income communities.

The partisan balancing act on tax credits resulted, in part, from the successful Republican-led effort to lower tax rates at the top of the income distribution in the early 1980s. Efforts by Democrats in the late 1980s and 1990s to enact tax credits for working families could be viewed as a

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[3] A good way to capture this trend is by referring to the NOMINATE scores computed by political scientists Keith Poole and Howard Rosenthal. These scores are based on all roll call votes for each session of Congress, and the values range from –0.5 (very liberal) to 0.5 (very conservative). Since 1980, and especially during the 1990s, the two parties diverged. The mean score of House Democrats was -0.28 in 1980 and -0.38 in 2000. The mean score of House Republicans was 0.27 in 1980 and 0.48 in 2000. Even in the Senate, supposedly the more moderate of the two houses, the story is much the same. The Democrats' score changed from –0.29 to –0.41, while the Republicans' score changed from 0.20 to 0.42. The change in the Democrats' score in both houses is due primarily to the greater liberalism of Southern Democrats (cited in Ornstein, Mann, and Malbin 2002).

response to that initial round of tax reform. By the 1986 Tax Reform Act, Republicans and Democrats together supported an expansion of the EITC in order to remove poor families from the federal income tax rolls. According to Steuerle (cited in Altman 2003), “Democrats found that they could achieve social policy goals using the tax code. In doing so, they were taking a page from the playbook of Republicans, who had long used the tax system to encourage business investment.” Today, the bulk of tax incentives are much more oriented toward social policy expenditures than toward business incentives (Howard 1997).

C. Budgetary Environment

In the last three decades, significant changes in the congressional budgetary environment have made tax credits more attractive policy tools. Tax credits often arise as small provisions in large budget and tax bills, known as omnibus bills. By combining numerous measures from disparate policy areas, they have become an increasingly powerful institutional tool within Congress over the past two decades. The use of omnibus bills is important not just for budgetary politics, where policy makers have faced gridlock and highly constrained spending choices, but also for tax politics. Observers note that part of the appeal of these bills owes to their sheer size, which serves to divert attention from smaller controversial items to other major provisions that enjoy widespread support, are necessary for government function, or both (Krutz 2001; Sinclair 2000). Tax credits are nearly always considered as part of these “must-pass” bills because they often contain that nucleus of widespread political support., serving as the glue that holds these bargains together. A larger EITC, for example, made it easier for many congressional Democrats to support the 1993 budget, which otherwise included more spending cuts and deficit reduction than they preferred.

It has been argued that federal budget rules established in the 1990s encouraged the growth of tax expenditures (Sammartino, Toder and Maag 2002). We conclude the opposite. The 1990 Budget Enforcement Act (BEA) did constrain discretionary spending by setting specific dollar limits for different categories of outlays, and by requiring that tax increases or spending cuts elsewhere in the budget offset any increases in mandatory spending. However, under the 1990 BEA, both tax expenditures and other forms of mandatory spending were subjected to PAYGO (pay-as-you-go) rules. Under these rules, existing programs could grow automatically, but any legislated change—creation of a new program like a child tax credit or expansion of an existing program like the EITC—had to be revenue neutral. Thus, the cost of any new tax expenditure or credit, as with any new budget outlay, had to be offset with spending cuts or tax increases. This made it harder, not easier, for new credits to be created; and it cannot explain why policy makers chose tax incentives over traditional entitlements, since both had to play by the same PAYGO rules.

The Budget Enforcement Act, including PAYGO rules, expired in September 2002 and have not been replaced. Some analysts might argue that these rules lost their force a few years earlier as legislators, buoyed by record budget surpluses, found creative ways to circumvent their boundaries (e.g., by reclassifying normal appropriations as emergency spending). Our point, however, is that new tax expenditures were subject to the same rules as new forms of direct spending, however strict or loose those rules were.

D. Public Policy Legitimacy

A fourth trend enabling the rise of tax credits is the growing legitimacy credits have enjoyed among policy experts. Historically, public finance specialists have generally opposed the use of tax expenditures to advance social goals, instead urging the use of direct spending programs to provide economic assistance to people in need (Surrey and McDaniel 1985). As Assistant Treasury Secretary Stanley Surrey once explained, “the Treasury is constantly presented with proposals to accomplish all sorts of desirable social objectives through the tax system: in general, these objectives can be accomplished more effectively and economically by other means” (cited in Thorndike 2002). Between 1955 and 1970, the Treasury's Office of Tax Analysis (OTA) weighed in against various proposals to create tax incentives for education and other social goals, concluding that new tax breaks would set a bad precedent for national tax policymaking (Howard 1997).

Although former Treasury officials in Republican and Democratic administrations have argued that tax expenditures violate core principles of an ideal tax system (horizontal equity, efficiency, and administrative simplicity), the exceptions are increasingly proving the rule. For example, amendments to the 1986 Tax Reform Act to expand the EITC actually sprang from a Treasury Department-led effort to remove working poor families from the tax rolls (Steuerle 1992; Ventry 2000). In a similar way, the Council of Economic Advisers (CEA), in the 1998 Economic Report to the President, highlighted the EITC as a vital instrument in improving the income security of low-income families (CEA 1998). The current Bush administration’s Treasury Department played an active role in highlighting new tax credit proposals in 2001, including an expansion of the child tax credit. In fact, it is now commonplace for the president’s annual budget to include numerous tax incentives in the form of credits and special rules, deductions, or exclusions for favored activities or situations. While not all of these ideas enjoy broad support among tax experts, proposals to use tax credits to address policy problems are perhaps less quickly dismissed as bad ideas in the public finance community.

E. The Political Design of Individual Tax Credits

Designing a tax credit is as much a political choice as an exercise in policy analysis. Credits can be structured in a number of ways, each with very different distributional consequences. They can be set at a fixed amount that does not vary by income (e.g., every filing unit receives a $500 child credit); they can be structured to be more generous for some income groups than others; or they can exclude some income groups altogether. Tax credits can be made refundable (i.e., the subsidy can exceed the taxpayer’s liability) if the legislative intent is to make them available to low-income families. Their size may be related to the cost of a particular consumption good or service, such as child care, higher education, housing, or health insurance premiums. Here we briefly highlight some design features that vary across tax credits.

Refundability. For income tax credits to provide direct benefits to low-income families, they generally must be refundable (Sammartino 2001). A credit is refundable if taxpayers are eligible to

receive excess credit value in the form of a refund if their tax liability is reduced to zero. The EITC is a fully refundable credit; the CTC is refundable up to a certain limit determined by the taxpayer's income. Nonrefundable credits, such as the Child and Dependent Care Credit (CDCC), only reduce tax liability; any balance remaining once tax liability is reduced to zero cannot be claimed. Similarly, several individual credits for consumption of goods and services (e.g., higher education) are not refundable and limited only to the amount of an individual's tax liability.

Eligibility. Eligibility for numerous credits, such as the EITC and CTC, is conditioned on income and family size, and Congress has increasingly used these income caps to keep total budgetary outlays under control (Sammartino, Toder, and Maag 2002). For example, credits intended exclusively for low- to very moderate-income families, such as the EITC, phase out rapidly once AGI exceeds certain thresholds. In contrast, the CTC extends benefits "equally" and more "universally" across the income distribution (i.e., eligibility does not phase out until AGI reaches $75,000 for individuals, $110,000 for couples—under current law). These individual credits (EITC, CTC) are similar to those direct spending programs that are available as entitlements to those who meet established statutory criteria.

Indexation. Indexing credits—that is, automatically adjusting their value and/or eligibility limits for inflation—reflects a policy technique long-applied in federal entitlement programs, but more recently adopted on the revenue side of the federal budget. For example, income tax brackets and the EITC are indexed, but the CDCC has never been indexed. As a result, the maximum amount of expenses qualifying for a credit, and the percentage of expenses allowed, has eroded over time, making many claimants worse off (fewer benefits to claim) but making the Treasury better off (less revenue loss).

Indexation can also generate political benefits. When a credit is not indexed, more individual and families "automatically" lose the benefit over time, but Congress can later claim credit by enacting popular changes (increasing the cap and phase-out levels) to the credit.

Limits. As noted above, some credits (such as the CTC) have specific eligibility limits incorporated into their design. The alternative minimum tax (AMT), by contrast, places an implicit limit on tax credit claims. The original idea behind the AMT was to prevent people with very high incomes from using tax benefits to pay little or no tax. Taxpayers must calculate their liability under the regular tax system and under the AMT, and then pay whichever tax amount is larger.[4] The AMT limits tax credit claims because many of the credits allowed in calculating regular income tax are not allowed in calculating AMT. The more credits one claims, the more likely it is that one might end up paying the alternative minimum tax.

Because the AMT's income thresholds have not been regularly indexed, families with children are increasingly likely to owe the AMT, in part because the exemption for dependent

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[4] If an individual is already paying at least that much because of the "regular" income tax, he or she does not have to pay the AMT. But if a regular tax (with the credits) falls below this minimum, he or she has to make up the difference by paying the AMT.

children is not allowed (Carasso, Rohaly, and Steuerle 2003). The focus of the AMT is thus shifting, with a greater share of middle-income families becoming subject to the AMT over time. In 2002, 1.4 percent of filers with incomes between $50,000 and $75,000 and 3 percent with incomes between $75,000 and $100,000 will face the AMT (all income classes are measured in 2001 dollars). By 2010, the predicted figures jump to 43 and 79 percent, respectively (Burman et al. 2002).[5]

[5] Without EGTRRA, the number of AMT taxpayers in 2010 would have been about 18 million. If the AMT had been indexed for inflation along with the regular income tax in 1981, and if EGTRRA had not been enacted in 2001, only about 300,000 people would have to pay the AMT in 2010 (Burman et al. 2002).

IV. A BRIEF REVIEW OF FEDERAL INCOME TAX CREDITS FOR WORKING FAMILIES

In this section, we report information on the major individual tax credits, highlighting variation in their political design. We explain how each credit works, offer a brief history of the credit's evolution, and describe its size and growth over time, which we report in constant 2002 dollars. We highlight the difference between credits designed primarily for income support (e.g., EITC, CTC), and those tied to consumption of a specific good or service (e.g., child/dependent care, higher education, health coverage).

A. Income Support Tax Credits

1. Earned Income Tax Credit (EITC), Enacted 1975

How Does It Work?

