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Tax Credits as Instruments For Social or Economic Policy

By Elsie M. Watters
Director, State-Local Research, Tax Foundation

In recent years increasing attention has been given to tax inducements to help in achieving certain social or economic policy goals. This is not a new idea. Various aspects of the tax system have long been used for nonrevenue purposes. Starting with Alexander Hamilton's first tariff to protect infant industries from foreign competition, Federal tax policy has been directed from time to time toward various nonrevenue goals.

Some observers refer to these devices as "tax incentives." Others object to this term on grounds that every tax is to some extent a disincentive and a lessening in the tax is merely a reduction of a tax disincentive. Whatever label we apply, the tax credit is one member of this family of tax provisions.

At the national level interest in the tax credit has been heightened by several developments. One of them is the history of the investment tax credit – its birth in 1962, suspension for a few months in 1966 and 1967, and its demise in 1969. Further, President Nixon, in his election campaign, indicated strong support for a new type of tax credit as a device for economic or social reform, for example, to encourage private business in efforts to combat unemployment in ghetto areas. Many tax credit proposals have been introduced in Congress.

Tax credits of this nature are viewed as a way of inducing individuals or businesses to undertake some action, or to do more of it, than they would do in the absence of the credit, on grounds that the action will benefit a segment of society over and above the immediate advantage to the one receiving the initial tax credit. In the states we have, in a similar category, credits against income tax for the installation of pollution control facilities, as well as other sorts of tax concessions to encourage industry to build a plant in one locality, say, in preference to another.

Interest in recent years has also been sparked by developments in another kind of tax credit – one aimed at getting governments, rather than individuals or businesses – to do something they would not otherwise do. For example, there have been recommendations that the Federal government

This Issue in Brief

Reviewing the various kinds of tax credits — past and present — Dr. Watters notes that interest in them has been heightened by several developments —including the rise and fall of the Federal investment tax credit. Credit plans still draw support, she points out, with many introduced in Congress currently.

A generic type of credit, she says in this **Review,** is the use in the states of the tax credit (instead of deductions) to adjust the individual tax burden. Major interest centers about the newest entry in the field, credit against income tax to offset the amount paid in state consumer sales taxes. After reviewing the favorable and unfavorable aspects of this type of tax credit, Dr. Watters cautions that sales (or other) tax credits must not be considered a "panacea," and should not be looked on as "potential cures for any big social problem."

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grant credits — rather than deductions — against Federal income tax for income taxes paid to state governments. Such a move would presumably encourage states to use the income tax more intensively, because taxpaying capacity formerly used by the Federal government would be freed up and could be picked up by the states at their option.

There is still another generic type of credit, and one which is probably of more immediate interest here. This is the use of the tax credit, instead of deductions or some other feature of the tax, to adjust the tax burden for an individual in order to alleviate what is presumed to be the harsh effects of another tax in the system. Compared to deductions from income, the tax credit is a powerful instrument. The tax credit is said to come off the top, whereas a deduction comes off the bottom. The credit is a straight subtraction from tax liability; the deduction simply reduces the amount to which the tax rate is to be applied. There are several different types of credits in use in the states — some to adjust the burden of the property tax, or the income tax itself, but the major interest here is one of the newest of these — the credit against income tax to offset the amount paid in consumer sales taxes.

Criticism of the Sales Tax

By most of the time-honored criteria of a good tax, the sales tax stands up quite favorably. It can produce large amounts of revenue at rates low enough to keep economic distortions at a minimum. Its yield is stable and it has potential for steady growth. It is generally broad-based. Despite some problems, it is reasonably easy to administer and for taxpayers to comply with, as compared with some other taxes. Its effects on resource allocation are at least as acceptable as those for any other comparable tax source.

Dr. Watters has been a member of the Foundation's Research staff since 1962. She formerly served in administrative, research and teaching capacities at Tulane University. She was associate professor in the University's School of Business, and is the author of publications on state-local finance. This **Review** is based on a speech before the National Association of Tax Administrators in Detroit in June.

But in one respect, the sales tax has had a bad press, and a bad name. The sales tax is widely labeled as regressive, bearing little relation to ability to pay, and falling more heavily on low-income groups. The word has been so well spread from theoretical economists to legislators and the public at large that even the man in the street has become doctrinaire about it. Whether or not one accepts the measures of tax incidence which we are able to compute with our limited data and information, the fact of life is that the sales tax is criticized as being unfair, or inequitable.

