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## A MAJORITY OF STATES WITH INCOME TAXES HAVE ENACTED STATE EARNED INCOME TAX CREDITS

By Jason Levitis and Jeremy Koulish

An Earned Income Tax Credit is a tax reduction and a wage supplement for low- and moderate-income working families. The federal government administers an EITC through the income tax. So do many states. States that enact EITCs can reduce child poverty, cut taxes, and increase the incentive to work for families struggling to make ends meet.

### Rising Number of States Offer EITCs

In the past 13 months, four states have enacted new EITCs — North Carolina, Louisiana, and New Mexico in 2007 and Michigan in late 2006. Furthermore, Illinois, Iowa, Kansas, Nebraska, New Jersey, and Oregon have recently improved their credits. These additions bring the total number of states with EITCs (counting the District of Columbia as a state) to 23. This is over half of the 42 states (again counting D.C.) with income taxes. In addition, two local governments — New York City and Montgomery County, Maryland — offer local EITCs.

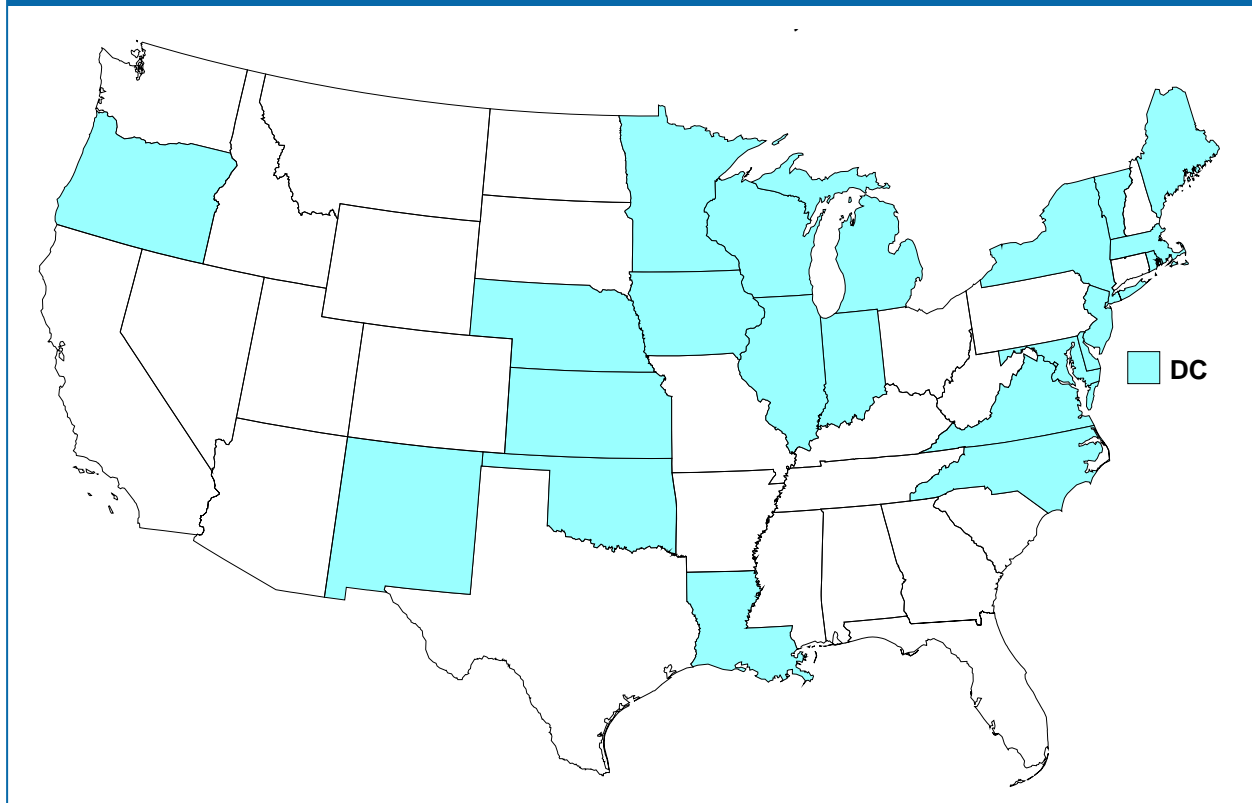
When the new EITCs are fully implemented, nearly two out of five recipients of the federal EITC will live in a state with an EITC. Annual state EITC benefits will exceed \$1.5 billion.