The EITC represents a major federal investment in income support for low-income and working poor families. Since its inception in 1975, the EITC has effectively grown into the largest federally funded means-tested cash assistance program in the United States (Hotz and Scholz 2002). The credit, which is fully refundable, supplements earnings for workers and families with modest incomes, and in the process acts to offset Social Security payroll taxes (Steuerle 1992; Howard 1997; Ventry 2000; Hotz and Scholz 2002).[6]

The amount of credit for which a taxpayer is eligible depends primarily on earnings and the number of children in the family.[7] One-child families were eligible for a credit of up to $2,506 in tax year 2002 if both earned income and AGI were under $29,201 ($30,201 if married); families with more than one child and earnings/AGI under $33,178 ($34,178 if married) were eligible for a credit of up to $4,140. A small credit ($376 maximum) is available to childless taxpayers between 24 and 65 and with earnings under $11,600 (Hotz and Scholz 2002). The amount of credit for which a family is eligible increases with earnings up to a point (the "phase-in" range), is constant over a small income range (the "plateau") and then declines with increasing earnings until reaching zero (the "phase-out" range). In 2002, the income amounts at which the phase-out begins and ends increased by $1,000 for joint filers.[8]

Brief History

The history of the EITC is well-documented elsewhere (Steuerle 1992; Yin 1996; Howard 1997; Ventry 2000), so we offer only a bare-bones chronology here. As Congress expanded

[6] Between 1972 and 1973, the employee payroll tax posted its sharpest one-year jump, rising from 5.2 percent to 5.8 percent. The longer-term trend was more dramatic: workers' share rose from 1.5 percent in 1950 to 3.0 percent in 1960, and to 4.8 percent in 1970 (Ventry 2000).
[7] It is possible for individuals to receive the EITC in advance of submitting their annual tax returns, with offsets against income taxes in each paycheck. Historically, only 0.5 percent of EITC recipients receive the credit via this "advance" option.
[8] For further details on the structure of the credit, see Hotz and Scholz (2002).

eligibility for the credit throughout the mid-1980s and early 1990s, the purpose of the EITC shifted from helping the very poorest of poor workers, to boosting families out of poverty and into more "moderate income" categories. Expansions have been favored historically by policymakers who wanted to transfer more income to lower-income families with children, and by those who viewed expansion as superior to increased welfare outlays (or, in the 1990 debate, a minimum wage increase). As a means-tested benefit that covered the very poor but also more and more working poor families above the poverty line, it was held up as one of the bipartisan political success stories of the prior two decades. Major expansions to the credit were enacted under both Republican (1986, 1990) and Democratic (1993) presidents.

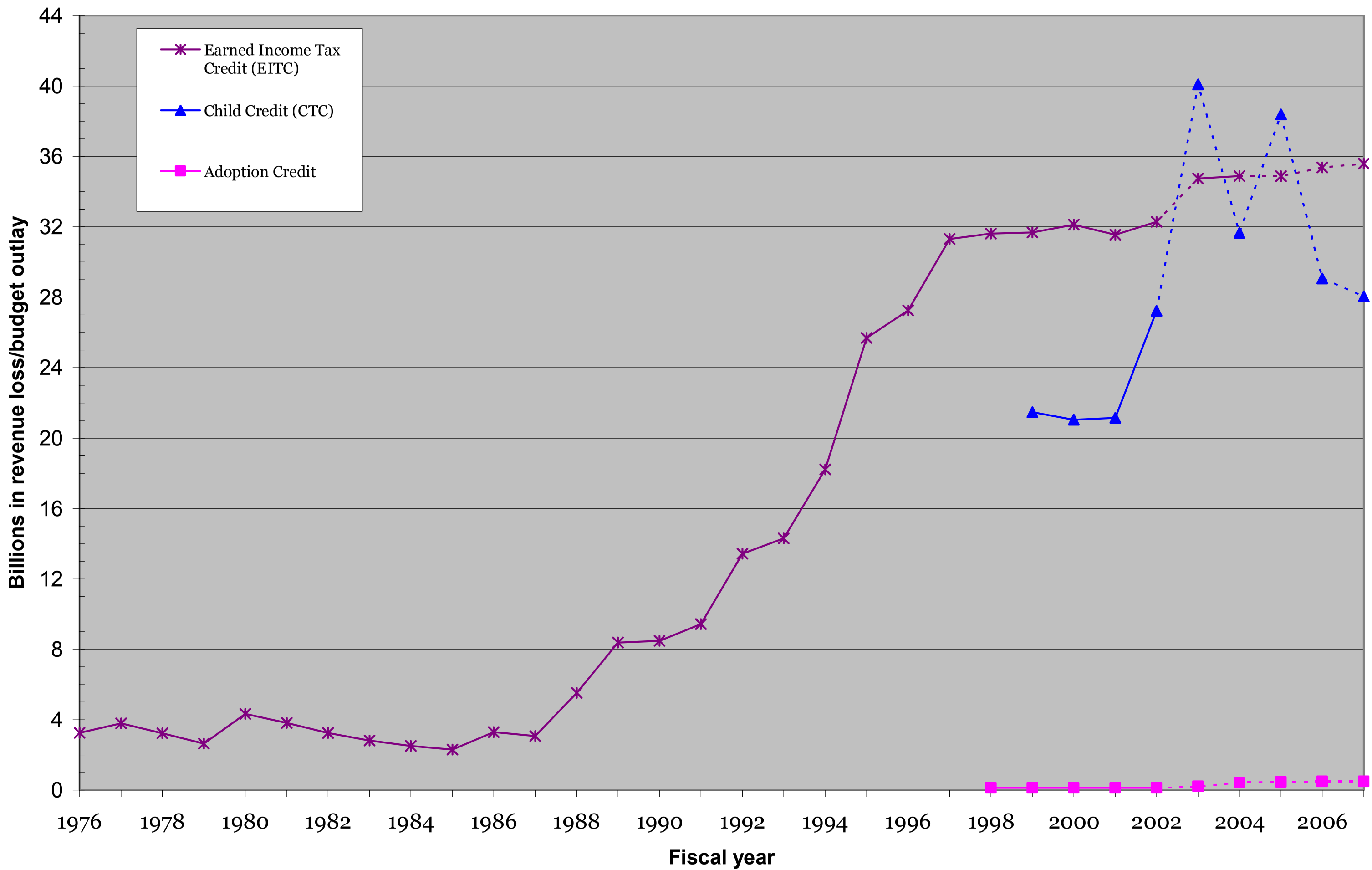
To some degree, though, the EITC has been a victim of its own success, with budgetary outlays so large that it has attracted increased congressional and executive-branch scrutiny. The combination of the GOP takeover of Congress in 1994 and several IRS studies throughout the 1990s revealed a high error rate in the credit made the EITC a prime target for cuts. Because it is refundable against income taxes and much of its total cost is shown in the budget as direct outlays, the EITC was unusually visible and thus more vulnerable to retrenchment (Holtzblatt 2000). The EITC endured and continued to grow thanks in part to advocates who were able to demonstrate that most of the costs of the EITC offset total federal tax burdens—particularly Social Security payroll taxes—just as Congress had intended with the credit when it was enacted in 1975 (Holtzblatt 2000). Moreover, President Clinton made saving the EITC a high priority; by his second term, he held up the EITC as one of the major anti-poverty policy success stories of his administration (Howard 2002).

The most recent expansion to the EITC occurred as part of EGTRRA, when it was expanded modestly to assist low-income couples whose eligibility for the credit subjected them to large "marriage penalties." The income limits for joint filers were raised so that more couples would be eligible for the credit, and those already eligible would receive slightly larger credits. These increases are scheduled to be phased in gradually, with the income limit increasing by $1,000 per year in 2002, 2005, and 2007 (Allred 2001).

Size and Growth

The EITC, as Figure 1 highlights, represented an initial $3.3 billion investment in 1976 (in 2002 dollars), and grew to more than $4.3 billion by 1980. From 1980 to 1986, the size of the credit stagnated. After the 1986 expansion and political commitment to indexation, the EITC, which had dropped in size to $3.3 billion, grew to an $8.5 billion investment by 1990. After the 1990 and 1993 expansions, the EITC multiplied in size, from $9.4 billion in 1991 to approximately $32.2 billion—$27.3 billion in budget outlay and $4.9 billion in revenue loss—in 2000. With its most recent expansion in 2001, and a continually growing low-wage workforce, the EITC is projected to continue to grow slowly, to $35.6 billion by 2007. Thus, over its first three decades, the EITC is projected to grow by more than 1,000 percent in real terms, from $3.2 billion in 1978 to $35.6 billion by 2007.

Figure 1. Federal individual income tax credit expenditure for income security, 1976-2007



Source: OMB, Analytical Perspectives, Budget of the United States Government. "*Table 5-2. Corporate and Individual Income Tax Estimates of Tax Expenditures*." Fiscal Years 1976-2003.

Note: All dollar values are reported in 2002 constant dollars utilizing the latest CPI index as calculated by the Bureau of Labor Statistics. Solid lines denote actual revenue loss/budget outlay. Broken lines denote estimated revenue loss/budget outlay.

2. Child Tax Credit (CTC), Enacted 1997

How Does It Work?

From a public finance standpoint, a child tax credit may be considered a reasonable way to adjust for lifetime tax burdens according to ability to pay: The child-rearing years are normally among the poorest years that individuals face over their working lives (Steuerle 1994). Enacted to provide additional income support to families with children, the CTC is a partially refundable credit for working individuals and families with dependent children up to age 17. Eligible families can claim a credit for each qualifying dependent child; in tax year 2002, the per-child credit was $600. The CTC provides income support to a broader range of families than the EITC; the credit under current law begins to phase out at $75,000 for a single person or head of household, and at $110,000 for couples (Taylor et al. 1997).[9]

The credit is first used to eliminate any tax liability that a family has after all other credits (except for the EITC) are taken into account. Changes enacted as part of EGTRRA in 2001 increased the credit to $600 per child in 2001 through 2004, $700 in 2005–08, $800 in 2009, and $1000 in 2010 (Allred 2001; Burman, Maag, and Rohaly 2002).[10] The CTC is not indexed for inflation, so what appears to be a doubling of the credit amount over the decade actually represents only a 54 percent increase over the level that would have applied if the $500 credit were indexed (Burman, Maag, and Rohaly 2002).

EGTRRA made the child credit partially refundable, in order that families with children but no income tax liability might benefit from the legislation. Unlike the EITC, the credit is only refundable for families above an income threshold—$10,350 in 2002 (this threshold is indexed, though the metric on which it is based—annual minimum wage earnings—is not). Further, between 2001 and 2004, the credit "phases in" at 10 percent of the taxpayer's earned income.[11] For tax years after 2004, the phase-in rate increases to 15 percent of income in excess of the threshold.[12] In May 2003, JGTRRA accelerated the phase-in of the value of the credit (but not the refundability provisions), thereby increasing the CTC from $600 to $1,000 for TY2003 and TY2004 only; if current law stands the credit will revert to a value of $700 in TY2005.

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[9] The total credit—not the per child amount—is reduced by $50 for each $1,000 (or part thereof) that adjusted gross income exceeds the threshold amount.

[10] As with most provisions of EGTRRA, the increase in the child credit sunsets in 2010, so that absent additional legislation the credit would be reduced to $500 per child in 2010.

[11] For example, if earned income were $15,000, an family would be eligible for a total (not per-child) refundable credit of ($15,000-$10,350) x 10 percent = $465.

[12] As with the EITC, any refund that low-income taxpayers receive is not counted as income when determining their eligibility for federal social programs or state or local programs financed with federal funds (Nitschke 2001).

Brief History

The origins of the child tax credit date back to at least the late 1980s when liberals and conservatives competed over the definition of "pro-family" policies. While liberals pushed for more direct spending on child care, a number of conservatives advocated tax relief for families with children. In particular, they wanted the government to do more for families where one parent, usually the mother, stayed home to care for children. Some conservatives felt that public policy unduly favored parents who paid others to care for their children, either through direct spending or the dependent care tax deduction. They achieved partial success in 1990 when Congress approved the Bush administration's Young Child Tax Credit (see discussion of Child and Dependent Care Credit below). The credit was small and targeted at children in their first year of life. Despite calls on the right to expand its scope and value, the credit was eliminated in 1993 as part of the first Clinton budget. Officials in the Clinton administration felt that the credit's complicated interactions with the EITC created headaches for taxpayers, and that expanding the EITC made better sense.

