Oregon Center for Public Policy

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March 30, 1999

Fixing Oregon's Low-Income Tax Credits: Should They Be Made Refundable?

by Charles Sheketoff and John Lewis

Executive Summary

In 1997, the Oregon Legislative Assembly created two new targeted tax credits aimed at providing tax relief to low-income working families, especially those who leave welfare for work. The Working Family Credit provides a credit equal to 40% of total child care costs for families with incomes up to 150% of poverty ($20,475/year for a family of three in 1998). The credit phases out as a family's income increases to 200 percent of the federal poverty level. The state Earned Income Credit (EIC) is set at 5 percent of the federal Earned Income Credit.

Both tax credits are "nonrefundable"; that is, if the amount of a credit exceeds tax liability, the excess credit is lost. Many low-income families also have little tax liability. Because of this, the tax credits are of limited value to the working poor and to former welfare recipients.

An analysis of the credits finds that:

- No one receives the full 40 percent child care credit.
- As a family's income increases, the family receives a greater share of its child care costs as a credit. In other words, under current law the benefit is less for those with less ability to pay for child care.
- Families working part time, and persons leaving welfare for work mid-year, are not able to utilize fully the state Earned Income Credit.

In addition, "carry forward" provisions used for other tax credits are inappropriate for low-income credits because they defer needed relief, are not likely to provide relief, and require additional record keeping which increases the likelihood of errors.

Finally, the cost to make both credits refundable at their current benefit levels is approximately equal to or less than the proposals to expand the credits without making them refundable.

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In 1997, the Oregon Legislative Assembly created two new targeted tax credits aimed at providing tax relief to low-income working families, especially those who leave welfare for work. The two credits are the Working Family Credit, that assists working families with child care costs, and the Earned Income Credit (EIC), that piggybacks on the benefits of the popular federal EIC. Both new state credits are only available to the extent of a family's tax liability. If the credits exceed the tax liability, unlike the federal EIC, the excess is not refunded to the taxpayer.

While the credits are aimed at providing tax relief to low-income families, many policy makers, advocates, members of the child care community, and government officials now recognize that as presently designed the credits miss their mark. The only people currently receiving the full benefit of the Working Family Credit are families where the wage earner is earning in excess of $12.00 per hour, and many people who leave welfare for work are denied full use of the state EIC.

Interest in modifying the credits in the 1999 legislative session is high. Senate Bills 2 and 5 would expand the Working Family Credit and the Earned Income Credit, but would maintain the non-refundable status.1 Senate Bill 1190 would make both the Working Family Child Care Credit and the EIC refundable and House Bill 305 1 would make the EIC refundable. [2] Senate Bill 119 1 seeks to expand the state EIC.

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[1] Senate Bill 2 would increase the income eligibility for the credit, with most of the benefits going to the added income group (see Appendix A). 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.

[2] Under House Bill 305 1 the refundable portion of the ETC would not be guaranteed in any tax year. If the legislature under-estimates the amount needed for refunds, the Revenue Department would reduce the credit to the amount set aside in the biennial budget. Senate Bill 1190 would allow full refunds. Senate Bill 119 1 does not

(footnote continued on following page)

Legislative interest in changing the credits stems in part from studies conducted during the interim subsequent to the 1997 legislative session. At the request of Senate President Brady Adams, the Commission for Child Care convened the Child Care Financing Task Force to study child care affordability issues. The Task Force studied both the state EIC and the Working Family Credit and concluded that neither credit provided adequate relief to low-income families. They recommended that the legislature make both credits refundable.[3]

Governor Kitzhaber's Tax Review Technical Advisory and Policy Advisory Committees also studied the tax credits as a part their review of Oregon's tax system. The Technical Advisory Committee found that non-refundable tax credits "are of limited use to low-income taxpayers." The Policy Advisory Committee subsequently recommended that the legislature make the Working Family Credit refundable.[4]

Proposals to change the tax credits must consider two questions: who will benefit and what are the costs? Doing nothing and keeping the credits non-refundable maintains the current costs of the credits, while still providing some tax relief to many low-income working families, though not the most in need and not to the extent provided by the legislation. Expanding the tax credits provides tax relief to people at higher incomes. As will be shown, making the tax credits refundable provides the greatest benefit to those at the lowest income levels, and can be less expensive than proposals to expand both credits.

