Oregon Center for Public Policy
204 North First Street, Suite C
P.O. Box 7, Silverton, OR 97381-0007
Telephone: 503.873.1201 Facsimile: 503.873.1947
e-mail: info@ocpp.org www.ocpp.org

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Tax Credits and Maintenance-of-Effort:
Using Refundable State Earned Income and Working Family Child Care Credits to Meet Welfare Spending Rules

By Charles Sheketoff

The 1996 federal welfare reform law, called the Personal Responsibility and Work Opportunity Reconciliation Act, created the Temporary Assistance to Needy Families Program (TANF) and ended the states' entitlements to federal matching funds for programs that assist families with dependent children. The federal TANF statute requires that states meet a "maintenance-of-effort" (MOE) requirement, a minimal spending level for the nation's dependent children. Newly issued regulations implementing the federal TANF statute allow states to meet the minimal spending requirement through the use of refundable earned income credits and through other tax credits such as child care credits that assist families with dependent children to enter and to stay in the workforce.

Oregon's financial reports to the federal government show that Oregon barely meets the minimal spending requirements under the TANF statute. A recent proposal by the Governor to reduce state spending in programs for needy families and to count different costs toward the spending requirement, raises concern that Oregon may have difficulty meeting its MOE obligation. This paper outlines those issues and discusses refundable tax credits for low-income working families as an option to assist the State in meeting federal maintenance-of-effort requirements.[1]

The Federal Funding Scheme and MOE

Under prior federal welfare law, states received federal funds based on the extent of state expenditures helping families with dependent children. As state spending increased or decreased, the federal government's assistance to the states changed as well. In place of this entitlement to matching federal dollars,

[1] For a discussion on why Oregon should make its low-income credits refundable, see *Fixing Oregon's Low-income Tax Credits: Should They Be Made Refundable?,* by Charles Sheketoff and John Lewis, Oregon Center for Public Policy, March 30, 1999.

the federal TANF statute created a block grant. The states get a set amount of funds through federal fiscal year 2002. Oregon receives $167.9 million in TANF funds each year.

When creating the block grant, Congress was concerned that once federal spending was fixed in a block grant and divorced from state spending levels, states might fail to maintain a commitment to needy families and begin what some call a "race to the bottom." To address this concern, one of the most important provisions in the federal TANF statute is the maintenance-of-effort (MOE) requirement. This provision requires states to maintain a certain level of spending on welfare programs, based on federal fiscal year (FY) 1994 expenditure levels. In general, states must expend 80 percent of the amount they spent in FY 1994, although under certain conditions states can spend less. Oregon, for example, is allowed to spend as little as 75 percent of FY 1994 to meet the MOE requirement because, technically speaking, Oregon has a high percentage of people in employment preparation activities. Because the MOE provision is critical to the successful implementation of the law, Congress gave the federal government the authority to enforce state compliance.

Budget Cuts Threaten MOE

On Friday, April 9, 1999, Oregon Governor John Kitzhaber and the Oregon Department of Administrative Services (DAS) announced a modified budget plan for the 1999-2001 biennium. Primarily to boost K-12 education funding, the plan included several revenue raising measures and General Fund reductions of $118.7 million across a variety of state programs, including $90 million from the Department of Human Resources (DHR). [2]

Over $40 million of DHR's contribution comes from the Adult and Family Services Division (AFS) budget. About one-fourth of the cut in General Fund expenditures ($9.1 million) comes from additional federal Child Care Development Funds being made available to the state. Three-fourths of the general funds contributed to the school funding issue ($31 million) come from cuts to the number of families that can be served next biennium in the state's

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[2] The Governor's original budget funded K-12 with $4.55 billion. The Governor's modified budget plan raises K-12 funding by $400 million to $4.95 billion. In addition to the $122.7 million in General Fund from enhancements and budget cuts, the modified budget relies on the projected personal income tax kicker refund, increasing the contribution from the Common School Fund, spending a significant portion of the state's tobacco litigation settlement next biennium, and temporarily increasing the corporate income tax from 6.6 percent to 7.6 percent.

child care subsidy program ($26.1 million)[3] and cuts in the cash assistance paid to dependent children and their parent(s) ($4.9 million).[4]

The withdrawal of $40 million in general funds from AFS programs requires Oregon to find another $40 million to count toward MOE because the state is spending no more than 75 percent of this requirement.[5] For the biennium, the $40 million represents about 21 percent of Oregon's $91.6 million annual MOE requirement.[6]

In order to continue to meet the $91.6 million requirement in the 1999-01 biennium, Oregon will begin to claim expenditures, such as child foster care spending, which it has not claimed in the past. The plan to charge new expenditures to the MOE raises risks.

An agency description of the modified budget plan explains some of the risks. [7] The federal government could disagree with what the state claims for MOE, levy a penalty against the state, and deny Oregon the use of TANF funds. The penalty payment would not count toward MOE. Moreover, unlike past food stamp penalties, the TANF statute and new rules make no provision for allowing a state to escape some or all of a penalty under a reasonable cause exception or corrective action plan. [8]

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[3] Employment Related Day Care (ERDC) is available to working families with low incomes. To find additional funds, DHR lowered the projected caseload estimate; the agency will help fewer families in the ERDC program than originally projected. An agency internal budget document notes two budget risks associated with this service reduction: (1) actual ERDC caseloads could be higher than forecasted, and (2) the savings could be limited to the 1999-01 biennium, creating a "budget hole" in the 2001-03 biennium.