Conservatives did not concede defeat easily. The GOP's "Contract With America" called for a child tax credit, and a number of Republican legislators pushed hard to pass such a tax credit after taking control of Congress in 1994. President Clinton was more receptive to this idea than many congressional Democrats. Clinton felt that targeted tax cuts were good policy and politics, because they allowed Democrats to help the working poor and cut taxes for all working families at the same time. He made a $500 per-child tax credit part of his re-election campaign in 1996. After wrangling over exactly who would benefit from the credit, and how much, the two sides worked out a compromise that was enacted in 1997 as part of a much larger package of tax cuts (Bauer 1993; Gosselin 1995; Harris and Pianin 1997; Howard 1997; Wildavsky and Victor 1997).

Through tax year 2000, the CTC was a nonrefundable credit.[13] During the debate over the 2001 tax package, some of President Bush's initial proposals to benefit higher-income taxpayers were scaled back to enhance cuts for lower- and more moderate-income families, in order to win Democratic support for the legislation (Nitschke 2001). Thus, a Senate Finance Committee provision amended the child credit to make it partially refundable. This added complexity to the tax code for working poor families, but policy makers believed it was simpler to explain than an equivalent measure to provide additional benefits to these families by expanding the phase-out range of the EITC (Steuerle 2001a).

The final version of the 2003 tax bill omitted a Senate provision that would have made the child tax credit's "refundability" rules more generous, and it was the last of numerous Senate provisions that negotiators dropped (Barshay 2003). Senate Republican leaders capitulated to

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[13] For taxpayers with three or more qualifying children, the credit was refundable only up to the amount that their Social Security and Medicare taxes exceeded their earned income, known as the FRED—"full refundability for excess dependents." This made the connection to payroll taxes, often implicit in the EITC's evolution, quite explicit. For families with one or two children, the credit was not refundable originally, but because it was subtracted from tax liability before the EITC, the child tax credit could supplement the refundable EITC portion.

Democrats' later repeated demands to increase the child credit for low-income families, arranging for the passage by voice vote of legislation that would allow more lower-income parents to share in the new tax law's temporary increase in the per-child credit from $600 to $1,000. The Senate voted overwhelmingly in June 2003 to allow 6.5 million low-income families to receive the credit, and the White House believed there was significant "political peril in being perceived as opposing tax breaks for low-income working people" (Firestone 2003a). The House version of the bill, however, adopts the low-income expansion amid increases in the credit in the out-years (i.e., post-2004) and increases in the income threshold at which the credit begins to phase out, at a much higher overall cost. While it appears unlikely, even if compromise occurred the battle over the future of the refundable EITC and CTC is likely to continue. Many conservatives want to curb the cost of both credits, while others see them as a way to help low-income families at a time when upper-income taxpayers are receiving substantial tax cuts (Ota 2003b).

The evolution of the child tax credit has produced a credit that is more complex, administratively, than originally intended. Its interaction with the AMT, the EITC, the child/dependent care credit, and the adoption credit (Steuerle 2000a) add to this complexity, as does the fact that the rules for determining whether children qualify for the credit differ from those for the EITC and the dependent exemption (Steuerle 2001a).

Size and Growth

In a few short years, the child credit has become the second-largest social policy-related individual tax credit. From a $21.5 billion level in 1999, the CTC is expected to reach $40 billion in 2003 with the recent JGTRRA expansions. Under current law it will drop back to $28 billion in 2007 (approximately $21 billion in revenue loss and another $7 billion in budget outlay) (see Figure 1). The CTC is projected to grow much faster in its first decade (31 percent) than the EITC, which remained practically flat. In 2003, these two income support credits will represent a combined $75 billion investment in mostly low-to-middle-income families .

3. Adoption Credit, Enacted 1996

Congress, as a provision in the 1996 Small Business Job Protection Act, enacted a nonrefundable $5,000 tax credit to provide financial incentives to adopt, and to ease the financial burden of adoption. The law allowed a $6,000 tax credit for domestic special-needs adoptions, such as those of disabled children. Under EGTRRA in 2001, Congress increased the credit to $10,000 per child, regardless of special needs, raised the phase-out range for the credit from $75,000 to $150,000 AGI, and indexed the credit for inflation (Allred 2001). While the credit is much more valuable than the EITC or CTC to individual taxpayers eligible for the credit (particularly middle-income families with significant tax liability), far fewer taxpayers qualify for the adoption credit than either the EITC or CTC. In its first full year (1998), the adoption credit represented a $130 million tax expenditure, and has remained relatively flat since then. With its expansion in 2001, however, the credit is projected to grow to $500 million by 2007 (Figure 1).

B. Individual Tax Credits for Consumption of Goods and Services

1. Child and Dependent Care Credit, Enacted 1976

How Does It Work?

Child care is widely recognized as an expense that many working families must incur in order to find and keep their employment. The Child and Dependent Care Credit (CDCC) is a nonrefundable tax credit designed to help families pay employment-related expenses for care of a child under the age of 13.

The credit is available to working families with children or other dependents, and the amount of credit for which a family qualifies is based both on child care expenses incurred, and on family income (Steuerle 1990). In 2002, families could claim qualifying expenses of up to $2,400 for one child, or $4,800 for two or more children. The credit is then calculated at between 30 and 20 percent of the amount claimed, phasing down one percentage point for each additional $2,000 in income above $10,000.[14] Thus, a family with two children and AGI of $20,000 would qualify for a credit of 25 percent of expenses up to $4,800, or $1,200. The CDCC is not indexed for inflation.

Brief History

In 1954, Congress allowed "gainfully employed women, widowers, and legally separated or divorced men" a maximum $600 deduction for certain child care expenses (Buehler 1998). Congress changed it to a credit in 1976 to address the criticism that a deduction benefited only upper-income families who itemized (Dunbar and Nordhauser 1991). Between 1976 and 1981 taxpayers could claim a credit of 20 percent of qualified child care expenses, with a maximum credit of $400 for each of the first two dependents. The 20 percent credit was the same for taxpayers at all income levels.

As part of the large tax bills (ERTA and OBRA) enacted in 1981, Congress expanded the credit to provide a higher ceiling on qualifying expenses, a larger credit for low-income individuals, and modified rules relating to care provided outside the home. Democrats justified the increase in allowable expenses as necessary to make up for the effect of inflation on child care costs since 1976. In an effort to make the credit more progressive, Congress changed it to a sliding scale credit based on family income. Thus, families with lower incomes could claim a proportionately larger tax benefit than families with higher incomes (Zeitlin and Campbell 1982). Another provision of ERTA established a new category of tax-free employee child care benefits (i.e., dependent care assistance programs).

For two decades thereafter, Congress failed to adjust the value of the credit for inflation, though it came close on several occasions. In 1990, as part of an agreement on a major child care bill, Congress enacted a supplement to the EITC for low-income families with children under age

[14] See http://lift.nccp.org/policy_index_14.html.

four, mirroring a Bush Administration proposal from the year before (*CQ Weekly* 1990). This supplement replaced provisions to expand and make the CDCC refundable, and to increase the standard deduction by $500 for families with children under the age of one (a "wee tot" allowance) (Rovner 1990). Similar provisions to expand the CDCC were debated as part of the 1997 Taxpayer Relief Act, but only the nonrefundable CTC emerged from that debate (Buehler 1998).

Under EGTRRA in 2001, however, Congress expanded the child care credit starting in tax year 2003 by raising the maximum qualifying expenses (to $3,000 for one child, and $6,000 for two or more children); by lifting the maximum credit percentage (from 30 percent to 35 percent); and by increasing the income level at which the credit begins to phase out (from $10,000 to $15,000). These changes will effectively increase the maximum CDCC for the family in the example above from $1,200 to $1,920, and will enable families with incomes of up to $45,000 to qualify for a credit rate above the minimum 20 percent.

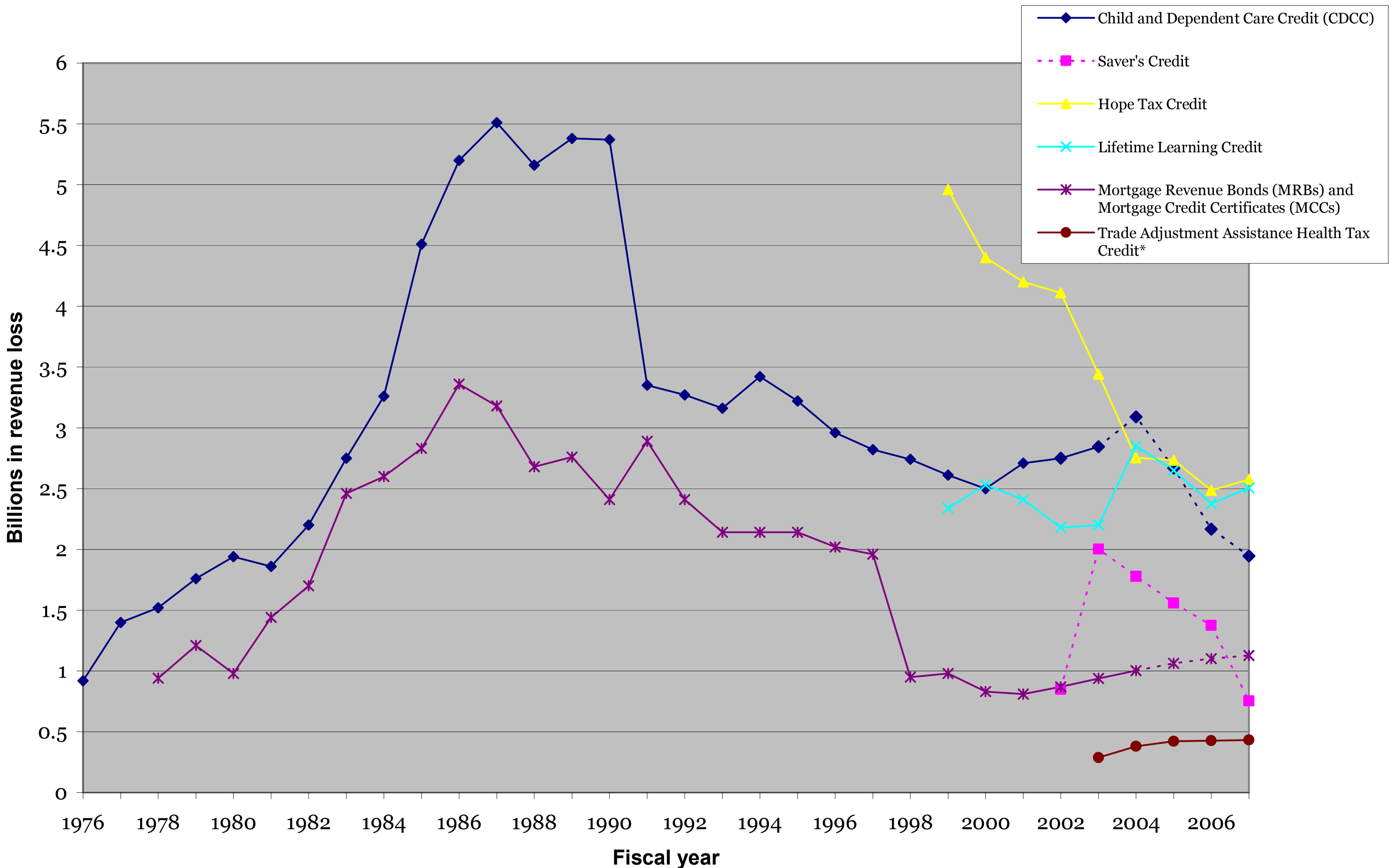
Size and Growth

The CCDC grew significantly in its first decade, both as a result of the 1981 expansion and as more families claimed the credit (Figure 2). Total expenditures rose from $920 million in 1976 to $5.5 billion by 1986. In the following decade, inflation eroded the value of the credit significantly, and claims decreased to $2.5 billion by 1999. With an expansion scheduled to begin next year, the size of the credit is expected to increase to $3.1 billion in 2004. Because the credit is not indexed or refundable, however, the CDCC is thereafter expected to shrink to less than $2 billion by 2007, its lowest level in 25 years. Thus, over roughly three decades, the CDCC is projected to grow by only 39 percent, from $1.4 billion at its inception in 1977 to $1.9 billion in 2007.