State EITCs have received broad support. EITCs have been enacted in states led by Republicans, in states led by Democrats, and in states with bipartisan leadership. The credits are supported by business groups, labor groups, faith-based groups, and social service advocates.

#### KEY FINDINGS

- Four states have enacted Earned Income Tax Credits within the past year. Of the 42 states (including the District of Columbia) with income taxes, 23 now have enacted such credits.
- State EITCs reduce poverty, increase workforce participation among low-income families, and make state tax systems fairer.
- Twenty states have made their credits refundable, ensuring the broadest impact on poverty and maximizing the work incentive.

FIGURE 1. States with an EITC, October 2007



## Why Consider an EITC?

Several developments explain the popularity of state EITCs.

- *Continued child poverty and economic hardship.* In 2006, some 8.6 million children in working families lived in poverty. And many families with incomes modestly above the official poverty line — roughly \$20,000 for a family of four — also face significant difficulty in meeting the costs of food, housing, transportation, clothing, and other necessities. Sluggish wage growth for low-earning families means that many families are likely to continue to struggle. The federal EITC alone now lifts more than 4 million people — roughly half of them children — out of poverty each year; it is the nation's most effective antipoverty program for working families. State EITCs can supplement this effect.
- *Low wages and welfare reform.* Wage and salary growth has been weaker since the current economic recovery began in 2001 than in most previous economic recoveries. Over the last several years, several million welfare recipients have left welfare and become employed, most of them for low wages. Many other families have accepted the challenge of making ends meet on low-paying jobs without seeking public assistance. But a full-time job at the minimum wage often is not sufficient to lift a family out of poverty. Concern about low wages has led a number of states and the federal government to raise their minimum wages, but even with

those increases, low-wage jobs may not provide a sufficient income on which to live.<sup>1</sup> State EITCs support families who enter and remain in the workforce.

- *Tax changes.* Rising revenues in some states are leading policymakers to consider enacting tax cuts. Enacting a state EITC is a way to ensure that low- and moderate-income families share in the benefits of tax cuts. In other states, budget deficits may lead to increases in sales, excise, and property taxes, the burden of which falls most heavily on low- and middle-income families. States already rely heavily on such taxes. Moreover, nearly half of the states impose an income tax on working-poor families, and most states levy income tax on families with incomes only slightly above the poverty line. A state EITC can help offset such taxes.
- *Extensive evidence that EITCs encourage work.* Empirical research has repeatedly confirmed that both the federal and state EITCs increase workforce participation among eligible families. Increasing the size of an EITC increases this effect.<sup>2</sup>
- *Evidence that EITCs are used for asset-building expenditures.* Interviews with EITC recipients show that many use their EITC refunds to make the kinds of investments — paying off debt, investing in education, securing decent housing — that enhance economic security and promote economic opportunity.<sup>3</sup>

## How Does a State EITC Work?

State EITCs are extremely simple to implement, administer, and claim. They typically "piggyback" on the federal EITC, meaning that they are set at a fixed percentage — between 3.5 percent and 35 percent — of the federal credit. As a result, states can take advantage of federal statutory structure and compliance apparatus, and filers need only multiply their federal EITC by the matching rate to determine their state credit. Most state EITCs therefore have the same benefit structure as the federal EITC.

