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Idea

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Enact a State Earned Income Tax Credit

Each Southern state with an income tax should enact a refundable earned income tax credit to bring working families' incomes above poverty.

Background

Every year on April 15, working families who live month-to-month or paycheck-to-paycheck can take a breath. Why? Because they get relief from a federal tax break that makes life easier.

In 2003, the federal Earned Income Tax Credit (EITC) helped 22.1 million poor and near-poor working families and individuals across the nation through income tax reductions and wage support. In fact, the federal EITC brought 4.4 million people above the poverty line in 2003.[1] Commonly described as a work incentive, the federal EITC reduces or eliminates income taxes for poor and near-poor working families and individuals, and provides a refund for the remaining amount of the credit. The refund helps offset other federal payroll taxes, such as Social Security, and can bring working families' income above the poverty line.

No Southern state currently offers a refundable Earned Income Tax Credit.

Since its inception in 1975, the federal EITC has received enhancements under the Reagan, Bush and Clinton administrations. Following the example set by the federal government, 19 states and the District of Columbia have enacted state-level earned income tax credits. In 2005 and 2006, Delaware and Nebraska created new EITCs, while Indiana, Oregon, Rhode Island, and the District of Columbia expanded their existing EITC programs. As other states have learned, linking to this federal program can improve tax *fairness* and provide wage enhancements for working families and individuals.

Effective in tax year 2006, Virginia will be the first Southern state to provide a state-level EITC, but it is not a refundable credit. All Southern states should consider the benefits of enacting a refundable state-level earned income tax credit for low and moderate-income families in the South.

Figure 1: State Earned Income Tax Credits	
Alabama	No
Arkansas	No
Florida	No income tax
Georgia	No
Kentucky	No
Louisiana	No
Mississippi	No
North Carolina	No
South Carolina	No
Tennessee	No broad-based income tax
Virginia	Yes, 20% of federal EITC, non-refundable

How the federal EITC works

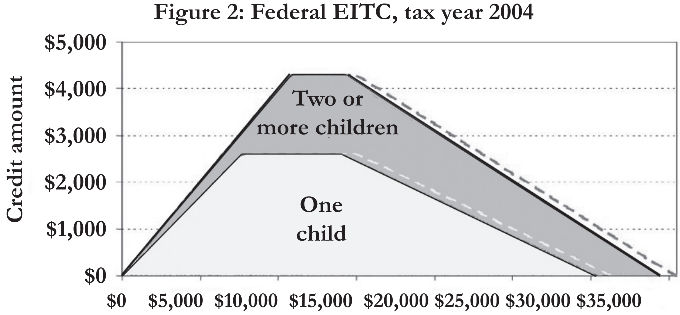
The federal EITC provides a credit and refund based on income and family size. Figure 2 illustrates the credit structure for different income levels and family compositions. Initially, the credit increases as income increases. After families reach a certain level of income however, the credit begins to decrease as income rises and phases out completely by $37,263. For tax year 2005:[2]

- Workers with one child and income less than $31,030 (or $33,030 for married filing jointly) could receive an EITC of up to $2,662.

- Workers with two or more children and income less than $35,263 (or $37,263 for married filing jointly) could receive an EITC of up to $4,400.

While the graph does not show credits for childless workers, there are smaller credits available for those workers. For tax year 2005, childless workers ages 25 to 64 with income below $11,750 (or $13,750 for married filing jointly) could receive an EITC of up to $399.

Figure 2: Federal EITC, tax year 2004



Source: *Center on Budget and Policy Priorities*
Note: Married couples with income in the phaseout range qualify for a higher credit than single parents—shown by dashed lines. Childless taxpayers are not shown but do qualify for a smaller credit

As shown in Figure 3, the federal EITC helps families across the South. In tax year 2003, the most recent year for available data, more than 6.4 million taxpayers in the South claimed the federal EITC for a total of over $12.1 billion.

Figure 3: Federal EITC claims, tax year 2003

State	Total tax returns	EITC claims	Share of returns claiming EITC	EITC amount
Alabama	1,835,245	473,872	25.8%	$966,598,821
Arkansas	1,094,925	272,269	24.9%	$520,673,980
Florida	7,611,223	1,522,835	20.0%	$2,741,529,828
Georgia	3,561,885	800,957	22.5%	$1,567,024,328
Kentucky	1,706,885	335,477	19.7%	$580,496,974
Louisiana	1,823,446	522,367	28.6%	$1,099,107,340
Mississippi	1,137,636	366,518	32.2%	$768,994,361
North Carolina	3,561,309	729,862	20.5%	$1,344,514,547
South Carolina	1,757,244	414,707	23.6%	$779,353,959
Tennessee	2,521,874	539,154	21.4%	$979,905,225
Virginia	3,302,139	482,732	14.6%	$833,408,420

Source: Brookings Institution, Metropolitan Policy Program[3]