One reason for the credit's less-than-robust growth may derive from the types of child care that many low-income families access. To claim the CDCC, tax filers must provide information on the tax form regarding the child care provider. In turn, this alerts the IRS that the provider might be subject to tax on those earnings. A large portion of lower-income parents rely on relatives, friends, or neighbors to provide care on an informal, though paid, basis. Those informal "providers" may not be willing to provide such care, however, if they know that information about their activities will be furnished to the IRS. As a result, far fewer families may take advantage of this credit than are eligible for it.[15]

[15] Thanks to Adam Carasso for pointing this out.

Figure 2. Federal individual income tax credit expenditures for consumption goods and services, 1976-2007



Source: OMB, Analytical Perspectives, Budget of the United States Government. "Table 5-2. Corporate and Individual Income Tax Estimates of Tax Expenditures." Fiscal Years 1976-2003.

Note: All dollar values are reported in 2002 constant dollars utilizing the latest CPI index as calculated by the Bureau of Labor Statistics. Solid lines denote actual revenue loss/budget outlay. Broken lines denote estimated revenue loss/budget outlay.

2. Tax Credits for Higher Education Access, Enacted 1997

How Does It Work?

The U.S. historically has relied on direct loans and loan guarantees to make higher education accessible and affordable to working families. The enactment of the Hope Scholarship and Lifetime Learning Credits reshaped the tax code into a vehicle for subsidizing higher education. These two very similar credits are nonrefundable and designed to help students and parents pay expenses for college, vocational training, and other postsecondary education.

For students in the first two years of college (or other postsecondary training), taxpayers can claim a Hope credit equal to 100 percent of the first $1,000 of tuition and fees (less grant aid) and 50 percent of the second $1,000. For students beyond the first two years of college, or for those taking classes part-time to improve or upgrade their job skills, taxpayers can claim a 20 percent Lifetime Learning tax credit for the first $5,000 of tuition and fees through 2002, and for the first $10,000 thereafter. Both credits are phased out for couples with AGI between $80,000 and $100,000, and for individuals with AGI between $40,000 and $50,000. Taxpayers may claim the Hope credit for some students and the Lifetime Learning credit for others in a given year, but not both credits for the same student in the same year (Taylor et al. 1997).

Brief History and Size/Growth

As a central part of President Clinton's middle-class tax cut and effort to expand educational opportunity, Congress enacted these two credits in the 1997 Taxpayer Relief Act. The Department of Education estimates that 13.1 million students—5.9 million claiming the Hope and 7.2 million claiming the Lifetime Learning—are expected to benefit each year.[16] In the first year in which it was generally available (1999), the Hope credit represented an approximately $5 billion investment, but demographic change and inflation lowered the revenue loss to $4.1 billion in 2002. The credit's overall value is expected to decline to $2.6 billion by 2007. The Lifetime Learning credit represented a $2.3 billion investment in its first full year, and its value has been relatively flat since. With a small expansion in tax year 2003, the credit is expected to provide roughly $2.5 billion to taxpayers in 2007, similar to the Hope credit. Overall, though, the real value of the two credits combined is actually projected to decline over the first decade of their existence (see Figure 2).

3. Savers' Credit, Enacted 2001

How Does It Work?

While eligibility for pension plans has increased among lower-income workers, participation is still very low, and these workers contribute smaller percentages of their earnings than higher-income employees (Gramlich 2001). Low participation may owe in part to the smaller economic

[16] http://www.ed.gov/inits/hope/.

benefit low-income individuals derive from the ability to deduct contributions to a retirement plan from their taxable incomes. Congress enacted an individual "Savers' Credit" in 2001 to subsidize low-to-middle-income working individuals' and families' retirement savings.

Working individuals with AGI of up to $25,000, and couples with AGI of up to $50,000, can claim a non-refundable credit based on contributions to an IRA, 401(k), 403(b), SIMPLE, or 457 plan. The Savers' Credit is nonrefundable, and taxpayers may claim an amount between 10 percent and 50 percent of their contributions not exceeding $2,000 ($4,000 for joint filers)—the credit rate phases down with increasing income. Because the credit is calculated before the EITC and CTC, it does not alter the amount of refundable credit for which taxpayers are eligible. As with other nonrefundable credits, however, lower-income working families with children will receive limited benefit from the Savers' Credit (Orszag and Hall 2003). EGTRRA sunsets the credit after tax year 2006.

Brief History and Size/Growth

Several provisions of EGTRRA expanded tax benefits for retirement savings contributions among higher-income workers. Congress raised the amount of contributions that taxpayers could deduct from income, and lifted the income ceiling under which taxpayers could qualify for such a deduction. The Savers' Credit, which had its origins in the Senate version of the tax cut bill, was designed to include lower-income workers and families in the expansion of retirement savings subsidies (Allred 2001). Unlike those other retirement savings provisions, however, the Savers' Credit was enacted for only a five-year period. The credit is expected to cost nearly $2 billion in its first full year (2003). Since the credit amount is not indexed, the overall investment is projected to decline gradually to $750 million upon its expiration in 2007 (Figure 2).

4. Mortgage Credit Certificates, Enacted 1984

How Does It Work?

In contrast to the deduction for home mortgage interest, which is estimated to cost $65.5 billion in 2003, the United States has few tax expenditures directly targeted at low- and moderate-income families. The Mortgage Credit Certificate (MCC) is a federal tax credit program administered by state and local housing agencies that helps low-to-moderate-income first-time home buyers qualify for home mortgages. Agencies allocate the credit in the form of certificates to eligible home buyers, generally those with incomes below the median in their area purchasing homes under specified dollar limits. Certificate holders may take up to 20 percent of their annual mortgage interest as a dollar-for-dollar credit against their federal income tax.[17]

[17] "Tax Information for First-Time Homebuyers," availablke at http://www.irs.gov/formspubs/page/0,,id%3D104120,00.html#I30 (August 2003).

MCCs are closely related to Mortgage Revenue Bonds (MRBs). State and local governments often finance public projects with federally tax-exempt bonds, but the federal tax code also allows them to issue a limited amount of tax-exempt bonds to finance certain "private activities." In 2002, states were permitted to issue $75 per capita in private activity bonds in the form of MRBs, rental housing bonds, student loan bonds, and industrial development bonds. MRBs finance homes for first-time, low-to-moderate-income homebuyers, effectively buying down the interest rate on their mortgages by exempting bond proceeds from federal income tax. In lieu of MRBs, state and local housing agencies may issue MCCs in an amount up to 25 percent of the annual ceiling on MRBs.

Brief History and Size/Growth

As interest rates on conventional mortgages peaked in the late 1970s, reaching almost 19 percent in 1981, tax-exempt bonds became a very successful instrument for states to increase the available supply of mortgage money.[18] In 1984, Congress authorized the MCC Program as a means of providing a direct housing subsidy to families of low and moderate income, and allowed state and local housing agencies to issue MCCs instead of MRBs. Thus, instead of investors getting reduced interest costs, homebuyers would receive a credit to reduce their tax liability (Rothman 1983; Sunlet and Walz 1985).

The program remains limited in scope, however. Through 2001, 25 states have operated MCC programs, and 156,000 MCCs have been issued over the life of the program across all states (NCSHA 2001). While official government data (OMB, JCT) do not report independent values of the annual revenue loss for the MCC, the aggregate MRB/MCC investment has grown from approximately $980 million in 1980 to a high of approximately $3.36 billion in 1986. Subsequently, the value of the investment dropped dramatically as inflation eroded the value of the private activity bond cap; by 2000 MRBs and MCCs accounted for only $830 million in revenue loss. The cap was increased and indexed for inflation in the 2000 Community Renewal Tax Relief Act, so that MRBs and MCCs combined are projected to grow to $1.1 billion by 2007 (Figure 2).[19]

5. Tax Credit for Health Insurance Coverage, Enacted 2002

How does it work?

The largest and most well-known tax expenditures for health care allow employers and employees to exclude from income their contributions to health premiums. While in the last few years Congress has advanced several proposals to "insure the uninsured" through federal income

[18] Congress, in 1980, enacted restrictions on the issuance and use of MRBs, limiting the amount a state could issue, which populations would benefit from the bond program, and the purchase price of the homes (Mortgage Subsidy Bond Act). Originally, MRBs were issued only until 1983; the sunset date was extended several times until 1993, when MRBs were made permanent through 1993 OBRA.

[19] The MCC is more likely to be claimed and is more valuable to taxpayers when interest rates are very high, as they were in the late 1970s and 1980s; much lower rates prevail today.

tax credits, little-noticed provisions in the 2002 Trade Act employed tax credits as a health insurance subsidy tool for the first time.

The Trade Adjustment Assistance (TAA) health insurance credit is a refundable credit that reimburses individuals designated eligible by the Secretary of Labor for 65 percent of their expenses for health insurance premiums (Cunningham 2002).[20] In general, eligible workers include those who lose their jobs from firms in which large numbers of workers are displaced by trade agreements. Eligible individuals and family members may claim the credit for up to two years after they lose their jobs.[21] In addition, the credit is available to older individuals (55 to 64 years of age) who are receiving benefits from the Pension Benefit Guaranty Corporation, and who are too young to qualify for Medicare and often do not have employer-provided health insurance.[22] Perhaps the most unique feature of the credit is that its value is required to be made available to claimants in the form of advance payments, so that individuals can meet their monthly premiums. The design of the advance payment system is not yet complete, however.

Brief History/Size and Growth

There was a small precedent for using tax credits to subsidize the purchase of health insurance for individuals. In 1990, Congress included in its expansion of the EITC a small additional credit for EITC-eligible families to offset their costs in purchasing health insurance for their children (CQ Weekly 1990). Because the credit "reimbursed" eligible families for only a small percentage of their premiums, very few families actually purchased coverage. The rise of very "thin" or "bare-bones" insurance policies, often purchased by unsuspecting families, set the stage for repeal of the supplement in 1993. Much of the effort to expand health insurance to working poor families in the late 1990s centered around expenditure programs like the State Children's Health Insurance Program (SCHIP) rather than tax credits.

The TAA health insurance credit is small compared to the other consumption credits, projected to cost $430 million in fiscal year 2007 (Figure 2). Nonetheless, we felt it important to

[20] Eligible workers currently receive these benefits (called trade adjustment assistance) under programs implemented pursuant to the Trade Act of 1974 (the 1974 Trade Act). The 2002 Trade Act generally extends the period during which trade adjustment assistance is available until September 30, 2007 (the original expiration date was September 30, 2001).