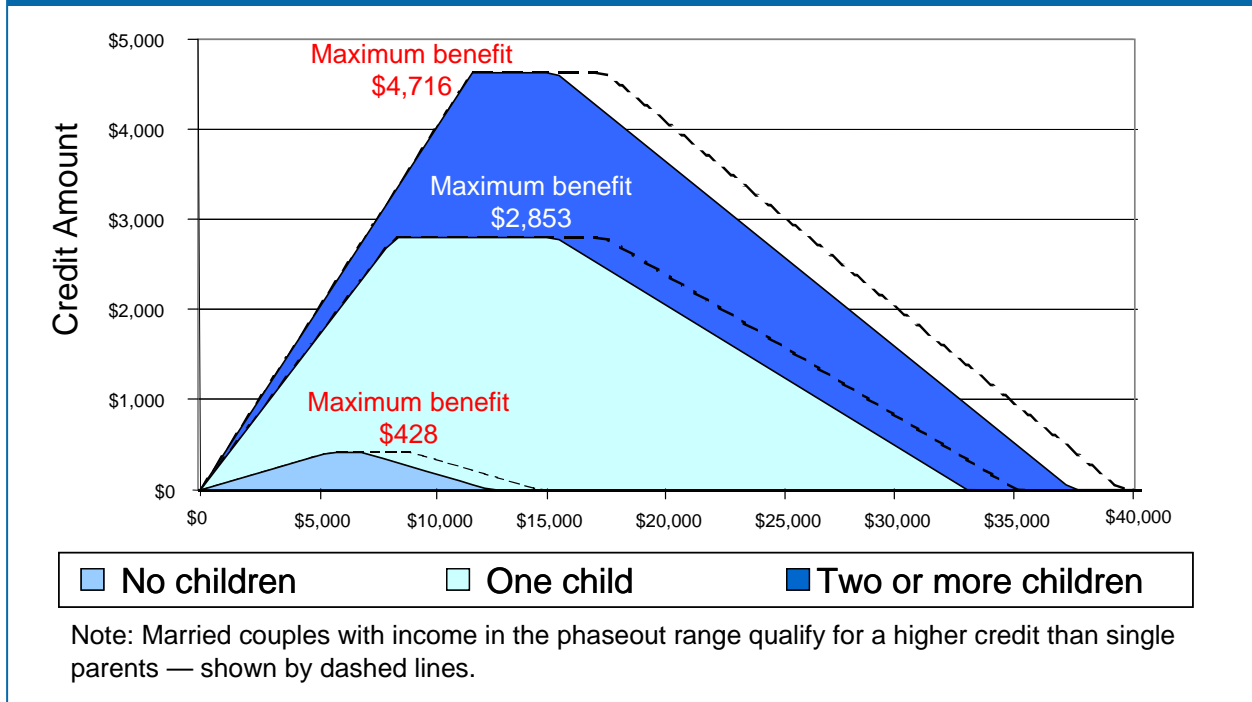
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<sup>1</sup> See Jason A. Levitis and Nicholas Johnson, "Together, State Minimum Wages and State Earned Income Tax Credits Make Work Pay," Center on Budget and Policy Priorities, revised November 20, 2006. Available at [www.cbpp.org/7-12-06sfp.htm](http://www.cbpp.org/7-12-06sfp.htm).

<sup>2</sup> For example, studies by Harvard economist Jeffrey Liebman and University of California economist Nada Eissa find a sizable EITC effect in inducing more single women with children to work. Liebman has noted that workforce participation among single women with children has risen dramatically since the mid-1980s, while there was no increase in work effort among single women without children. A study by Northwestern University economists Bruce Meyer and Dan Rosenbaum finds that EITC expansions explain more than half of the increase in employment among single mothers over the 1984-1996 period. Meyer and Rosenbaum found evidence that state EITCs also contributed to workforce participation increases in the states where credits were available. A more recent study confirms a very strong connection between the size of a family's EITC benefit and its likelihood of employment. Authors V. Joseph Holtz, Charles H. Mullin, and John Karl Scholz found that welfare-recipient families with two or more children experienced noticeably faster rates of employment growth than families with one child because the larger families were eligible for greater EITC payments. And a recent study by University of California economist David Neumark and William Wascher of the Federal Reserve Board finds strong evidence that EITC boosts employment among young women.

<sup>3</sup> Timothy M. Smeeding, Katherin Ross Phillips, and Michael O'Connor, "The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility," No 13, Center for Policy Research Working Papers.