[4] The monthly cash assistance payment has been frozen since July 1, 1991, at $460 for a one adult, two needy children family. The Governor's original budget called for a 1.8 percent increase in 1999 and a 2 percent increase in 2000. The modified budget takes away from the families these long-awaited, partial cost of living increases.

[5] Oregon's ACF-196 Financial Reports to the federal government.

[6] Oregon's 100 percent MOE requirement is approximately $122 million per year. Because Oregon is not spending 100 percent MOE, $60 million each biennium is available to the general fund to support education and other state-funded services as a result of federal welfare reform.

[7] The document does not indicate whether it is from DAS or DHR, and its author is not specifically identified.

[8] For the last two fiscal years the U.S. Department of Agriculture (USDA) has sanctioned AFS for failure to meet quality control payment accuracy requirements in the food stamp program. Oregon was allowed to pay the penalty through reinvestment in the program to correct the problem with new, unmatched state expenditures.

The state's plan to use foster care expenditures to meet MOE may not be tenable. The TANF statute, and new federal rules adopted to implement the statute,[9] limit MOE expenditures to "eligible families." Eligible families must "include a child living with a custodial parent or other adult caretaker relative (or consist of a pregnant individual)."[10] Only foster care expenditures where the child is living with a relative would qualify for MOE. Under limited circumstances TANF federal funds may be spent on non-relative foster care, but under no circumstances may state General Fund expenditures on non-relative foster care qualify for MOE. Because the state could use TANF funds for non-relative foster care, the state might exchange TANF funds in the TANF program, with general funds in the foster care program, in order to meet the MOE requirement.

Low-income Working Family Tax Credits and MOE

The new TANF rules provide that refundable tax credits may be used to help meet a state's MOE if the credits are "reasonably calculated to accomplish one of the purposes of the TANF program."[11] A goal of the TANF program is to help people find and keep jobs and become self-supporting, the same goal as Oregon's low-income tax credits. Under the new rules, only the portion of the tax credits that are refunded *in excess of a family's tax liability* may be counted. Non-refundable tax relief such as Oregon's Earned Income Credit (state EIC) and Working Family Child Care Credit (WFC) cannot be counted toward MOE.[12]

If Oregon made the state EIC and WFC refundable (*see* SB 1190), Oregon could count the refundable portion (the amount of the credits that exceed tax liability) toward the MOE. To complete the process, Oregon would need to amend its state TANF plan to define "eligible families" for the EIC and WFC services and incorporate the EIC and WFC income criteria into the eligibility criteria.[13] The portion of the tax credit that exceeds tax liability would then count toward MOE.

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[9] The new federal rules take effect on October 1, 1999. Until then states are free to continue applying reasonable interpretations of the statute. Because the MOE issue raised by the modified budget plan is for the 1999-01 biennium, the new federal rules will govern.

[10] 45 CFR § 263.2(b)(2) (64 Fed. Reg. 17894 (April 12, 1999)).

[11] 45 CFR § 260.33 (64 Fed. Reg. 17880 (April 12, 1999)).

[12] A refundable state earned income credit can also be paid for with TANF funds.

[13] 45 CFR § 260.33 and § 263.2 and preamble discussion at 64 Fed. Reg. 17764-65 (April 12, 1999).

Making both credits refundable would maximize the creation of MOE expenditures. However, because the EIC is small (5 percent of the federal EIC) and child care expenses are so great, making the WFC refundable creates more MOE.[14]

Proposals that increase income eligibility or the extent of the two credits without refundability, such as SB 2 and SB 5, would not count toward MOE because they only reduce tax liability of some people.[15] The federal rules do not allow that portion of the credits that reduce tax liability to count toward MOE.[16]

Conclusion

Congress recognized the importance of states meeting minimal spending requirements when it established the maintenance-of-effort requirements. The requirements help ensure that, as welfare cash assistance caseloads decline, states continue to support needy families with dependent children in their efforts to move toward self-sufficiency.

Congress recognized that as the cash assistance caseloads decline there is an increasing need to support working families with assistance other than cash assistance. The new federal MOE rules recognize that tax credits for working low-income families can support the purposes of the federal welfare reform effort to help families stay in the workforce. The new federal rules defining allowable MOE expenditures provide Oregon with the opportunity to use refundable credits to assist the thousands of low-income working Oregon families who no longer receive cash assistance and at the same time help Oregon meet the maintenance-of-effort requirements.

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[14] The Legislative Revenue Office calculates that making the WFC refundable would cost $24 million, while making the EIC refundable would cost $18 million. These calculations are subject to revision.

[15] Senate Bill 2 would increase the income eligibility for the working family child care credit, with most of the benefits going to the added income group. Senate Bill 5 would increase the state EIC from 5 percent to 10 percent of the federal credit, raising Oregon's tax threshold and providing an increased credit to families at higher incomes. The benefits provided by these two credits may not exceed liability. See *Fixing Oregon's Low-income Tax Credits: Should They Be Made Refundable?,* by Charles Sheketoff and John Lewis, Oregon Center for Public Policy, March 30, 1999.

[16] 45 CFR § 260.33 (64 Fed. Reg. 17880 (April 12, 1999)).