[21] To meet the definition of an "eligible TAA recipient," a person must be in one of the following two categories: receiving trade readjustment allowances under the Trade Adjustment Assistance (TAA) program or the NAFTA Transitional Adjustment Assistance (NAFTA-TAA) program; or eligible to receive a trade readjustment allowance under the TAA or NAFTA-TAA programs but not yet having exhausted the unemployment insurance (UI) benefits. See http://wdr.doleta.gov/directives/attach/TEGL16-02_Attach.html).

[22] PBGC insures nearly 38,000 private defined benefit pension plans covering more than 43 million American workers and retirees. PBGC is a federal government corporation established by Title IV of the 1974 Employee Retirement Income Security Act (ERISA) to encourage the continuation and maintenance of defined benefit pension plans and provide timely and uninterrupted payment of pension benefits to participants and beneficiaries in plans covered by PBGC.

highlight the credit here because it may represent a “camel’s nose under the tent” in future congressional strategies to subsidize health insurance for working families.[23]

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[23] The refundable portion of the TAA health insurance credit is not reflected in the OMB tax expenditure data. Estimates cited here are from the CBO score of the conference version of the Trade Act of 2002. See http://www.cbo.gov/showdoc.cfm?index=3726&sequence=0.

V. Comparing Tax Credits for Working Families—Income Support vs. Consumption, and Individual vs. General Business

In this brief section, we move from descriptions of each credit to a broader comparison of aggregate data within and across categories of tax credits. Comparing across the individual credits, two major findings emerge. First, the two major income security credits—the EITC and CTC—are each considerably larger than all of the individual consumption credits combined. Second, the EITC and CTC have grown significantly since their inception, while the credits tied to the consumption of particular goods and services have declined in value in recent years.

In 2003, the federal government will invest roughly $75 billion in the two major income security credits. Congress supported significant expansions of these credits in recent years, effectively doubling the value of the EITC between 1993 and 2002, and adding significantly to the value of the child credit over six years. In contrast, the five consumption tax credits examined here will total only $11.6 billion in 2003 (including amounts for Mortgage Revenue Bonds). Each individual consumption credit had significant value at or near its inception, but lack of indexation and only occasional expansions have prevented the credits from undergoing the sort of robust growth that the income security credits have.

A third observation: the value of individual income tax credits for working families compares favorably to the value of a wide range of general business tax credits designed specifically to benefit lower-income workers and communities (Table 2). These general business tax credits are several in number and have a wide range of social policy goals (additional background information on these credits can be found in Appendix B):

- The Targeted Jobs Tax Credit (TJTC) and its successors, the Welfare-to-Work Tax Credit (WWTC) and Work Opportunity Tax Credit (WOTC), have aimed to increase the employment of disadvantaged groups of workers by providing firms with tax credits for hiring these workers.
- The Low-Income Housing Tax Credit (LIHTC) and the New Markets Tax Credit (NMTC) aim to promote community and economic development by rewarding investors in affordable housing and low-income community businesses with tax credits.
- Empowerment Zone/Enterprise Community (EZ/EC) and Renewal Community (RC) tax incentives, including tax credits to promote local hiring, aim to engage the private sector in public-private efforts to revitalize distressed urban and rural communities.
- The Small Business Retirement and Employer-Provided Child Care credits aim specifically to stimulate the provision of benefits at firms that might otherwise not offer these options to their employees.

Table 2. Comparison of Individual and General Business Tax Credits by Size
(Revenue loss and budget outlay in billions of dollars, 2003)
All numbers are reported in 2002 constant dollars.

Individual Tax Credits	2003	General Business Tax Credits	2003
Child Tax Credit (CTC)	40.10	Low Income Housing Tax Credit (LIHTC)	3.38
Earned Income Tax Credit (EITC)	34.74	Empowerment Zone and Enterprise Communities	1.10
Hope Tax Credit	3.44	Credit for Employer Paid FICA	0.39
Child and Dependent Care Credit (CDCC)	2.84	TAA Health Insurance Tax Credit	0.29
Lifetime Learning Credit	2.20	New Markets Tax Credit (NMTC)	0.19
Low & Moderate Income Savers Credit	2.00	Work Opportunity Tax Credit	0.14
Mortgage Revenue Bonds/Mortgage Credit Certificates	0.94	Employer Provided Child Care Credit	0.09
Adoption Tax Credit	0.22	Qualified Zone Academy Bond Credit	0.07
		Small Business Retirement Plan Credit	0.05
		Welfare-to-Work Tax Credit	0.04
TOTAL	**86.48**	**TOTAL**	**5.73**

Source: OMB, Analytical Perspectives, Budget of the United States Government. "Table 5-2. Corporate and Individual Income Tax Estimates of Tax Expenditures"; Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 2, The "Jobs and Growth Tax Relief Reconciliation Act of 2003."

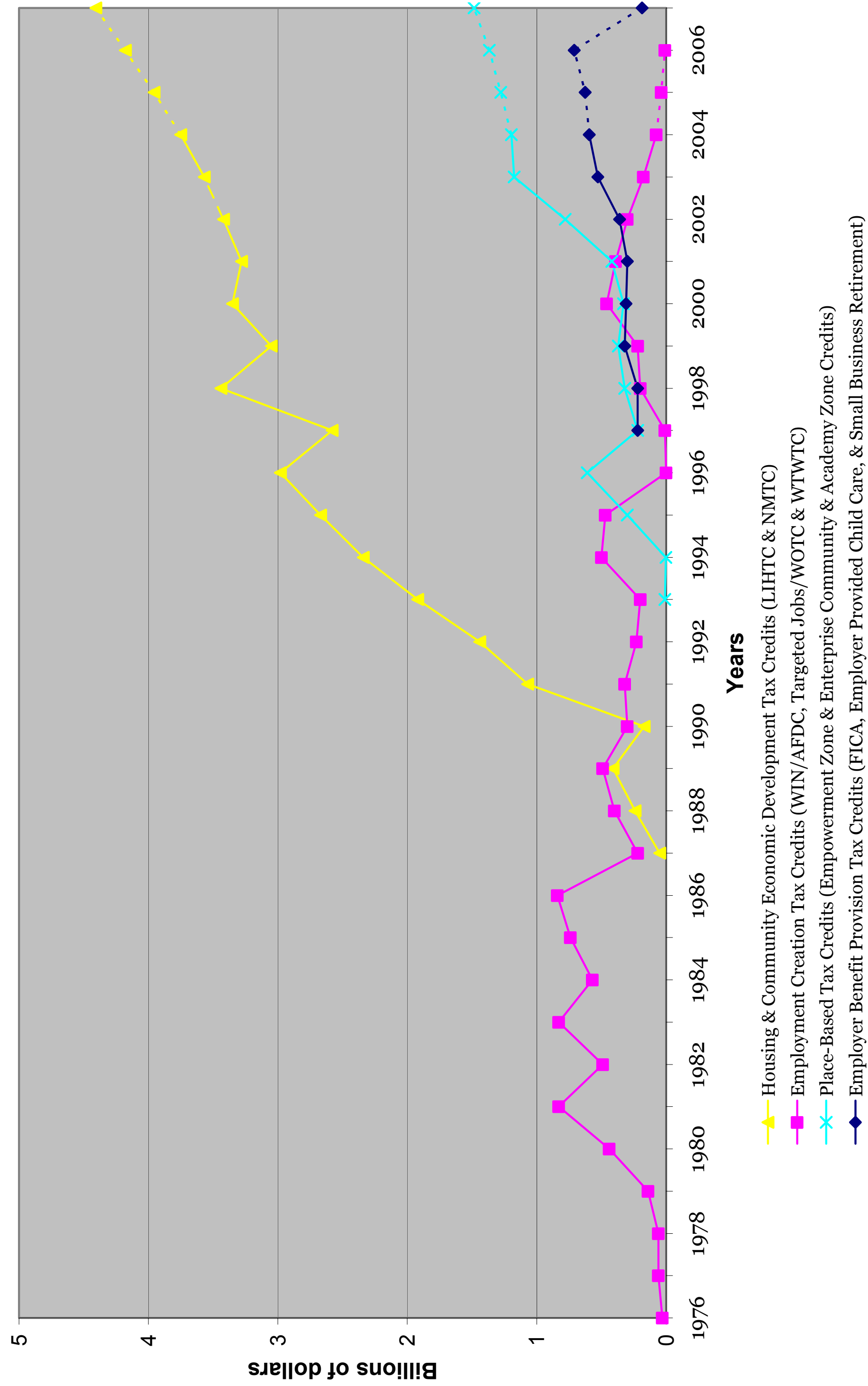
Yet general business tax credits do not begin to approach the scale of support provided to lower- and middle-income families through individual income tax credits. Overall, the individual income tax credits discussed in the previous section have increased in size and number significantly over the last 25 years, from just over $5 billion in 1977 to $87 billion today. The general business tax credits listed here (pictured in Figure 3) grew from a much smaller $30 million in 1976 to $5.4

billion today.[24] Thus, the major individual tax credits are now 16 times as large in the aggregate as the social-policy-related general business tax credits.

This observation is not meant to suggest that policymakers have wasted effort in creating and extending general business tax credits for lower-income workers and communities. Despite their smaller size and slower growth, these credits have provided significant social benefit over several decades, and have endured thanks to powerful political support among third-party beneficiaries such as employers, developers and investors. The large difference in magnitude between the individual and general business tax credit investment, however, encourages us to look more closely at how individual income tax credits—particularly those for income support—could broaden public understanding and political support in favor of future investments in low-to-middle-income working families.

[24] Tax expenditure amounts for Empowerment Zones/Enterprise Communities and Renewal Communities include amounts for non-tax-credit provisions, such as enhanced equipment expensing, capital gains exclusions, and tax-exempt bond authority.

Figure 3. Federal general business tax credit expenditures by category, 1976-2007



VI. A Working Families Tax Credit for Low-to-Middle-Income Families

The prevailing wisdom among many political scientists suggests that narrowly-targeted income transfers (i.e., direct cash assistance to low-income families) enjoy only sporadic political support in Congress, as they tend to be enacted in periods of partisan imbalance and to be vulnerable to retrenchment when elections shift the balance of power (Ferejohn 1983). Proponents who wish to channel federal benefits to a narrow sector of the income distribution face a particularly difficult problem: There remains a tradeoff between the effectiveness of any federal allocation in delivering benefits to its intended targets and coalition support for the program within Congress. Several policy scholars also have highlighted the political limits of "geographically targeted" or "place-based" social policies. The political vulnerability of place-based social policy became evident in the 1980s when the demographic shift of population into suburban areas made it possible for national policy makers to win elections without the urban vote (Weir 1995).

The EITC, as a targeted individual credit with both distributional and spatial impacts, is a notable counterexample to the conventional wisdom on the politics of social policy. Howard (1997) concluded that the meteoric rise of the EITC over its first two decades indicated that it is possible to build a durable political coalition on behalf of means-tested programs that support low-income and working poor families in the United States. Similarly, Greenstein (1991) concluded that the EITC's policy design—"a middle ground of maintaining a targeted program structure while incorporating near-poor and moderate-income working families that are struggling themselves"—has strengthened its underlying political support.

