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ALLOWING STATES TO PAY FOR STATE CHARITABLE CONTRIBUTION TAX CREDITS OUT OF TANF BLOCK GRANTS WOULD NOT BE AN EFFECTIVE USE OF FEDERAL WELFARE FUNDS

By Ed Lazere

One of the proposals included in President Bush's faith-based initiative would encourage states to create income tax credits for contributions to charities that seek to address poverty.[1] The suggested structure of the credit would allow married couples to claim a credit for up to half of the first $1,000 of charitable contributions; single taxpayers could claim up to half of the first $500 of charitable contributions. Federal law would be changed to allow these state income tax credits to be supported with federal funds that states receive under the Temporary Assistance for Needy Families block grant, the welfare funding stream created in the 1996 welfare legislation.

Linking a charitable contribution tax credit to the TANF block grant would be inappropriate for several reasons, particularly because it could weaken states' welfare reform efforts.

- There is no guarantee that TANF funds used to support a charitable tax credit would enhance work-related services or target resources on families that need the most help to prepare for work. A tax credit for charitable contributions would, by its nature, give support to a broad and range of services and activities that is less focused on supporting work than current TANF programs.

- TANF-funded state tax credits would likely result in reduced funding for other TANF-funded work supports, such as transportation, training, and child care. The President's budget estimates the tax credit would use at least $400 million per year in TANF resources. The President's budget does not call for any increase in TANF funding and does not assume that overall TANF expenditures will increase over the next 10 years. Thus, the credit would have to push out other, more targeted, uses of TANF funds.

- The costs of a charitable contribution tax credit cannot be predicted or controlled. There is no way to cap the total amount of tax credits that can be claimed. If the revenue lost due to a TANF-funded tax credit were to be larger than a state had anticipated, additional cuts in other TANF-funded programs might be required.

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[1] See "Rallying the Armies of Compassion," January 2001, page 11, http://www.whitehouse.gov/news/reports/faithbased.pdf.

- Many states and counties operate some TANF-funded services through contracts with non-profit providers. Using TANF funds for a state charitable contribution tax credit may limit resources available for contracted services with these organizations, in part defeating the purpose of the tax credit.

- The potential donors are not well-positioned to conduct rigorous evaluations of the financial integrity and programmatic effectiveness of social service providers. Shifting the decision about which organizations receive funds from state and local welfare reform managers to individuals also makes it difficult to hold service providers accountable for the efficiency and effectiveness of their programs.

In addition to these concerns, it is not clear that the tax credit would lead to much of an increase in contributions to organizations addressing poverty. The new state income tax credits would be claimed by many households that already make contributions to service providers that assist low-income households and would continue doing so in the absence of the tax credit. If overall anti-poverty contributions do not increase by at least the amount of TANF funds used — which appears to be the likely outcome — the total funds available for assisting low-income families would decrease and federal funds that would otherwise be used to serve low-income families would instead enrich those making charitable contributions.

In short, while services provided to needy families by non-profit organizations play an important role in augmenting the safety net for low-income families, a charitable contribution tax credit is an inefficient way to support that role. Furthermore, TANF funds should be retained for targeted work-related services, rather than the diffuse set of services that would be supported under a charitable contribution tax credit. These issues are discussed in more detail below.

Using TANF Funds for Charitable Contribution Tax Credits Could Detract from Coordinated Welfare Reform Efforts

Each state's TANF funding level is based on its welfare funding levels of the early 1990s, when cash assistance caseloads were higher than today. Since 1994, when welfare caseloads peaked, spending on cash assistance has fallen by more than half. The combination of fixed funding and falling caseloads has freed up these funds for use in providing a broader range of assistance to needy families.