Refundability and the Working Family Credit

The Working Family Credit was designed to help alleviate the costs of child care for low-income working families. Families with incomes up to 150% of poverty ($20,475/year for a family of three in 1998) may be eligible to take a credit, a subtraction from their taxes, for 40 percent of their child care expenses. As a

(footnote continued from previous page)
specify a rate; however, the intent as described in section 1 of the bill is to increase the EIC to the level at which working families with poverty level income do not pay income tax.

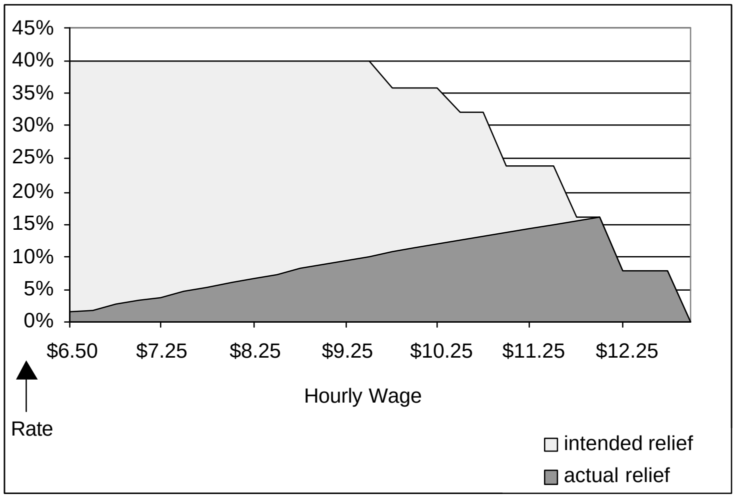
[3] *Child Care Affordability Recommendations*, Oregon Commission for Child Care, presentation to the Senate Interim Revenue and School Finance Committee, (September 23, 1998).

[4] *Review of Oregon's Tax System:* Policy Recommendations, (January 1999) p. 55-56. Although the committee was charged with determining whether both credits should be made refundable, the report does not discuss why the committee recommended that only the Working Family Credit be refundable.

family's income increases from 150 to 200 percent of the federal poverty level ($27,300 for a family of three), the credit phases out.

The Working Family credit was designed in response to welfare reform in order to assist families leaving public assistance for employment, or to assist families avoiding public assistance. The hypothetical family used in the calculations is the same as that used by the state's welfare agency in describing the typical welfare family entering employment: a one-adult, two-child family. The family's child care costs are assumed to be $626 per month or $7,512 per year.[5]

Figure 1 - WFC without ERDC Participation



Assumes a one-parent, two-child family, full-time employment, no child-support, and no participation in Employment Related Day Care (ERDC). Also assumes the family claims the Oregon EIC. "Intended relief" is the relief intended under statute. "Actual relief" is the tax relief actually returned to the taxpayer because the credit does not provide refunds.

Working Family Credit without ERDC participation								
Wage	$6.50	$7.25	$8.25	$9.25	$10.25	$11.25	$12.25	$13.25
Intended Relief	40%	40%	40%	40%	36%	24%	16%	0%
Actual Relief	1%	3%	6%	9%	11%	14%	16%	0%

The effectiveness of a refundable working family credit varies widely depending on whether the family pays for all child care expenses (Figure 1) or participates in the state's child care subsidy program (Figure 2), Employment Related Day Care (ERDC). Although it provides a substantial benefit to the low-income working families who participate, only about 12,000 families use the ERDC

[5] Since 1992, the state's welfare agency, the Adult and Family Services Division (AFS), has used $626 when comparing work versus welfare. Coincidentally, it is also equal to the provider rate for two pre-school or school-aged children in a child care center facility in the Salem, Oregon area under AFS's rules for the state child care subsidy program, OAR 461-155-150.

program. The vast majority of working families is not in the program, often because a family must pay a high co-payment at relatively low income levels, and as the family's income increases the co-payment increases dramatically.[6]

The typical family does not receive the full benefit of the credit. Because the Working Family Credit is non-refundable, families at most eligible income levels — especially the lowest income levels — receive only a fraction of the total credit set forth in statute. According to the 1999-01 *Tax Expenditure Report*, on average only 36 percent of the credit could be used in 1997 because it was non-refundable.[7]

The typical single-parent family with two children, working full-time at $9 per hour, does not enjoy the full benefit of the Working Family Credit:

- Under the statute, the typical family should receive a credit equal to 40 percent, or $3,005, of their $7,512 yearly child care costs.