Developments in the past decade seem to indicate new interest in the states in making the sales tax a more palatable measure. Whereas a decade ago, only eight of the 34 sales-tax states exempted food from the statutory base, and none made use of the sales tax credit, it is significant that ten of the eleven states which have adopted the tax in the past ten years have either exempted food or provided for a sales tax credit or both. As of now, 15 states exempt food, seven allow a credit against the income tax for sales tax purchases, and Massachusetts, Vermont, and the District of Columbia do both.

Present Status of Sales Tax Credits

Although their general rationale is the same, the tax credits against income tax are of two principal types: either a fixed dollar amount per capita or a variable amount depending upon income and sometimes other factors.

Indiana, which pioneered with the credit in 1963, uses a fixed credit, as do Colorado, Idaho, and Nebraska. The dollar amounts of the credit, which are subtracted from income tax liability, vary from $7 to $10 per dependent. Depending upon the sales tax rate, they serve to exempt purchases from the sales tax varying from $280 and $400 per dependent. (The Indiana credit of $8, for example, with the prevailing rate of 2 percent, means in effect the forgiveness of the sales tax on $400 of purchases per person.) In all of these states except Idaho, a cash rebate is given if there is no income tax due. (Idaho gives a rebate only for persons 65 and over.)

The variable type of credit is used in Hawaii, Massachusetts, Vermont and the District of Colum-

bia. Except in Massachusetts, the credits allowed are reduced as income rises, and in all cases the credits vanish at some income level.

Arguments in Support of the Sales Tax Credit

Evaluation of the credit depends of course upon what it is being compared with. Despite a great deal of initial controversy – some continuing – the credit appears to have met with a substantial degree of approval in most of the states which have had experience with it. The credit emerges strongest perhaps when it is compared with the alternative of consumer exemptions, particularly the food exemption.

1. On equity grounds, the fixed credit gives a bloc exemption of several hundred dollars per capita, approximately equal to basic food costs. Since the amount is the same for all, the credit represents a higher percentage of income (and expenditure) for lower income groups than for those in higher brackets, thus improving the equity rating of the sales tax. Higher income groups probably spend more money for food than the credit provides, and it is held, there is no reason why these purchases for "luxury" food items should not be taxed. On the equity issue, as seen by an egalitarian, the variable credit comes out even better on theoretical grounds, because it allows no tax advantage to higher income groups who presumably do not need it anyway.

2. As to revenue effects, the credit also performs well as compared with exemptions. If the credit is linked with a broad sales tax base that includes most consumer goods and services, revenue actually increases. Further, tourist trade can be taxed with no loss of revenue, since the credit is limited to residents. Credits are likely to cost the state less than exemptions because there is greater control: exemptions are open-ended, whereas the credit has a specified limit. Moreover, once exemptions are introduced, various interest groups can feel free to press for additional exemptions, leading to potentially serious erosion of the tax base.

3. As to administrative and compliance considerations, costs of the credit to sales tax administrators are clearly less than that of exemptions. Auditors no longer need to determine whether retailers are accurately reporting figures of exempt items. Compliance costs to retailers also fall since there is no necessity of keeping records for taxable and nontaxable items.

4. On grounds of resource allocation, the credit is said to be superior to the exemption, since the credit is more neutral. Although the statutory citation for the credit sometimes indicates that it is designated to offset sales tax on food purchases, in reality it does not matter how the money is spent. Thus the credit does not affect consumer preferences for taxable or nontaxable items. (At least one critic has attacked the food exemption, on grounds that it subsidizes obesity.)

5. Finally, on the pro side, the credit is seen as a way of changing the image of the sales tax from a measure placing an onerous burden on the poor to one which is related to popular views of ability to pay. Thus the credit may make it politically feasible to introduce a sales tax, or to increase the rate of an existing tax when more revenue is needed.

Arguments Against the Sales Tax Credit

Critics of the credit have a corresponding list of counter-arguments:

1. On the equity issue, many question the presumption of inequity under the sales tax and the need for either exemptions or credits. It is certainly true that our measurements of equity are vulnerable to attack, and that numerous other considerations enter, such as the benefits of government services. To do justice to questions in this area, however, would take us far beyond our scope.