While some states have unspent TANF funds, states also are making substantial new investments. In the first two years following passage of the federal welfare law, many states left a large share of their TANF block grant unspent, resulting in a build-up of TANF reserves. But states have now implemented programs that use most of their annual TANF allocations. For example, in fiscal year 2000, states spent $15.9 billion in TANF funds, an amount equal to 94 percent of the $17 billion in TANF funds awarded that year, and 12 states spent more than their annual block grant allocation. In fiscal year 2001, TANF spending nationally is expected to exceed the annual grant amount.[2] Since many states are already drawing on their TANF reserves, new spending cannot simply be added to existing efforts without dipping further into reserves and eventually depleting them. Because TANF block grant funding is fixed, it is prudent for states to maintain at least some funds in reserve, particularly during the current period of economic weakness. To whatever extent states devote TANF funds to charitable contribution tax credits, they will eventually have to reduce spending on other important TANF investments that support low-income families.

Reduced Opportunity for States to Coordinate Supports for Working Families

A substantial share of the funds that have been freed up from reduced cash assistance caseloads have been reinvested in supportive services for low-income working families, such as child care and transportation, including supports for low-income working families not on the welfare rolls. For example, some state TANF programs now include efforts to help parents find better-paying initial jobs, provide case management once families find work to ensure that jobs are retained, and help employed parents move to better jobs. Many states also are undertaking efforts to address the multiple barriers to stable employment faced by many families that remain on welfare and are approaching time limits. All of these endeavors are intended to increase the ability of parents to leave welfare and to continue supporting their families through work. Because receipt of cash assistance generally is time limited, efforts to help families find work and remain employed are particularly important.

Using TANF funds for charitable contribution tax credits would not ensure that funds are targeted for appropriate services provided by qualified non-profit organizations and could detract from welfare reform efforts. While many non-profit organizations provide work support services, the most experienced organizations typically receive government funds for these activities, through federal, state, or local grants. It is not clear that a tax credit for charitable giving would enhance the existing services already being provided through public and private funds. As noted earlier, donations claimed under the new tax credits would likely support a very broad range of social services many of which are at best tangentially related to TANF's goals.

Moreover, by their nature, charitable contribution tax credits would result in the distribution of resources to a wide array of organizations providing a broad range of services. For example, the tax credit could be claimed for contributions to mentoring or tutoring programs, drug awareness activities, services for runaway youth, or community health programs. While these services are important, they are bound to be less focused on coordinated welfare reform efforts than a state's current TANF-funded activities.

[2] In August 2001, the Congressional Budget Office projected that TANF outlays in fiscal year 2001 would total [$18] billion, while the basic TANF grant and various additional grants will total about $17 billion.

Funding anti-poverty efforts through a tax credit also lessens the likelihood that services will be provided to the geographic areas with the greatest needs. Most non-profit organizations provide services to families in a targeted area, such as the neighborhood in which they are located, or in some cases, an entire city or metropolitan area. Rarely are non-profit providers large enough to serve an entire state. Because social service agencies in poor communities or remote rural areas are less able than agencies in other areas to seek donations and because donors may prefer to support local charities, the distribution of charitable contributions supported by a new tax credit is not likely to reflect the distribution of needy families within a state.

States are in a position to identify common needs of families making the transition from welfare to work and systematically fill those gaps. For example, more than one-third of TANF funds not used for cash assistance are now used to provide child care assistance. The increased funding for child care also has included efforts to expand care for very young children and for children whose parents work in the evenings or on weekends. A tax credit for individual donors, as compared with direct spending, would neither provide explicit incentives to develop child care services of this nature nor ensure that such services are available where they are needed.

In another example, some states are using TANF funds to provide income supplements directly to families that work but remain low-income. This includes state earned income tax credits, cash bonuses to families that leave welfare and remain employed for a specified period, and benefits to offset ongoing work-related expenses. A recent study of several welfare reform programs suggests that efforts that lead not only to increased employment but also to higher incomes among former welfare recipients contribute to improved outcomes for children, such as higher school achievement and better health.[3] An evaluation of Minnesota's Family Investment Program (MFIP), which included significant financial incentives to work, found it promoted marriage and family stability by increasing marriage rates and reducing the likelihood that married couples would split up.[4] These types of income supplements are generally not provided by non-profit entities. As a result, using TANF funds to support charitable contribution tax credits could drain states of the capacity to exercise their flexibility in some of the ways that have been shown most effective in helping low-income families to succeed.