**FIGURE 2. Federal Earned Income Tax Credit, 2007**



The federal EITC was established in 1975 to offset the effects of federal payroll taxes on low-income families. It has been expanded several times since, providing additional assistance to welfare recipients entering the workforce and other workers supporting their families on low wages.

The maximum federal EITC benefit for the 2007 tax year is \$4,716 for families with two or more children and \$2,853 for families with one child. The greater EITC benefit for larger families reflects recognition that larger families face higher living expenses than smaller families. Workers without a qualifying child also may receive an EITC, but the maximum credit for individuals or couples without children is \$428 in 2007, much lower than the credit for families with children. Figure 2 shows the EITC benefit structure for families. (As with most other provisions of the federal tax code, EITC amounts and parameters are adjusted each year by the IRS for inflation; the figures shown here are for 2007.)

The EITC benefit that an eligible family receives depends on the family's income. For families with very low earnings, the value of the EITC increases as earnings rise. For example, families with two or more children receive an EITC equal to 40 cents for each dollar up to \$11,790 earned, for a maximum benefit of \$4,716. Families with one child receive an EITC equal to 34 cents for each dollar earned up to \$8,390 of earnings, for a maximum benefit of \$2,853. Families continue to be eligible for the maximum credit until income reaches \$15,390 (or \$17,390 for married-couple families).

The maximum EITC benefits go to working families with incomes below the federal poverty line, but many families with incomes well above the poverty line benefit to at least some degree. (The 2007 federal poverty line is about \$20,000 for a family of four.) This is because the EITC phases out gradually as income rises above \$15,390 for single-parent families or \$17,390 for married couples. Single-parent families with two or more children are eligible for some EITC benefit until

income exceeds \$37,783, while such families with one child remain eligible for some EITC benefit until income exceeds \$33,241. For married couples, the maximum eligibility levels are \$39,783 for two or more children and \$35,241 for one child.

<b>TABLE 1: STATE EARNED INCOME TAX CREDITS BASED ON THE FEDERAL EITC</b>			
<b>State</b>	<b>Percentage of Federal Credit (Tax Year 2007 Except as Noted)</b>	<b>Refundable?</b>	<b>Workers Without Qualifying Children Eligible?</b>
Delaware	20%	No	Yes
District of Columbia	35%	Yes	Yes
Indiana <sup>a</sup>	6%	Yes	Yes
Illinois	5%	Yes	Yes
Iowa	7%	Yes	Yes
Kansas	17%	Yes	Yes
Louisiana	3.5% (effective in 2008)	Yes	Yes
Maine	5%	No	Yes
Maryland <sup>b</sup>	20%	Yes	No
Massachusetts	15%	Yes	Yes
Michigan	10% (effective in 2008; to 20% in 2009)	Yes	Yes
Minnesota <sup>c</sup>	Average 33%	Yes	Yes
Nebraska	8% (to 10% in 2008)	Yes	Yes
New Jersey	20% (to 22.5% in 2008, 25% in 2009)	Yes	Yes
New Mexico	8%	Yes	Yes
New York <sup>d</sup>	30%	Yes	Yes
North Carolina <sup>e</sup>	3.5% (effective in 2008)	Yes	Yes
Oklahoma	5%	Yes	Yes
Oregon <sup>f</sup>	5% (to 6% in 2008)	Yes	Yes
Rhode Island	25%	Partially <sup>g</sup>	Yes
Vermont	32%	Yes	Yes
Virginia	20%	No	Yes
Wisconsin	4% — one child	Yes	No
	14% — two children		
	43% — three children		

Notes: From 1999 to 2001, Colorado offered a 10% refundable EITC financed from required rebates under the state's "TABOR" amendment. Those rebates, and hence the EITC, were suspended beginning in 2002 due to lack of funds and again in 2005 as a result of a voter-approved five-year suspension of TABOR. Under current law, the rebates will resume in 2011, but a recent income tax cut that also depends on the rebates is likely to exhaust the funds, leaving the EITC unfunded.

<sup>a</sup> Indiana's EITC is scheduled to expire in 2011.

<sup>b</sup> Maryland also offers a non-refundable EITC set at 50 percent of the federal credit. Taxpayers in effect may claim either the refundable credit or the non-refundable credit, but not both.