2. Related to equity, but reflecting a somewhat different sense of social justice, are the arguments of those who oppose the credit because it represents a form of negative income tax. This was the principal argument against the credit in the early years in Hawaii, and apparently was instrumental in the repeal of the credit in Iowa, where it was tried for a short time.

3. Some who seem to support the credit in theory hold that it does not in practice accomplish its purpose, because it sometimes gives tax relief where none is needed, and sometimes does not reach those who need it most. A spokesman from Hawaii has commented that the people who are supposed to benefit are the ones with little experience in income taxes. They must file returns to get a tax credit or refund; "every social worker in Hawaii would have to become a tax expert to advise these poor poeple,"

he said. Under the original law in Hawaii non-resident military people were not specified as being ineligible for the credit. The result was that thousands of soldiers, sailors, marines, and airmen filed for and got the top amount of cash available for each member of their families although some of them had never paid a dime in income taxes and had been in the islands only a few months.

4. Either an income tax credit or a sales tax exemption erodes the base and requires a higher rate of tax to produce the same revenue. In Iowa the estimated initial cost of the credit program was $17 million a year – an amount equal to the state's cost for aid to dependent children and old-age assistance combined. Further, once initiated, credits like exemptions can proliferate. Hawaii, for example, in addition to the sales tax credit, has a credit for taxpayers with children in kindergarten through grade 12, and another for those in higher education. In the last session two more consumer-type credits were enacted – one for drugs and medical expenses, and the other for renters.

Quite a lot of attention was focussed on such measures at the Federal level, when in 1968 the Treasury Department prepared a comprehensive list of special exemptions, deductions, credits, and concessions through which the tax system operates to affect the private economy in ways that might alternately be accomplished by direct government expenditures. This list was recently revised, and Assistant Treasury Secretary Murray Weidenbaum announced that the cost of such items for fiscal 1969 amounted to $44 billion (excluding government-assisted credit programs). This was equal to almost one-fourth of direct outlays of $185 billion. These "concessions" have been referred to as "tax aids" or, alternately, as tax expenditures."

Critics of such policies ask why expenditure programs cannot be used to accomplish the same ends – open and outright subsidies rather than devices which are hidden through tax reductions, and do not appear in the budget.

In connection with revenue effects, some ask: why have a sales tax at all, and go to the expense of collecting and administering it if the revenue is going to be so small? Again, if the base of the sales tax is already riddled with exemptions, what is the advantage of a credit?

5. In the area of administrative and compliance costs, while the problems for sales tax administrators are lessened, the credit puts a heavier job on the income tax division, as well as increasing the compliance problems of households. These problems appear to relate to the variable credit primarily, although not entirely. Tremendous administrative problems have been reported in Hawaii and Massachusetts, and I understand that the credit is extremely unpopular within the tax departments in those states.

Some Conclusions

A list of strong and weak points inherent in any form of tax credit, or tax incentive, can be drawn up. Although credits have elements in common, *the* "tax credit" as an instrument of social or economic policy cannot be put on trial in terms of generalities. Each type of credit must be judged on its merits and in relation to circumstances within the jurisdiction in question. Certainly the sales tax credit has merit, in comparison with some alternatives. Clearly, costs in terms of revenue foregone, administration, and compliance, etc., should not exceed social benefits. Unfortunately, the benefit side of the equation is difficult to measure with any degree of precision.

A mild note of caution should be sounded. In their enthusiasm for what can be done with the credit, proponents will sometimes oversell the merits of this tax device. The sales tax credit—and other tax credits—are not a panacea. They should not be looked upon as potential cures for any big social problem, such as poverty. A minidose of tax relief is not going to go far in that direction. The basic long-run answers lie elsewhere, and it is too much indeed to expect the sales tax—and the state income tax—to take on the burdens of solving such problems.

The sales tax credit attracts interest today for two principal reasons: (1) It is relatively new and is probably the most important sales tax development of the past decade. Though still not widely used, its adoption has accelerated, and it is likely to spread to other states. (2) If the main objection to the sales tax is that the poor have to pay too much, the credit can make it possible to remove all taxpayers below a certain income level from the direct effects of the sales tax. It may thus become the standard answer to sales tax critics in the years ahead and thus make it politically feasible to use the sales tax more intensively.