Southern families in need

With a generous federal EITC program, is there a need for a similar state-level program? As discussed previously, state and local tax systems across the South are *regressive.* That is, those with the lowest incomes pay the highest share of their incomes in state and local taxes. Although low-income families pay a smaller share in income taxes, those families pay an excessively high share of income in sales and property taxes as compared to wealthier households. For example, non-elderly Arkansans in the lowest income quintile (average income of $7,000) pay an estimated 12.4 percent of their income in state and local sales, income and property taxes. That compares to a range of 6.1 percent to 9.5 percent tax obligation for Arkansas's highest earners after federal offsets.[4]

> **While low-income families pay a smaller share in income taxes, they pay an excessively high share of their income in sales and property taxes. The federal Earned Income Tax Credit is a *progressive* strategy that helps more than 6.4 million Southern taxpayers to get a better tax balance every year.**

To illustrate further, consider a family of four living in Arkansas with one parent working and one parent providing childcare. At a full-time, year-round job, the worker earns $9.00 an hour for an annual salary of $18,720, or just below the poverty guideline for a family of four in 2005. On its federal income tax form, this family, like more than 270,000 other Arkansans, applied for the federal EITC. The family received a refundable earned income credit of $3,900, which brought the family's income above the poverty line, offsets other federal withholding taxes, and provides wage enhancements to a family that likely has trouble paying the bills. In contrast to the federal refund, the Arkansas family owes an estimated $350 in state income taxes.[5] This $350 income tax obligation is in addition to the *regressive* sales and property tax the family faces.

A state EITC can correct for such circumstances by lowering income taxes on working poor families. If the state EITC is refundable, it can also offset other taxes, such as state sales and property taxes. Enacting a state EITC increases the *fairness* of the state tax system overall by increasing the *progressivity* of the income tax system and lessening the *regressivity* of the sales and property taxes.

Designing a state EITC

Designing a state EITC is relatively straightforward as examples exist in 19 other states and the program piggybacks on the structure of the federal EITC. For the most part, variations in design center around three components related to how generous the program will be:

- **Level of credit.** States base their credit levels and eligibility rules on the federal EITC. The level of credit is a percentage of the federal credit and ranges from 5 percent to 50 percent among states. For example, Oklahoma's EITC is 5 percent of the federal EITC. Vermont's EITC is 32 percent. Thus, a family qualifying for a federal EITC of $4,000 would receive a $200 state credit if they live in Oklahoma or a $1,280 state credit if they live in Vermont. Figure 4 shows the state EITC benefits at the 5 percent, 10 percent and 20 percent levels of the federal credit for different family incomes and sizes.

Figure 4: EITC by family type and income level, 2005					
	Gross earnings	Federal EITC	20% state EITC	10% state EITC	5% state EITC
Family of four with two children					
Full-time minimum wage	$ 10,700	$ 4,290	$ 858	$ 429	$ 215
Wages equal to poverty line	$ 19,350	$ 3,767	$ 753	$ 377	$ 188
Wages equal to 150% of poverty line	$ 29,025	$ 1,735	$ 347	$ 174	$ 87
Family of three with one child					
Full-time minimum wage	$ 10,700	$ 2,662	$ 532	$ 266	$ 133
Wages equal to poverty line	$ 16,090	$ 2,662	$ 532	$ 266	$ 133
Wages equal to 150% of poverty line	$ 24,135	$ 1,423	$ 285	$ 142	$ 71

Source: GBPI calculations using IRS EIC tax tables and Nagle (2005)[6]

- **Refundable versus non-refundable.** As noted previously, the federal EITC is a refundable credit. That means families receive a refund for the amount of the credit that is in excess of the income taxes they owe. If a family owes $300 in federal income taxes and qualifies for a $2,000 EITC, they will receive a refund of $1,700. The majority of states with an EITC also make the credit refundable. This provides income tax assistance and offsets other taxes, such as sales and property. Delaware, Iowa, Maine, and Virginia have non-refundable credits, which lowers the income tax liability but does not offer further assistance. Consider a family with a $100 state income tax liability that qualifies for a $150 state EITC. With a non-refundable EITC, their taxes are reduced to zero but they do not receive the additional $50. Since 2000, the majority of states that have created or expanded their EITC have chosen to make the credit refundable.

- **Interaction with Existing Low-Income Tax Credit.** A final design concern is the interaction of existing low income tax credits with a new state earned income tax credit. Several states already have low income tax credits; however, those credits often suffer from the following drawbacks: they are not indexed to inflation and they do not reward work. In contrast, state EITCs automatically adjust for inflation since they are linked to the federal EITC, which is indexed for inflation. Additionally, state EITCs reward work by providing a tax credit that rises as income increases, thus encouraging additional work and earnings. Although state-level EITCs offer many advantages over existing low income credits, they are mainly focused on working families with children. For this reason, certain taxpayers (usually those without children) would benefit more under existing credit programs. Thus, a state EITC should not necessarily replace existing low income tax credits, but instead, work as a complement.

Estimating the cost

The cost of a state EITC depends on the level of credit and refundable component discussed above, as well as the number of residents claiming the EITC. A non-refundable credit would be a loss of income tax revenues, while a refundable credit would be both a loss of income tax revenues and the cost of the refundable portion that is beyond a family's tax liability.