It is highly unlikely that TANF funds used to support a charitable contribution tax credit would result in services that are as targeted on moving families to employment and helping them remain employed as current TANF expenditures are.

Reduced Funding for Other TANF Programs

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[3] Manpower Demonstration Research Project, *How Welfare and Work Policies Affect Children: A Synthesis of Research*, January 2001, http://www.mdrc.org/Reports2001/NGChildSynth/ng-childsynth.pdf.

[4] Manpower Demonstration Research Project, *Reforming Welfare and Rewarding Work: A Summary of the Final Report on the Minnesota Family Investment Program*, September 2000. (http://www.mdrc.org/Reports2000/MFIP/MFIP-ExSum-Final.htm)

The Administration's budget, which includes the state tax credit proposal, indicates that some states would be expected to take advantage of this new option and that it would lead to an additional $400 million in TANF expenditures in 2003. The President's budget does not, however, include additional TANF resources and does not assume there will be any net increase in overall TANF expenditures over the next 10 years. Under these assumptions, the President's budget effectively acknowledges that a new state option to use TANF funds for state charitable contribution tax credits would, over time, reduce TANF investment in other areas.[5]

The President's budget describes the proposal as allowing states to "partially offset revenue losses" from state charitable tax credits with federal TANF funds.[6] If the proposal were enacted, states would need to be willing to commit new state funds to adopt charitable tax credits. (If the proposed limitation that TANF funds could partially rather than entirely offset the revenue losses were not enacted, it is possible that even more TANF funds would be used — and effectively shifted away from other work-support activities — than the president's budget assumes.)

For most income tax credits, all eligible households are allowed to claim the credit. In this sense, tax credits thus typically operate as entitlements. This feature is critical to the functioning of tax credits for two reasons. First, tax credits can be an attractive way to deliver benefits to taxpayers because they are relatively easy to administer. Establishing a tax credit does not require creating a bureaucracy; application for the credit is simply incorporated into a household's annual tax return. Second, to the extent that tax credits are intended to create incentives for certain behavior — as the charitable contribution tax credit proposal is intended to do — they work best if taxpayers are certain they can receive the credit if they meet the credit's eligibility rules.

If a new tax credit for charitable contributions were to operate this way, as it very likely would, its costs could not be projected with certainty. It is possible that in some states, the costs of the credit would be less than projected, but it is also possible that the costs would exceed projections in other states, with more individuals claiming the credit than expected. If costs were to exceed projections, a state would need to find additional resources to meet the full costs of the credit. The state could devote more of its own resources to paying for the credit, but this would

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[5] The President's budget assumes the new tax credit option would increase TANF outlays in fiscal years 2003 through 2005 compared with anticipated spending under current law, with no credit option. But it also assumes that over the course of the next 10 years, overall TANF spending would be neither higher nor lower than what would be expected under current law. As a result, the budget assumes that states that enact charitable tax credits would eventually have to scale back programs and services they otherwise would have provided in order to accommodate tax-credit costs.

[6] Fiscal Year 2002 Budget, page 111. The Administration has not provided details regarding what portion of revenue losses could be offset with TANF funds or how such a limitation would function operationally.

likely require increased state taxes or a reduction in state expenditures for other programs. Neither of these options is likely to be attractive to state policymakers. States in this situation might instead choose to devote more federal TANF funds to the credit, reducing TANF spending in other areas. To the extent that such a credit proves popular, becomes widely used, and is funded with TANF funds, states may have to make increasingly deep cuts over time in their investments in TANF employment supports. They also may find that in times of economic downturn, they are less able to meet the cash assistance and work support needs of the increased number of families looking for work.

A state could attempt to set a limit on the costs of a charitable contribution tax credit, but that would not be practical. To set limits, taxpayers would have to be required to apply for the credit, and the state would then approve the credit if the household appeared eligible *and* if the cost limit had not been reached. This would present serious administrative problems for states and also would remove the certainty that if a household makes a charitable contribution, it would receive the credit.

