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**For Immediate Release**

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## **WHEN TAX DAY IS A MAZE OF INEQUITIES: MOVING TOWARD FAIR TAX POLICY FOR WORKERS AND FAMILIES**

*By Kinsey Alden Dinan, MA, Senior Policy Associate and Michelle Chau, Research Analyst*

Every year at tax time, Americans struggle to make sense of the credits and deductions available to them, and millions find that they are excluded from the best and biggest of these – precisely *because* they have less than their wealthier counterparts.

The truth is that American tax policy imposes a heavy burden on those who struggle to make ends meet even before the bite of tax withholdings. While several provisions in the American Recovery and Reinvestment Act of 2009 (ARRA) and President Obama’s budget plan lessen the burden for low- and moderate-income families, these changes are not sufficient to reverse existing inequities.

The ARRA has ushered in valuable short-term measures that increase tax breaks for low- and moderate-income families: one new credit – the Making Work Pay Credit – and expansions of two existing credits – the Earned Income Tax Credit (EITC) and the Child Tax Credit. A key feature of all three credits is that they are at least partially refundable, and thus low-income families are able to access them (see sidebar).

- The Making Work Pay Credit provides a refund of up to \$400 (or \$800 for couples) in Social Security payroll taxes for taxpayers earning up to \$95,000 a year (\$190,000 for couples). Millions of low- and moderate-income families pay more in payroll taxes than income taxes, and this measure provides important relief.
- The expansions to the EITC allow families with three or more children to receive a somewhat larger credit and reduce the marriage penalty by increasing the income limit for married filers. The EITC has long been recognized as one of the country’s most effective anti-poverty programs, both encouraging employment and putting money back in the hands of families who are struggling despite their hard work. These measures build on this successful program.
- The expansion of the Child Tax Credit extends it to more low-income families. Families with children can now qualify for a portion of this credit once income exceeds \$3,000 a year, as opposed to \$12,550 under prior law.

These changes represent an impressive step in equitable tax reform, and while they are temporary under the ARRA, Obama’s budget proposes making them permanent.

But even with these changes, tax breaks remain heavily weighted towards the wealthy. For example, the mortgage interest tax deduction is the largest tax deduction, and costs the federal government about \$70 billion – as compared to only \$40 billion spent on the EITC.<sup>1</sup> To qualify for the deduction, families must be homeowners and must itemize their deductions – criteria that completely exclude many lower-income families from benefits. Even among homeowners, wealthier homeowners can claim larger deductions

because they have more expensive homes (the mortgage interest tax deduction may be claimed on up to \$1 million of debt for up to two homes). Finally, the actual dollar value of a tax deduction depends in part on the filer's tax bracket, with larger benefits going to those in higher brackets (see sidebar).

Other examples of tax breaks that benefit wealthier taxpayers far more than their less wealthy counterparts include exemptions for retirement savings and employer-based health insurance costs and lower tax rates on capital gains than on earnings. In all, the federal government spends roughly \$750 billion a year in tax expenditures, with the vast majority benefiting wealthier taxpayers.<sup>2</sup>

Altogether, tax expenditures raise the after-tax income of the wealthiest families – those in the top 20 percent of the income range – by 13 percent. Families at the bottom and middle of the income range, on the other hand, see an increase in after-tax income of just 7 percent as a result of tax breaks.<sup>3</sup>

Tax breaks for low-income filers without (custodial) children are especially limited. To qualify for the EITC under current provisions, filers without children must have income below \$13,000 a year, and maximum annual benefits are limited to \$452. For families with two or more children, on the other hand, the income limit is about \$40,000 and the maximum benefit \$5,000. Fortunately, in addition to the EITC expansions enacted under ARRA, researchers' proposals to expand the EITC for workers without children have gained momentum in policy discussions.

Increasing the income limit and doubling or tripling the benefit for childless tax filers would provide important support to millions of low-wage workers, many of whom are noncustodial parents with financial obligations to their children. Based on the effects of the expansion of the EITC for families with children, there is evidence that such an increase would be a powerful work incentive for this important population.

With renewed attention to the economic struggles faced by so many of America's workers and families, policymakers are poised to make great strides toward equitable tax policy. The benefits to America would be twofold: families would be able to afford the necessities that make them strong, safe, and healthy; and thriving families are better equipped to contribute positively to the workforce and economy.

Crafting better tax policy is no easy task. But recent successes prove it *is* possible – and efforts are underway. By ensuring that current improvements are made permanent and supporting additional reforms, today's leaders can become the architects of tomorrow's prosperity. We urge them to make the most of this opportunity.

#### **Structuring Tax Breaks: Deductions versus Credits**

**Deductions** are subtracted from income before taxes are calculated. Their value depends in part on the filer's tax bracket. For example, a \$100 deduction is worth \$10 to someone in a 10% tax bracket and \$20 to someone in a 20% tax bracket. Deductions do not provide any benefits to those whose income is too low to owe taxes.

**Credits** are subtracted from filers' tax liability *after* taxes are calculated. Thus their value does not automatically vary based on tax bracket.

- **Nonrefundable credits** provide benefits only up to the level of a filer's tax liability. No benefits are provided when income is too low to owe taxes.
- **Refundable credits** offset families' tax liability and provide a refund to those whose income is too low to owe taxes.

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#### References

<sup>1</sup> Estimates are for Fiscal Year 2008. *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*. The Joint Committee on Taxation. <http://www.house.gov/jct/s-2-08.pdf>

<sup>2</sup> For more on these provisions, see Huang, Chye-Ching; Shaw, Hannah. 2009. *New Analysis Shows "Tax Expenditures" Overall Are Costly and Regressive: Findings Highlight Need to Restrain Tax Subsidies As Part of Solution to Long-Term Budget Problems*. Washington, DC: Center on Budget and Policy Priorities.

<sup>3</sup> Ibid.