The fact that the EITC yields a distribution of benefits that extends well beyond only the poorest of "working poor" families in central cities to low-to-moderate-income families in the suburbs may also an important factor explaining its political resiliency, although these spatial characteristics have only recently begun to draw attention (Berube and Forman 2001). While targeted programs are indeed more likely to be strong politically when they serve low-to more moderate-income as well as the very poor, Greenstein (1991) also notes that a range of targeted federal programs that have also proved sustainable over time (i.e., EITC, Medicaid, food stamps, Supplemental Security Income) "supports the idea that if the public considers benefits to be earned, or strongly approves of the services being provided, political strength can be sustained among targeted means-tested programs." Indeed, much recent research continues to focus on making sustainable improvements in the conditions faced primarily by low-income and working poor families. Ideas such as expanding the EITC, increasing the minimum wage, boosting child care subsidies, and creating a refundable payroll tax credit target those at the lower end of the income distribution (Sawhill and Thomas 2001; Sammartino 2002).

On the other hand, some analysts suggest that instead of expanding policies that target families at the low end, society should advance policies that address the needs of both low-income and middle-income families (Skocpol 1991; 1997; 2000). Wilson (1987) argues that advocates seeking to ameliorate poverty and enhance economic security should support broad policies that include whites and people of color, and middle-income as well as economically disadvantaged

families. Such a "targeting within universalism" approach would deliver income support to all families that combine working and parenting, but with larger benefits (proportionately and absolutely) for the neediest low-income families (Skocpol 1991). Advocates argue that social benefits, such as universal health coverage, paid family leave, and affordable child care that are made available to both low- and middle-income workers are the cornerstones for building a family-friendly society (Skocpol 2000). A similar logic undergirds calls to strengthen urban-suburban electoral alliances around policies that "cut across groups and move them toward cooperation, rather than heightening inter-group polarization" (Dreier, Mollenkopf, and Swanstrom 2002).

Is there a middle ground between these approaches? Sawhill and Thomas (2001) conclude that "focusing federal assistance on the bottom one-third of the population is a good policy compromise, avoiding both the worst disincentives to work associated with more tightly-targeted programs (which sharply reduce benefits when recipients move up the income scale) and the huge budgetary outlays associated with universal programs." While this targeted method to assist low-income and working poor families is well intended, we argue that it may not enlist the critical political support of more middle-income families, whose electoral heft might lend weight to work-family investments. The universal approach has its limits as well, failing to recognize the political and budgetary constraints against any new public entitlement programs or employer mandates.

In light of this, we argue for a "targeted within universal" individual tax credit, moving beyond the confines of either the purely targeted or wholly universal policy approaches. Extending benefits to middle-income families would also respond to the policy criticism that tax benefits are smaller in the middle of the income distribution than they are at the low and high ends (Cherry and Sawicky 2000; Ellwood and Liebman 2000).

If, as recent history suggests, the tax code is the bipartisan policy instrument of choice for providing income support, creating a tax credit to serve as a child or family "allowance" for all working families (which we defined as those with an AGI of less than $75,000) would represent one promising approach. One pathway to achieving this, proposed by Carasso, Rohaly, and Steuerle (2003), would merge the child credit and the EITC and offer it to all eligible families with children aged 18 and under. Their "Earned Income Child Credit" (EICC) would offer tax benefits similar to the current EITC and CTC, although it would provide more relief at the bottom of the income distribution, by increasing the maximum credit in the EITC portion and boosting the refundability of the CTC portion. Consistent with keeping the credit targeted, they would begin to phase out the credit entirely at somewhat lower income levels ($60,000 for singles, $90,000 for married filers) than under current law.

Ellwood and Liebman (2000) offer other tax policy options that could broaden support for working families. One option would create a "three-step" working family tax credit that combines a more generous EITC at the bottom end of the income scale with a more generous child credit ($1,500) in the middle ($20,000 to $110,000 for married filers) and ultimately phases the credit down to $1,000 per child for high-income filers. A different but similar option would extend the point at which the EITC begins to phase out all the way out to $110,000—and would then phase it down to

$1,000 per child (while eliminating the dependent exemption and CTC). These credit options would penalize virtually no taxpayer while equalizing and sometimes raising child tax benefits across income groups. Ellwood and Liebman's options would extend tax credits to filers beyond our definition of "working families" (up to $75,000) but still represent a "targeted within universal" approach in that benefits are somewhat higher at the lower end of the distribution. Overall, we are not wedded to any single policy proposal or specific parameters on the targeted distribution of larger tax benefits at the lower end of the distribution.

Combining the EITC/CTC or designing a new simplified working family tax credit would not only create a single individual credit that is more seamless to taxpayers applying for it, but also would create significant potential, politically, to broaden popular understanding of and political support for working family investments. While generally enjoying popular support, EITC noncompliance has been a longstanding political and administrative weakness (Book 2003). Periodically, political "outrage" over the high rates of error has left the EITC vulnerable to political attack, and it recently encouraged the IRS to embark on a program to "pre-certify" EITC filers, an approach that may further weaken the program politically (IRS 2003, Greenstein 2003). An EICC-like credit would broaden the range of families who benefit from the credit (by tying together the EITC and the CTC), while also reducing the error in the EITC through reduced complexity. At the same time, a credit with one set of streamlined eligibility rules may also go a long way towards reducing refundable credit payments made in error (Nelsestuen 2000). The interaction of the EITC, the CTC, and the CDCC, as well as the ordering rules for refundable and nonrefundable credits, make it very difficult for most American working families to understand their child-related tax benefits.

Some might argue that any policy reform that unites two existing credits (EITC, CTC) under one roof or integrates them into a unified working families tax credit would dilute the support that each credit separately enjoys, rather than enhance their current and future political sustainability. Would policy makers be emboldened to reduce portions of the credit that provide income support for low-to-moderate-income families while leaving the credit targeted toward middle- and upper-middle-income families untouched? We submit that this is no more or less likely to succeed than attempts to directly cut the refundable portions of the EITC or CTC under current law.

The current split within the GOP between conservatives and moderates over a stalled child tax credit bill does raise questions about whether the two-decade bipartisan bargain over individual income tax credits is eroding, and whether refundable tax credits will continue to garner political support as alternatives to welfare and minimum wage increases. Conservative Republicans argue that refundable credits are unfair to those who pay more taxes. Democrats argue that the failure of recently enacted tax laws benefit primarily wealthy families and shortchange working poor families. Indeed, the CTC stalemate may give greater prominence to the role of tax credits and working families as themes in the 2004 presidential campaign. Meanwhile, though, it appears that a bipartisan coalition in Congress still strongly supports work incentives for those at the bottom of the income distribution as well as benefits for most families with children.

Political scientists are notoriously bad at prediction, and we do not wish to add to that dubious record. We feel it is safe to say, though, that individual income tax credits designed to provide broad income support, and those designed to subsidize consumption of goods and services with social benefits, will continue to encourage individual claimants and third-party beneficiaries to mobilize in favor of their continuation or expansion. We do not know for sure which of the smaller individual tax credits created or expanded in recent years will prosper and grow. In analogizing to other tax expenditures, we find more than one path to political success. Examples over the past three decades demonstrate how Republicans and Democrats alike have found their way around "gridlocked" policy debates over direct spending and employer mandates to enact bipartisan tax credits that increase income security and improve access to child care, higher education, and other social goods. The ensuing revenue loss and budget outlay represent important sources of investment in working families, with important geographic implications for the communities in which they live and work.

In concluding, we note that several policy observers have claimed that the obstacles to activist government and support for working families have grown in recent years. Certainly, the budgetary environment of the moment does not hold a great deal of promise for expanded federal investments in working families. Yet recent policy history and empirical trends over the last three decades demonstrate that new or expanded work/family efforts are indeed possible politically, even at times of budget and economic stress.

An EICC or any broader working family tax credit (i.e., one that accounts for child care and family medical leave) that connects the fates of low- and middle- and upper middle-income working families as worthy beneficiaries of federal assistance, could represent the American equivalent of family or child allowances in Europe, run through the federal income tax code rather than paid directly out of a social insurance fund. Such a credit could broaden the EITC's constituency to include more workers as claimants of family-friendly federal tax credits.

APPENDIX A: ESTIMATING FEDERAL TAX CREDIT EXPENDITURES

Most public finance experts consider tax expenditures to be conceptually equivalent to direct spending. According to the official Senate Budget Committee definition, tax expenditures “may, in effect, be viewed as the equivalent of a simultaneous collection of revenue and a direct budget outlay of an equal amount to the beneficiary taxpayer” (U.S. Senate Committee on Budget 1998). The cost of tax expenditures is reported sometimes as revenue loss and sometimes as a budget outlay equivalent. We report cost as revenue loss, in part because such figures are available for a longer span of time. “Revenue loss” refers specifically to the reduction in income tax liability that results from a given tax expenditure. Federal budget analysts typically measure the revenue loss caused by a tax cut over a five- or ten-year period; but if a credit or deduction is temporary, its revenue effect for budget-scoring purposes appears much smaller.

The revenue loss and budget outlay data used in this analysis are adapted from OMB's Analytical Perspectives (1976–2003), prepared as part of the President’s budget, and JCT’s Estimates of Federal Tax Expenditures (1994–2007), prepared for the House Ways and Means and Senate Finance committees. We report actual cost (based on IRS claims data from Statistics of Income (SOI)) rather than estimates whenever possible. This includes individual and corporate SOI data. Official government estimates of tax expenditures always come with a warning not to aggregate because of the extensive interactions among tax provisions (Holztblatt 2000). Readers should therefore treat any aggregate figures reported in this paper with appropriate caution.

The OMB data presented here consist of each fiscal year's actual revenue loss in billions of dollars, which is published in revenue loss tables two years after the initial estimates were reported (i.e., the FY 1999 Budget reports actual revenue loss figures for tax expenditures in FY 1997, but estimates the figures for FY 1998 and forward). All data after FY 2002 are estimates reported by OMB in the FY 2004 Budget of the U.S. Government. For “refundable” individual tax credits such as the EITC and the child tax credit, we report the effect of the credit on revenue loss (receipts) as well as on overall budget outlays in order to capture the total aggregate investment.[25] Note also that revenue loss in a given fiscal year generally reflects credit claims from the prior tax year (e.g., FY 20004 losses reflect credits claimed for TY 2003).

The OMB, JCT, and IRS report data that represent the tentative amounts of general business tax credits claimed rather than the actual amount of the credit received after being subjected to IRS limits. It is also important to note that if the dollar limitations on the general

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[25] Budget outlay equivalence, which estimates the value of a traditional budget outlay “required to provide the taxpayer with the same after-tax income as would be received through the tax preference,” is a different concept first reported in the early 1980s.

business tax credit prevent firms from claiming all of it in a “credit year,” they can generally carry it back to the preceding year, or forward to the following 20 years.[26]

[26] Credits arising before 1998 could be carried back for the three years preceding the credit year, and forward to the 15 years following the credit year. http://www.winco.info/federal1.html.

APPENDIX B: SOCIAL POLICY-RELATED GENERAL BUSINESS TAX CREDITS

The category of general business tax credits broadly encompasses a number of federal tax credits designed to encourage certain business and investment activities. More generally, these credits include the investment tax credit (which consists of the rehabilitation credit, the energy credit, and the reforestation credit); the alcohol fuels credit; the research credit; the enhanced oil recovery credit; the disabled access credit; the renewable electricity production credit; the orphan drug credit; and the trans-Alaska pipeline liability fund credit.