Using 2004 data on the number of federal EITC claims in each state, the Center on Budget and Policy Priorities estimated the following cost for a refundable EITC in Southern states that have income taxes and do not currently have EITCs (Figure 5).

Figure 5: Estimated cost of refundable state EITC for FY 2007

State	Percentage of federal credit		
	5% of federal credit	10% of federal credit	20% of federal credit
Alabama	$47 million	$95 million	$190 million
Arkansas	$26 million	$51 million	$102 million
Georgia	$79 million	$159 million	$318 million
Kentucky	$28 million	$57 million	$114 million
Louisiana	$54 million	$108 million	$216 million
Mississippi	$38 million	$75 million	$150 million
North Carolina	$66 million	$133 million	$266 million
South Carolina	$38 million	$76 million	$153 million

Source: Center on Budget and Policy Priorities[7]
Note: Cost estimate assumes a 90 percent participation rate.

An additional cost consideration is the availability of Temporary Assistance for Needy Families (TANF) funds. While states can pay for the program through General Fund revenues, the federal government also allows states to pay for the refundable portion of state EITCs using federal TANF funds or state Maintenance of Effort (MOE) funds. The federal government recognizes that the EITC is a work incentive since it provides assistance for families transitioning to work, and thus, can be included in the goals of TANF. One consideration, however, is that the use of TANF or MOE funds for a state EITC would reduce the amount of money going to other assistance programs such as cash assistance, child care and other programs. Thus, there would need to be a thoughtful policy discussion on whether to include the EITC in this stream of funding, as it might affect funds available to other programs.

The federal Earned Income Tax Credit is considered a work incentive because it helps families transition to work. States can consider it to be the same.

Learning from and improving upon Virginia's example

In 2004, Virginia's General Assembly passed legislation (HB 5018) establishing a state-level earned income tax credit. Beginning in tax year 2006, qualifying Virginians can claim a non-refundable state EITC equal to 20 percent of the federal credit. The cost of the EITC program will be an estimated $61.3 million in FY 2007, $62.4 million in FY 2008, and $63.7 million in FY 2009.[8] Virginia offers a blueprint for other states that already have low-income tax credits since Virginia's EITC will not replace the existing low-income tax credit. Rather, residents will be able to apply for either the new EITC or the existing low-income tax credit. While Virginia's EITC would benefit from a refundable component, Southern states should watch to see how

Virginia's program works and how they can implement similar programs in their own states.

> **Virginia offers a blueprint for other states that already have low-income tax credits since Virginia's EITC will not replace the existing low-income tax credit.**

Helping low-income families by making work pay

The federal earned income tax credit has long been associated with making work pay. Through tax assistance and work supplements, the EITC brings incomes above the poverty line and helps working families make ends meet. Nineteen states and the District of Columbia have also recognized that state-level EITCs can balance the *regressive* nature of state and local taxes and assist working families. Virginia remains the only Southern state to enact an EITC, which itself is non-refundable.

Southern states, including Virginia, should consider the benefits of creating a refundable state EITC as one more step towards a fair, balanced tax structure.

Talking points

- Millions of working families across the South live at or below the poverty level.

- One way to give hope to these Southerners and to help balance the *regressive* sales and property taxes is to provide an Earned Income Tax Credit to families that work.

- An Earned Income Tax Credit is not welfare. It is a tool to help working families get out of poverty.

- No Southern state has a refundable EITC and only one—Virginia—has a non-refundable credit. Refundable credits are preferable because they provide needed cash that can lift some families out of poverty.

- A state-level Earned Income Tax Credit should not be a partisan issue. At the federal level, the EITC program has been expanded under Republican and Democratic administrations.

- The issue for Southern states is to help lessen the burden of sales and property taxes for working poor families by taking advantage of the *progressive* nature of the income tax.

Endnotes

[1] Greenstein, Robert. *The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor*. Center on Budget and Policy Priorities. August 17, 2005. *www.cbpp.org*.

[2] Internal Revenue Service.

[3] *2005-2006 Congressional Districts EITC Data*. Brookings Institution, Metropolitan Policy Program. *www.brookings.edu/es/urban/eitc.htm. (excel spreadsheet download*)

[4] Calculations by the Institute on Taxation and Economic Policy, August 2004 from: Metzger, James. *Property Tax Reform for Arkansas*. Arkansas Advocates for Family and Children. March 2005. *www.aradvocates.org/_images/pdfs/propertytax.pdf*.

[5] GBPI estimates based on H&R Block Tax Estimator and Arkansas Department of Finance and Administration tax publications.

[6] Nagle, Ami and Johnson, Nick. *A Hand Up: How Earned Income Tax Credits Help Working Families Escape Poverty in 2006*. Center on Budget and Policy Priorities. March 2006. *www.cbpp.org*.

[7] *Ibid*.

[8] Interview with staff at the Virginia Department of Taxation. May 10, 2005.