- The credit covers only 8 percent of their family's child care costs because it is non-refundable.

- In other words, with a non-refundable credit the family gets only 20 percent of what the legislature intended they receive through the Working Family Credit. They pay $2,398 more for child care than if the credit were refundable.

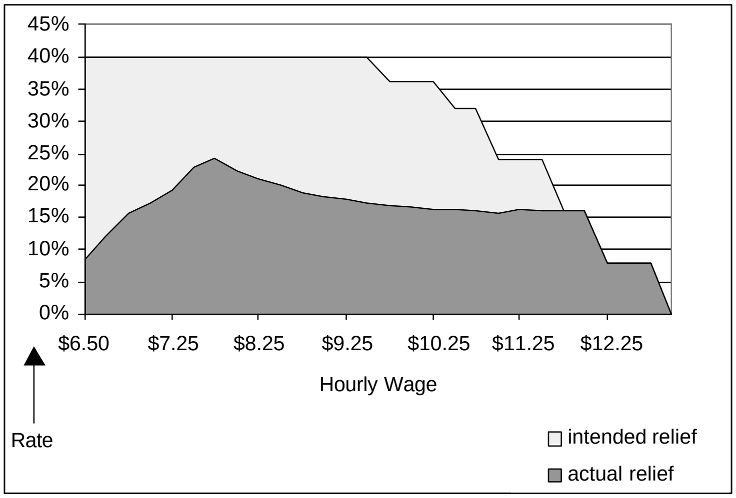
- The single parent would have to earn over $12.00 per hour before the family would receive the full credit set forth in the statute. At that income level, the family has a larger portion of its child care expenses "reimbursed" by the credit than families earning less.

[6] This can result in a drop in net monthly income despite an increase in hourly wages or earnings. For a more complete explanation of this issue see *Welfare and Work Assumptions: A Guide to Comparing Spendable Income*, Oregon Center for Public Policy (August 23, 1998). Low provider payment rates also contribute to under-utilization of ERDC.

[7] This estimate is probably high because it is based only on those who attempted to take the credit but were unable to use the full amount due to their limited tax liability. People who did not take the credit because they had no liability after other credits (such as the personal exemption credit and the EIC) were not factored into the calculation.

As Figure 2 demonstrates, families in Oregon's child care subsidy program (Employment Related Day Care or ERDC) fare somewhat better. In addition to receiving subsidized child care, these families are able to take better advantage of the Working Family Credit, though still far less so than if it were refundable. As pointed out earlier, however, few eligible families participate in ERDC, for a variety of reasons.

Figure 2 - WFC with ERDC participation



Assumes one-parent, two-child family, full-time employment, no child support, and participation in Employment Related Day Care (ERDC). Also assumes the family claims the Oregon EIC. "Intended relief" is the relief intended under statute. "Actual relief" is the tax relief actually returned to the taxpayer because the credit does not provide refunds.

Working Family Credit with ERDC participation

Wage	$6.50	$7.25	$8.25	$9.25	$10.25	$11.25	$12.25	$13.25
Intended Relief	40%	40%	40%	40%	36%	24%	16%	0%
Actual Relief	9%	17%	22%	18%	17%	16%	16%	0%

The legislature had three basic goals for the Working Family Credit:

- Treat all families below 150 percent of poverty the same,
- Provide a 40 percent credit to those families, and
- Reduce the credit as income increases above 150 of poverty ($9.84/hour for a family of 3 in 1998).

Because the credit is non-refundable however, not one of these goals is being met. As Figure 1 demonstrates, families below 150 percent of poverty receive a credit that increases with income, and no family below 150 percent of poverty is receiving a full 40 percent credit. Finally, as income rises above 150 percent of poverty, so too does the ability to take advantage of the credit. The extent of reimbursement increases with ability to pay.

The typical family working at minimum wage receives a credit equal to one percent of their child care costs. A family with an annual income of $25,480 (187% percent of poverty) will receive a credit of 16 percent of child care costs.