This appendix focuses largely on a subset of general business tax credits that have urban or social policy objectives. These include: the Work Opportunity Tax Credit (WOTC), the Welfare-to-Work Tax Credit (WWTC), the Low-Income Housing Tax Credit (LIHTC), the Empowerment Zone credit, the employer FICA (Social Security) credit on tips, the Indian Employment Credit (IEC), and the Community Development Credit/New Markets Tax Credit (NMTC). Like individual income tax credits, each of these general business tax credits is historically rooted in different underlying social and economic objectives, and has varying legislative origins and paths of development. Generally, these credits are nonrefundable, but in many cases may be carried backward or forward to a year in which the taxpayer has positive tax liability and can make full use of the credit.

We also note that the complexity and intricacies of each credit, in general, have made it difficult for many individual and corporate taxpayers to understand these benefits and determine if they qualify for the credits, and in what amount. Not surprisingly, then, large firms have been the most likely to claim many of these credits. In TY 1999, firms with over $250 million in gross receipts received the lion's share of these credits in TY 1999 (Appendix Table A). Only the Empowerment Zone and Indian Employment tax credits are claimed in large amounts by smaller firms.

Appendix Table A. Distribution of Selected General Business Tax Credits by Size of Gross Receipts, Tax Year 1999

		Percentage of total dollar amount claimed			
Tax expenditure	*Total amount (In billions of $)*	*<$10M*	*10M-50M*	*50M-250M*	*>250M*
Low Income Housing Credit	$2.29	1.4%	1.2%	2.3%	95.0%
Indian Employment Credit	$0.02	43.8%	19.4%	7.6%	29.3%
Empowerment Zone Credit	$0.04	28.4%	20.4%	11.0%	40.2%
Welfare-to-Work Credit	$0.08	9.8%	0.7%	2.1%	87.5%
Work Opportunity Credit	$0.22	3.1%	1.3%	4.2%	91.5%

Source: IRS selected tentative business credits by size of gross receipts (Tax years 1992-1999).
Notes: Percentages may not total 100% because of rounding.

A. Employment (Wage) Credits to Aid Disadvantaged Workers

Work Opportunity Tax Credit and Welfare-to-Work Tax Credit, Enacted 1996–97

How do they work?

Employment credits provide financial incentives directly to employers to reduce the labor costs of hiring targeted groups of less-skilled workers. As such, the credits are designed to stimulate demand for these types of employees, and to raise their employment rates and earnings (Katz 1998).[27] The Work Opportunity Tax Credit (WOTC) and the Welfare-to-Work Tax Credit (WWTC) are general business tax credits that encourage private-sector employers to hire individuals from nine different targeted employee groups or from among former welfare recipients, respectively.[28] The WOTC provides a credit of up to $2,400 per qualified new worker. Because economically disadvantaged youth are also eligible workers, the credit provides smaller subsidies for summer hiring: $750 for employees working 120 hours, or $1,200 for employees working 400 hours or more per summer.[29] The WWTC encourages employers to hire long-term recipients of federally-funded cash assistance (TANF or AFDC), and can reduce employers' income tax liability by as much as $8,500 per new hire.

Brief History

Federal general business tax subsidies to employers had their origins in President Carter's proposed 1977 economic stimulus package. Under that proposal, firms could choose between either a general business tax credit equal to 4 percent of Social Security payroll taxes, or an increase in the investment credit for machinery and equipment (from 10 percent to 12 percent) (Sunley 1980).[30] In response, Congress enacted a New Jobs Tax Credit (NJTC) that in the 1978 Revenue Act it replaced with the Targeted Jobs Tax Credit (TJTC). Under the TJTC, employers could claim credits for hiring economically disadvantaged youth (18–24), whose unemployment rates at the time were five times the national average (30 percent). Because the TJTC allowed employers to deduct a certain fraction of their workers' wages and to offset additional training costs of hiring new workers, a bipartisan coalition in Congress was able to portray the credit as both a subsidy to employers as well as a direct benefit for less-skilled workers (Howard 1997).

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[27] Firms, however, may simply claim a tax credit for an employee whom they would have hired even without the subsidy. In this case, the credit is just a transfer—a windfall—to the employer (Bishop and Montgomery 1993).

[28] The WOTC partially reimburses companies for the cost of employing adults under age 25, veterans, ex-felons, teenagers working at summer jobs, and disabled people. The credit was created in 1996 and modeled on theTJTC, which existed from 1971 through 1994. Before TRA-97, companies received a credit equal to 35 percent of the first $6,000 paid to eligible workers during their first year, provided they worked at least 180 days or 400 hours (20 days or 120 hours for summer employees). TRA-97 introduces a two-tiered subsidy rate: 25 percent for employment of 120 hours to 400 hours and 40 percent for employment of 400 hours or more. It also allows recipients of Supplemental Security Income to qualify for the credit. In addition, employers could claim a WOTC only if they confirmed that an applicant was eligible before offering him or her a job (which was not the case with the TJTC) (Taylor et al. 1997).

[29] See, http://workforcesecurity.doleta.gov/employ/wotcdata.asp.

[30] The effect would have been to reduce payroll costs by less than one quarter of 1 percent (4 percent of the employer's social security rate of 5.85 percent) (Sunley 1980).

The TJTC endured many changes throughout its 15-year history. Congress added several new eligible employee groups in 1981–1982, including AFDC recipients, involuntarily terminated Comprehensive Employment and Training Act (CETA) and public service employment (PSE) workers, and summer-employed youth.[31] In 1986, Congress lowered the value of the credit to 40 percent of the first $6,000 in wages, and eliminated eligibility in the second year of employment. The credit's value was further restricted upon its extension in 1988.

The TJTC continued as a credit until 1994, but because it was not indexed the real value of the maximum credit declined by 75 percent over the course of the program (Katz 1998). The TJTC remained a temporary credit, requiring periodic congressional reauthorization, and on several occasions, it actually expired. The TJTC was particularly vulnerable due to its highly targeted eligibility, which decreased the political clout of claimants and increased the program's complexity. With such narrow eligibility categories, the TJTC was not much of a benefit to many of the workers and families who were eligible for the EITC.

By the mid-1990s, federal policymakers were seeking ways to make the credit more effective in light of a Labor Department report that claimed the credit encouraged employers to produce only low-wage, high-turnover part-time jobs. As part of the 1996 Small Business Job Protection Act, a bipartisan agreement between the White House and Congress replaced the TJTC with the Work Opportunity Tax Credit (WOTC)—a credit for employers who hired certain targeted low-income groups. Compared to the TJTC, the WOTC offered firms additional incentives to employ and retain eligible workers by reducing the minimum employment period, increasing the subsidy rate, and by providing credits for two years, with larger credits in the second year (Rubin 1996). Congress has extended the credit on three separate occasions, the last through December 2003. One year after enacting the WOTC, Congress authorized the Welfare-to-Work Tax Credit as part of the 1997 Taxpayer Relief Act; the political origins of that credit could be traced to a 1971 credit for employing Work Incentive Program (WIN)/AFDC participants (Howard 1997). It, too, will be available through December 2003 absent further extension.

Size and Growth

Amid expansions, contractions, and inflationary erosion, the TJTC had a roller-coaster existence. It grew from $330 million in 1980 to $830 million in 1983. By 1986, it had increased slightly to $840 million, but dropped to $500 million in 1994. In comparison, the WOTC and WWTC are quite small, projected to cost a combined $180 million in 2003.

[31] Congress, with the 1983 Job Training Partnership Act (JTPA), also provided temporary subsidies of 50 percent of wages for up to six months of employment to encourage firms to hire and train JTPA participants.

B. General Business Credits for Employee Contribution/Employer Provision of Benefits

1. Credit for employer-paid Social Security/Medicare taxes on employee tips, Enacted 1993

Brief History and Size/Growth

Many service sector employees earn a substantial portion of their income from tips. Recognizing this, Congress requires employers and employees to pay FICA payroll taxes on tip income. This was meant to ensure that employees' total earnings were reflected in their Social Security wage history, which determines the amount of Social Security benefits employees receive upon retirement. Currently, restaurant and other service employees who earn $20 or more in tips per month are required to report them to their employers, and the employer must pay Social Security and Medicare (FICA) taxes of 7.65 percent on all reported tips.[32]

In 1993, Congress created incentives to employers to pay these FICA taxes by reducing their share of the tax contribution burden (*CQ Almanac* 1993).[33] This general business tax credit, known as the 45(B)—a section of the Internal Revenue Code (IRC)—allows these service employers to reduce their income tax liability by the amount of FICA taxes paid on certain employee tips. The employer-paid FICA tip began as a $220 million investment in 1997, and is projected to reach $390 million by 2003, and then to $460 million in 2007.

2. Credit for employer-provided child care, Enacted 2001

Brief History and Size/Growth

Employer-provided child care, unlike employer-sponsored health and pension benefits, remains relatively uncommon in the United States. Until recently, there were no tax advantages provided to firms for providing child care; employers could only assist working parents in financing childcare expenses by establishing reimbursement accounts funded entirely with employee pretax contributions.

[32] The FICA payroll tax, which employers and employees each pay on workers' wages, includes two components: Social Security and Medicare. The Social Security tax, 6.2 percent, is paid on wages up to $80,400 a year. The Medicare payroll tax, 1.45 percent, is assessed on all wages.

[33] The amount of the credit is the employer's FICA tax rate (currently 7.65 percent) multiplied by any employee-reported tip income that was not used to support tip credit for minimum wage purposes. For example, under the current federal minimum wage, if an employee is paid an hourly cash wage of $2.13 and he or she reports hourly tips of $6.02 (on average), the first $3.02 of reported tips may be considered "wages" to bring the employee to the required federal minimum wage of $5.15 ($2.13 cash wage + $3.02 tip credit = $5.15). In this example, the remaining $3.00 of reported tips ($6.02 - $3.02) is not considered "wages" under the Fair Labor Standards Act (FICA), and the FICA tax paid by the employer on this portion of reported tips is eligible for the FICA credit.

To provide a new incentives for employer-provided child care, a Senate amendment to the 2001 EGTRRA allows companies to claim a general business tax credit if they provide day care for their workers' children (Allred 2001). The credit allows employers to claim an amount equal to 25 percent of their expenses for employee child care and/or 10 percent of expenses for child care resource and referral services.[34] The maximum credit that may be claimed cannot exceed $150,000 per taxable year. The credit is projected to increase from an initial $90 million in 2003 to $140 million in 2006, but then decline to $60 million by 2007.

3. Small business pension credit, Enacted 2001

Brief History and Size/Growth

In the United States, small businesses employ 53 percent of the private-sector workforce, yet fewer than half of the employees working for small businesses have access to a retirement plan. Only 17 percent of those who work for businesses with fewer than 25 employees have access to employer-sponsored plans. Many small businesses find pension plans too expensive and too burdensome to administer.[35] In 2001's EGTRRA, Congress enacted a general business tax credit that allows small employers to claim up to 50 percent of expenses incurred as a result of establishing a pension plan, including a 401(k), SIMPLE, SEP, or payroll deduction IRA. The credit is limited, however, to $500 per tax year over the first three years of the plan.[36] This pension credit is expected to grow from a projected $50 million in 2003 to $130 million by 2007.

C. Business Credits Targeted at Developers/Investors in Lower-Income Communities

1. Low-Income Housing Tax Credit, Enacted 1986

How does it work?