<sup>c</sup> Minnesota's credit for families with children, unlike the other credits shown in this table, is not expressly structured as a percentage of the federal credit. Depending on income level, the credit for families with children may range from 25 percent to 45 percent of the federal credit; taxpayers without children may receive a 25 percent credit.

<sup>d</sup> Should the federal government reduce New York's share of the TANF block grant, the New York credit would be reduced automatically to the 1999 level of 20 percent.

<sup>e</sup> North Carolina's EITC is scheduled to expire in 2013.

<sup>f</sup> Oregon's EITC is scheduled to expire in 2011.

<sup>g</sup> Rhode Island made a very small portion of its EITC refundable effective in TY 2003. In 2006, the refundable portion was increased from 10 percent to 15 percent of the nonrefundable credit (i.e., 3.75 percent of the federal EITC).

## Designing a State EITC

Twenty-two state EITCs (including the District of Columbia's) piggyback directly on the federal EITC; those 22 states use federal eligibility rules and express the state credit as a specified percentage of the federal credit. (The percentages are shown in Table 1.) The twenty-third state with an EITC, Minnesota, also uses federal eligibility rules, and its credit parallels major elements of the federal structure.

Twenty of the 23 states with EITCs follow the federal practice of making the credit “refundable.” This means a family receives the full amount of its credit even if the credit amount is greater than the family’s state income tax liability. The amount by which the credit exceeds annual income taxes is paid as a refund. If a family has no income tax liability, the family receives the entire EITC as a refund. All low-income working families with children can participate in a refundable EITC.

The remaining three states — Delaware, Maine, and Virginia — offer credits that are non-refundable. Such a credit is available only to the extent that it offsets a family’s state income tax. A non-refundable EITC can provide substantial tax relief to families with state income tax liability, but it provides no benefits to working families that have income too low to owe any income taxes. For these families, a non-refundable EITC neither reduces taxes nor creates an incentive to increase earnings. Thus a non-refundable credit assists somewhat fewer working-poor families with children and is likely to be less effective as a work incentive.

## Financing a State EITC

Existing refundable state EITCs cost less than 1 percent of state tax revenues each year, though their dollar cost varies considerably from state to state because of differences in the size of state economies. (Vermont’s EITC costs about \$18 million per year, while New York State’s costs about \$700 million.) The cost of a state EITC depends principally on four factors: the number of families in a given state that claim the federal credit, the percentage of the federal credit at which the state credit is set, whether the credit is refundable or non-refundable, and how many state residents that receive the federal credit also learn about and claim the state credit. Because state EITCs are more specifically targeted to low- and moderate-income working families than many other major tax cuts, the cost may be relatively modest.<sup>4</sup>

State EITCs are financed in whole or in part from funds available in a state’s general fund — the same funding source typically used for other types of tax cuts. When an EITC is used to offset the effects of a regressive tax increase, such as a sales tax increase, a part of the proceeds of the revenue increase may be set aside for the EITC. Current federal regulations also offer the opportunity to finance a portion of the cost of a refundable credit from a state’s share of the federal Temporary Assistance to Needy Families block grant. Most states have very limited availability of such funds, however, because the value of the TANF block grant has eroded over time and because states face costly new work requirements under the most recent federal budget law. No matter how it is

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<sup>4</sup> For further information about estimating the cost of state EITC, see Sloane Kuney and Jason Levitis, "How Much Would a State Earned Income Tax Credit Cost in 2008," Center on Budget and Policy Priorities, February 7, 2007. Available at [www.cbpp.org/2-7-07sfp.pdf](http://www.cbpp.org/2-7-07sfp.pdf).

financed, however, an EITC can complement a state's welfare program by assisting low-income working families with children.

*Further details on state EITCs and how they can help working families escape poverty are available in the following report from the Center on Budget and Policy Priorities: "A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2006" by Ami Nagle and Nick Johnson. The report can be found at: [www.cbpp.org/3-8-06.sfp.pdf](http://www.cbpp.org/3-8-06.sfp.pdf).*