Making the Working Family Child Care credit refundable would achieve the three goals stated above.

Refundability and the State EIC

The state Earned Income Credit (EIC) is set at five (5) percent of the federal credit, relying on the structure of the federal credit to establish the extent of the credit at different income levels.[8] For families with very low incomes, the federal EIC is a percent of a family's earnings. Once the earnings reach a specified level, the family receives the maximum credit amount, which remains constant over several thousand dollars of earnings.[9] As income rises above that range, the credit phases down.

At Oregon's new $6.50 per hour minimum wage, a family working full-time throughout the year will receive the full benefit of the state EIC. However, if the parent works part-time, or full-time for only part of the year (for example, a parent who leaves welfare in July would have only six months of full-time income), the family may not receive the full EIC benefit. According to the *1999-2001 Tax Expenditure Report*, on average only 55 percent of the credit was taken in 1997 because it is non-refundable.[10]

Figure 3 illustrates how part-time workers (20 hrs/week or 1040 hours/year) do not receive the full benefit of the Oregon EIC because it is non-refundable:

- A parent who works half-time for a full year or full-time for six months at Oregon's $6.50 per hour minimum wage will *not* receive any benefit from Oregon's non-refundable credit.[11]

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[8] For an explanation of the federal EIC and a review of its success in helping the working poor, see *Good News For Low Income Families: Expansions in the Earned Income Tax Credit And The Minimum Wage*, The Council of Economic Advisers (December 1998).

[9] Different formulas are used for families with one child, families with two or more children, and individuals or couples without a qualifying child. Each formula operates on the same design but results in different income levels at which the maximum credit is reached, in different maximum credit amounts, and different phase-down schedules.

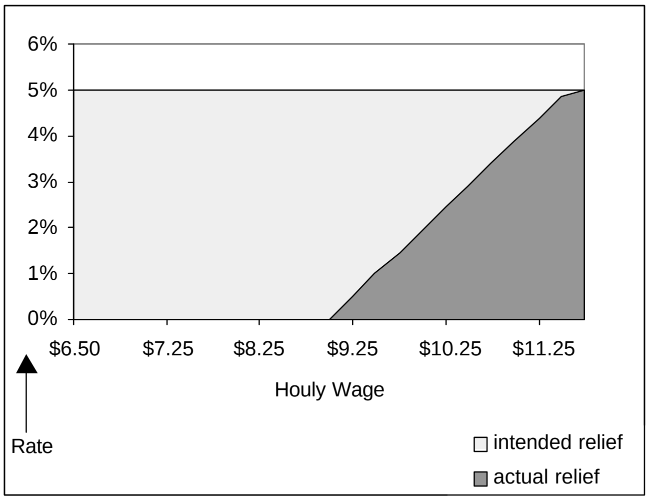
[10] See Footnote 7.

[11] The family's state tax liability is $206. The state allows a personal exemption credit of $396 for a family of three, eliminating the tax liability. The excess personal exemption credit ($190) is also not refundable.

- For the same parent working at $10 per hour, the state EIC returns only 1.5 percent of the federal EIC. This is 70 percent less than the 5 percent allowed in statute.

Individuals enter work from welfare throughout the year, and some low-income families have only seasonal income. A refundable state EIC would provide additional assistance to families without twelve months of full-time income.

Figure 3 - EIC (part-time/part-year)



Assumes one-parent, two-child family working for 12 months half-time or 6 months full-time. Assumes family does not have child care costs. "Intended relief" is the relief intended under statute. "Actual relief" is the tax relief actually returned to the taxpayer because the credit does not provide refunds. The family in our example would need to earn over $29,640/year before becoming ineligible for the EIC.

EIC (part-time/part-year)

Wage	$6.50	$7.25	$8.25	$9.25	$10.25	$11.25	$12.25
Statutory Rate	5%	5%	5%	5%	5%	5%	5%
Actual Rate	0%	0%	0%	0%	2%	3.9%	5%

Refund vs. Carry Forward

Some supporters of non-refundable credits argue that we should not have tax credits that exceed tax liability. However, Oregon already allows tax credits, including many business tax credits, to exceed liability through the use of "carry forward" provisions. Taxpayers are allowed to “carry forward” unused portions of the credits into the next tax year and beyond.[12] Under carry-forward provisions, any portion of a credit not used in a particular year because of insufficient tax liability can be used in later years, typically over a 3 or 5 year period.