Reduced Accountability

When states contract with organizations providing services to low-income families, the contracting process allows for coordination, targeting, oversight, and evaluation of services provided. States can award contracts based on research findings on the effectiveness of certain types of programs, oversee the fiscal practices of contractors, and conduct evaluations of program effectiveness.

Increasingly, states are entering into contracts containing terms that require providers to achieve specific performance-based outcomes. Even when contract provisions are not explicitly performance-based, the competitive process involved in contracting provides states with an opportunity to evaluate performance and select contractors accordingly. Once a contract is underway, one of the primary responsibilities of contract managers is to monitor the performance record of service providers.

These contracted services to low-income families often are provided by non-profit organizations. Providing support to non-profit organizations through government contracts is beneficial in many respects. It allows governments to take advantage of the effectiveness that many non-profit organizations have displayed in meeting social needs. It also helps ensure that federal and state policy goals are met, by specifying the services that organizations will provide under contract with the federal or state government and by allowing governments to select the providers that would be most effective at providing those services.

Individuals — potential donors — are not well-positioned to evaluate service providers so comprehensively. Thus, even though individual taxpayers have an incentive to make contributions to organizations that spend their funds well, they may not have access to useful information on which to base their assessments. This problem is likely to be exacerbated by the marketing efforts of charities. Effective marketing is not necessarily correlated with effective programs, but individual donors are more likely to be exposed to promotional materials than performance evaluations.

Higher-income individuals could easily be in a situation in which less than half of their qualified donations come from their own pockets, after taking into account a 50 percent state credit and a federal itemized deduction that reduces taxes owed by more than 30 percent of the contribution amount. (Offsetting federal tax increases resulting from the reduction in state income taxes would reduce the tax subsidy somewhat.[7]) Under current tax law, by contrast, individuals bear the majority of the costs of charitable contributions they make. To the extent it is even possible for one person to monitor an organization, the diminished cost of charitable donations to individuals reduces their incentive to monitor carefully the organizations to which they contribute. Establishing a policy under which such a large portion of individual charitable contributions are reimbursed by the federal and state governments through tax credits essentially retains the bulk of government's responsibility for funding social services while decreasing accountability for how these funds are spent.

Reducing state oversight of funding for service providers and leaving that responsibility in the hands of individuals who, in all likelihood, will be ill-equipped to evaluate programs, would likely reduce overall accountability for how TANF funds are spent and conflicts with a performance-based approach to budgeting.

Would A Charitable Contribution Tax Credit Increase Support for Anti-Poverty Efforts of Non-Profit Organizations?

The effort to encourage states to create charitable contribution tax credits has been described by the Bush Administration as a way to expand charitable giving.[8] It is unclear, however, how well the new credits would accomplish that goal. While the tax credits would

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[7] New state charitable tax credits would result in higher federal income taxes for some taxpayers. This would occur because state income tax payments are allowed as an itemized deduction on the federal income tax. A reduction in a family's state income tax as a result of a charitable contribution tax credit would lower the amount of federal itemized deductions the family could claim and therefore would increase its federal income tax liability. Consider the example of a $1,000 contribution that leads to a $500 state charitable tax credit. For a family that itemizes federal deductions and has income in the 35 percent marginal federal tax bracket (the top rate when the recently enacted tax cuts are fully implemented) a $500 state income tax credit would reduce itemized federal deductions by $500, resulting in a $175 increase in federal taxes owed, an amount equal to 17.5 percent of the contribution amount. Even considering this increase, the net tax benefit for charitable contributions would be 67.5 percent — 50 percent from the state credit and 35 percent from the federal itemized deduction for charitable contributions, less 17.5 percent for the reduced federal deduction for state income taxes.

[8] In "Rallying the Armies of Compassion," op. cit., the state option to create a charitable contribution tax credit is listed under a section entitled "Expanding Private Giving."

likely encourage some new giving, they also would allow many taxpayers to secure tax benefits for contributions they are already making to organizations serving low-income families. In so doing, a sizable share of the TANF funds used to support the new tax credits would be consumed without providing new resources for non-profit service providers or additional supports to needy families.