The Low-Income Housing Tax Credit (LIHTC) is the largest federal government affordable housing production program. It provides a tax subsidy to leverage private-sector development and rehabilitation of affordable rental housing for low- to moderate-income families (50 to 60 percent or less of area median income). The IRS issues credits to state Housing Finance Agencies on a per capita basis, which in turn allocate the credits to property owners. Many LIHTC properties are owned by limited partnership groups that are put together by "syndicators." In return for additional equity financing, the syndicator passes through the credits to development investors.[37] In this manner, a variety of companies and private investors participate within the LIHTC program.

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[34] Qualified child care expenses include costs paid or incurred by employers who "construct, operate, or contract with a child care facility."

[35] http://www.house.gov/smbiz/democrats/PensionReform.htm.

[36] A small business is defined as one that has no more than 100 employees who receive compensation in excess of $5,000.

[37] http://www.danter.com/taxcredit/lihtccht.htm.

To be eligible for the LIHTC, 20 percent or more of the residential units in a project must be rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income; or 40 percent or more of the residential units in a project must be rent restricted and occupied by individuals whose income is 60 percent or less of area median gross income. Prior to 2000, each state received a $1.25 credit per person that it could allocate toward funding rental housing; this was raised to $1.50 in 2001 and $1.75 in 2002, and will be adjusted for inflation beginning in 2003.[38] Properties receiving credits must stay eligible for 15 years. Because of the way state HFA's award credits, many developers find it in their interest to exceed these minimums, as most states look more favorably on projects serving a higher percentage of income-eligible households.

Brief History and Size/Growth

In the 1986 Tax Reform Act, Congress provided a general business credit to owners of rental housing projects, and allowed states to select among projects that meet the subsidy criteria (*CQ Weekly* 1986; Sammartino, Toder, and Maag 2002). In 1988, Congress liberalized the rules to permit the use of the credit in either of the two subsequent years after it was granted, if at least 10 percent of the project costs were paid in the year of the credit (*CQ* 1988). The LIHTC operated for most of its life under the threat of short-term congressional "sunset" provisions. In fact, the credit was suspended on several occasions until Congress approved last-minute extensions. However, in 1993 Congress made the LIHTC permanent (*CQ Almanac* 1993), and in 2000 raised the per-capita allocation and indexed it for inflation. Over its 17-year history, the LIHTC has steadily increased from $240 million in 1988 to $3.4 billion in 1998, and is projected to reach $3.7 billion by 2007.

2. New Markets Tax Credit (NMTC), Enacted 2000

What is it and how does it work?

The promotion of community economic development in low-income areas has traditionally been financed by public sector grants like the Community Development Block Grant. The New Markets Tax Credit (NMTC), established in the 2000 Community Renewal Tax Relief Act, provides an allocated general business tax credit to Treasury-certified Community Development Entities (CDEs). In turn, these CDEs use NMTC allocations to attract equity investments from private taxable investors, and use those investments for commercial development in low-income areas.[39] The NMTC can provide a subsidy equivalent to more than 30 percent of the amount invested over seven years in present value terms.[40]

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[38] For small states, a minimum annual cap of $2 million was provided for 2001 and 2002. Beginning in 2003, the small state minimum will also be adjusted for inflation.

[39] A low-income community is an area (census tract) with a poverty rate of at least 20 percent or with median income of up to 80 percent of the area median or statewide median, whichever is greater, and, for a non-metro area (census tract), 80 percent of the statewide median income.

[40] http://www.housingonline.com/development_issues/newmarket_background.htm.

In general, financing of low-income rental housing is not allowed under the NMTC, and this credit may not be combined with other federal tax benefits, including the LIHTC. The Treasury Department's Community Development Financial Institutions (CDFI) Fund allocated authority to certified CDEs to issue credits for up to $2.5 billion in equity investments in 2002. Investors will be able to claim a credit of 5 percent for each of the first three years of the credit, and 6 percent for each of the last four years.

Brief History and Size/Growth

A general business tax credit toward the economic development activities of community development corporations (CDCs) originated in a 1993 pilot program, the Community Development Corporation (CDC) Tax Credit, established as part of the Empowerment Zones/Enterprise Communities initiative. Prior to this program, tax credits were not viewed as a viable method of stimulating revitalization because most low-income communities did not have a strong enough organizational infrastructure, or sufficient development opportunities, to attract meaningful private-sector investment or participation (Steinbach 1998). Historically, small local venture funds experienced difficulty raising sufficient capital to grow businesses in inner cities and distresses rural areas.

The CDC tax credit was small in scale, allowing individuals and corporations to claim a credit for cash grants and loans made to one of just 20 CDCs selected by HUD (*CQ Almanac* 1993). The NMTC is much larger in size, and is designed to generate $15 billion in new private-sector equity investment in urban and rural low-income communities (Tluchowski 2002; Nather 2000). From an initial $90 million cost, the NMTC is projected to increase to $740 million by 2007.

D. General Business Credits Based on Location of Employer/Employees, and Public Schools

1. Empowerment Zones/Enterprise/Renewal Communities, Enacted 1993

How does it work?

The Empowerment Zones (EZs) and Enterprise Communities (ECs) initiative was designed to provide a market-driven approach to fostering economic growth in economically distressed urban and rural areas. The initiative, adopted in the 1993 omnibus budget act, targets tax incentives, performance grants, and loans to federally-designated low-income areas to create jobs, expand business opportunities, and support people looking for work. Employers in the designated areas are eligible for a number of tax incentives, including an employment credit, preferential tax treatment for certain depreciable property, and special tax-exempt bond financing. [41]

[41] http://www.hud.gov/progdesc/ezec.cfm.

Renewal Communities (RCs), created as part of the 2000 Community Renewal Tax Relief Act, provide similar incentives to a separately-designated set of lower-income areas. Unlike the EZ and EC programs, which require rigorous, detailed application and detailed coordination with local consolidated planning programs, RCs were ranked and selected on the basis of measures of community need, from most to least severe. Documented areas of pervasive poverty, unemployment, and general distress that pass specific thresholds for certain indices (poverty, unemployment, income for urban areas) were eligible for a RC designation.[42]

Wage tax credits are the centerpiece of the EZ/RC strategy. The EZ employment credit, an incentive to hire individuals who both live in an EZ and work for an EZ business, is worth 20 percent of the first $15,000 in paid wages, up to $3,000 annually.[43] Similarly, a Renewal Community (RC) employment credit is available to companies located in federally-designated RCs who hire a portion of their workforce from within that RC. Businesses may claim up to a $1,500 credit for every newly-hired or existing employee who lives and works in an RC.[44]

Brief History and Size/Growth

Congress initially authorized the EZ/EC as a demonstration project in 1993, directing HUD and USDA to designate Empowerment Zones and Enterprise Communities.[45] Under the 1997 Tax Relief Act, Congress provided for the designation of two additional EZs, and authorized the designation of 20 "Round II" EZs using expanded eligibility criteria. Firms in the Round II zones cannot claim the EZ employment tax credit. Congress, in 2000, extended the designation of EZ status for all existing zones (other than the District of Columbia Empowerment Zone) through 2009 and authorized the creation of 40 Renewal Communities for which similar tax incentives—including a wage credit—would be available (Nather 2000).

In 1995, the combined EZ/EC tax expenditure amounted to $300 million. This grew to $610 million in 1996, but declined to $220 million by 1997. Since the 1997 and 2000 expansions, however, investment in EZs, ECs and RCs has grown steadily, and is projected to reach $1.1 billion in 2003, and $1.4 billion by 2007.[46]

[42] Congress, as part of the 2002 Job Creation and Worker Assistance Act, enacted additional place-based tax incentives to encourage investment in Lower Manhattan, and expanded the WOTC to include workers employed by businesses located in a New York Liberty Zone (covering most of the area south of Canal, East Broadway, and Grand streets) or relocated as a result of the events of September 11, 2001 (CBO 2002).
[43] http://www.winco.info/federal3.html.
[44] http://www.hud.gov/news/release.cfm?content=pr02-013det.cfm.
[45] The 1993 OBRA also made these zones eligible for a variety of programs administered by other agencies, including HUD and the Small Business Administration (CQ Almanac 1993).
[46] These amounts include revenue loss associated with non-tax credit items, including increased equipment expensing, accelerated depreciation, and certain capital gains incentives.

2. Qualified Zone Academy Bonds, Enacted 1997

Brief History and Size/Growth

Also targeted at lower-income communities, the Qualified Zone Academy Bonds (QZAB) general business tax credit allows public school corporations to obtain interest-free financing for the purpose of establishing "qualified zone academies." These are schools or programs within a school located in economically distressed areas whose curriculum is designed through school/business partnerships.

To provide capital financing for these new programs, eligible public schools are permitted to issue no-interest bonds for sale to eligible holders. The bond holders receive credits on their federal income tax intended to compensate them for the value of the forgone interest. The amount of the credit is based on the face amount of the bonds and a credit rate established by the Secretary of the Treasury. The academies must either be located in an EZ or EC, or at least 35 percent of the participating students must be eligible for free or reduced-cost lunches under the National School Lunch Program.

The Education Zone Academies, created in 1997, expire in 2003. Congress allocated $400million in bonds for issue under this program in its first four years (1998-2001), and the total tax expenditure was $50 million. If extended beyond 2003, the annual cost is expected to increase to $80 million by 2007.

E. Trends 1976–2007

Among all urban/social policy-related general business tax credits, the LIHTC has enjoyed the most significant growth, from $240 million in 1988 to $3.4 billion in 2003. The EZ/EC/RC tax incentives are also projected to grow rapidly, from $300 million in 1995 to $1.4 billion in 2007. The amount claimed from each of the other general business tax credits has never reached more than $1 billion per year, and is not projected to do so (although the NMTC is projected to reach $740 million in 2007). Overall, the social policy-related general business tax credits analyzed here are projected to represent at least a $6 billion investment in 2007.

Admittedly, in the realm of the overall federal budget outlays and tax expenditures, these amounts do not represent significantly large national investments. Indeed, the aggregate amount pales in comparison to the $87 billion spent on individual income tax credits for working families in 2003 (Table 2). Yet despite their smaller size and slower growth in aggregate over time, these business credits have endured over several decades, delivered benefits to low-to moderate-income communities, and in many cases have gained powerful political support from third-party

beneficiaries—employers, developers and investors.[47] While small in comparison to the EITC and CTC, they still represent an important tool to support lower-income families in the urban and rural areas in which they live.

[47] The Affordable Housing Tax Credit Coalition, a group of developers, syndicators, lenders, nonprofit groups, public agencies, continues to play a major role in ensuring the future of the LIHTC. Employers in service and retail industries, where labor costs are a significant fraction of total business costs, remain strong proponents of employment credits. Chambers Associates, a Washington D.C. based government affairs consultant, lobbies for the continuation of employment credits. Rapoza Associates, a public interest lobbying and government relations firm, helped organize the New Market Tax Credit Coalition and continues to lobby for the NMTC. WinCo, formed as a non-profit organization and capitalized by the Local Initiatives Support Corporation (LISC) and The Enterprise Foundation, helps for-profit and non-profit clients without federal tax liability to capture the value of general business tax credits -- both those credits based on personal characteristics of employees (WOTC, WWTC) and credits based on location of employer and employees (EZEC, RCEC, IEC).

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