[12] The other child care credit, the "Child and Dependent Care Credit," also has a carry-forward. The child and dependent care credit is not designed for or generally used by low-income families.

While this may be an attractive alternative for some credits, carry-forward provisions are inappropriate for low-income credits, such as the Working Family Credit and the EIC, for three principle reasons. First, low-income families need the credit income to meet current work related expenses. The credits were created out of recognition that low-income families have a difficult time meeting the expenses work requires, such as child care and transportation. A carry-forward provision, like a non-refundability provision, denies use of the credit near the time the expenses are incurred.[13]

Second, carry-forward provisions only work well where the expense is either not recurring or will be diminishing during the carry-forward time frame, or where the income of the taxpayer increases to incur substantially increased tax liability. A family leaving welfare for work, at an average starting wage of $7.05 per hour, will not have the luxury of waiting several years to fully utilize the Working Family Credit. Already they must wait until they file tax returns to receive the tax relief that is available. If the family's child care costs do not go down, or if its income does not rise significantly, the family would be unable to utilize a carry-forward provision. Like the non-refundable credit, the promise of the credit would never materialize.

Third, carry-forward provisions place a burden on low-income families to keep more complicated tax records, and they make tax filing more difficult. The complications add administrative burdens for the taxpayer and for the state revenue department, and they increase the possibility of filing errors.

Refundability and Cost

Budget questions can and should present a significant obstacle to creating tax credits. When the state EIC and Working Family Credit first passed the State Senate in 1997 on a 30-0 vote, they were fully refundable and were not slated to go into effect until two years later. Thus, the cost of the credits was not part of the budget debate during that legislative session. More importantly, the Legislative Assembly was able to review the credits from a policy perspective. While the ultimate cost to the state in subsequent biennia was properly of concern in the design of the credits, the primary focus was on the policies embodied in the two tax credits, not on their cost.

[13] Congress recognized that low-income families need the benefits of the federal EIC credit sooner rather than later and allow a portion of the credit to be paid to the low-income worker "in advance" each pay period. The Oregon credits do not have advance payment provisions.

Late in the 1997 legislative session, however, the bill's chief proponent pushed to have the measure amended and have the credits start two years earlier, making the cost of the credits a part of the current budget debate. Once that occurred and legislative leadership determined that there were not enough funds to enact refundable credits, the legislature trimmed the credits' cost by making them non-refundable. As shown above, the Legislative Assembly not only saved dollars but also significantly reduced the effectiveness of the credits to meeting the needs of low-income working families.

With bills pending before the 1999 Legislative Assembly, the Legislative Revenue Office has recalculated the projected costs of making the credits refundable. The most recent estimate is that in the 1999-2001 biennium a refundable EIC would cost $18 million, while a refundable Working Family Credit would cost an additional $24 million.[14]

Proposals to expand the credits without making them refundable do not necessarily cost less. The proposal to expand the income eligibility provisions of the Working Family Credit (SB 2) would cost an additional $28 million. Increasing the state EIC from 5 to 10 percent (SB 5) would cost an additional $17.1 million.

While a non-refundable credit minimizes the impact to state revenues and provides some low-income tax relief, it also minimizes the effectiveness of the credits for families closest to the minimum wage or working part-time.

[14] These are the costs to implement HB 3051 and SB 1190 and are subject to revision.

Appendix A

Senate Bill 2, 1999

To provide some perspective, the graph below demonstrates what happens when the Working Family Credit is expanded without being made refundable. Senate Bill 2, introduced during the 1999 legislative session, would allow families up to 200 percent of poverty ($13.13/hour for a family of three in 1998) to claim a 40% credit. The credit would phase out between 200 and 250 percent of poverty.

As the graph demonstrates, expanding the credit provides *no additional benefit* to those making less than about $12.25 per hour.

The light gray area represents the actual benefit of the current Working Family Credit. The black area represents the added benefit under SB2. The heavy line indicates the statutory rates under SB 2. If the Working Family Credit were refundable, families would receive the full value of the credits, represented by the thin line (current statute) and the thicker line (SB 2).