States could take some steps to improve the likelihood that tax credits would be claimed only for new contributions. For example, most states with an income tax already allow taxpayers to include charitable contributions in their itemized deductions. States could design a new charitable contribution tax credit so it could be claimed only for contributions that exceed the amount of charitable contributions included in the taxpayer's itemized deductions in a given base year. This is how Arizona operates a recently enacted tax credit for contributions made to organizations that serve needy families.[9] While this step may improve the likelihood that a tax credit would support new giving, it poses serious operational problems.

- Tax credits generally are open both to taxpayers who itemize deductions and taxpayers who do not itemize. For families that do not itemize deductions but are eligible to claim a new charitable contribution tax credit, it would be impossible to establish a baseline for their previous year's level of charitable giving. As a result, these families would be able to claim the credit for their current level of charitable contributions to qualifying organizations.

- In 11 of the 44 states with an income tax in 1999, there were no broad deductions for charitable contributions.[10] In these states, it would not be possible to identify a baseline contribution amount for any family. As a result, a charitable contribution tax credit could not be limited to new donations.

- Even in states with itemized deductions that include charitable contributions, establishing an individual baseline based on past charitable contributions does not capture the portion of past giving that went to anti-poverty organizations. Thus, some families that itemize could claim the new credit even if their giving to organizations that serve poor families had not increased. Consider, for example, a family that made $1,000 in charitable contributions in a given year, $400 to organizations addressing poverty and $600 to other non-profit institutions.

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[9] Tax-exempt charitable organizations also must self-certify to the state that they spend at least 50 percent of their budget on TANF recipients or others with incomes below 150 percent of the federal poverty line and meet other qualification requirements. For a detailed description of the Arizona credit, see Margy Waller, "Charity Tax Credits: Federal Policy and Three Leading States," May 2001, http://pewforum.org/publications/articles/charitytaxcredits.pdf.

[10] Those 11 states are Connecticut, Illinois, Indiana, Massachusetts, Michigan, New Hampshire, New Jersey, Ohio, Pennsylvania, Tennessee, and Virginia. See State of Wisconsin, Legislative Fiscal Bureau, "Individual Income Tax Provisions in the States," January 2001, p. 9.

> Assume the family increases its total contributions to $1,400 in the next year, continuing the $400 to anti-poverty organizations but increasing other giving to $1,000. The family could demonstrate that its contributions had increased by $400 and that $400 of its contributions addressed poverty, which could allow it to claim the new credit. Yet the family's giving to anti-poverty organizations would have remained the same.

In short, it would be virtually impossible to design a state credit that effectively limits the credit to increases in contributions to anti-poverty organizations. Moreover, any effort to do so would increase the complexity of claiming and administering the credit, thereby placing additional burdens on claimants and state tax departments. States that instead choose simpler credit designs are less likely to generate increased contributions to anti-poverty organizations, while nonetheless reducing the TANF funds available for other activities that meet the needs of low-income families. States endeavoring to enact a state charitable tax credit would therefore face a choice between designing an extremely complicated credit that still allows for leakage of anti-poverty dollars and creating a somewhat less complex credit that allows for greater leakage of anti-poverty funds.

Conclusion

Improving efforts of private social service providers to support welfare reform by helping needy families is a worthwhile goal. Encouraging states to enact charitable contribution tax credits by allowing them to cover part of the costs of the credits with TANF funds is unlikely, however, to lead to this result. There is no guarantee that such credits would significantly increase the resources available to anti-poverty organizations. Moreover, using TANF funds for charitable tax credits could undercut state welfare reform efforts already underway. Many states have invested TANF resources in supports for low-income working families. Drawing TANF funds away from these activities to support charitable contribution tax credits may weaken efforts to help families move from welfare to work. The TANF block grant is not an appropriate funding source to bolster support of private social service providers through state charitable contribution tax credits.