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A HAND UP
How State Earned Income Tax Credits Help Working Families Escape Poverty in 2003

Summary

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Earned Income Tax Credits provide tax reductions and wage supplements for low- and moderate-income working families. The federal tax system has included an EITC since 1975, with major expansions in 1986, 1990, and 1993, and an additional expansion in 2001. More than 19 million families and individuals filing federal income tax returns — roughly one out of every seven families who file — claim the federal EITC.

The EITC has been widely praised for its success in supporting work and reducing poverty. The federal credit now lifts more children out of poverty than any other government program. Some 4.8 million people, including 2.6 million children, are removed from poverty as a result of the federal EITC. The federal EITC also has been proven effective in encouraging work among welfare recipients; studies show it has a large impact in inducing more single mothers to work. Support for the EITC has come from across the political spectrum.

The success of the federal EITC has lead a number of states to enact state Earned Income Tax Credits that supplement the federal credit.

- Seventeen states now offer state EITCs based on the federal credit. In addition, two local governments — Montgomery County, Maryland, and Denver, Colorado — offer local EITCs. Like the federal credit, state EITCs have gained support across the political spectrum. EITCs have been enacted in states led by Republicans, states led by Democrats, and states with bipartisan leadership. The credits are supported by business groups as well as social service advocates.

- In the current challenging fiscal environment, when most states are cutting spending, raising taxes, or both, state EITCs may be vulnerable. Indeed, **Colorado** has suspended its EITC, and the EITC in **Illinois** will expire unless the legislature and governor extend it.

- On the other hand, many state policymakers recognize the continuing importance of an EITC in difficult economic times. At a time of high unemployment and declining wages, state EITCs can help working families stay afloat. And when states are raising taxes in ways that may be burdensome to low-income families, state EITCs can relieve some of that burden. Despite the fiscal crisis, **Indiana** in 2002 created a state EITC based on the federal credit, and **Kansas** expanded its existing EITC.

Other states are considering similar actions.

Why Consider a State EITC?

Several developments explain the popularity of state EITCs, including the continued prevalence of poverty among children, the importance under welfare reform of supporting families' transition from welfare to work, and interest in tax changes that promote tax fairness.

State EITCs Reduce Poverty Among Children

In 2001, the Census Bureau reported that nearly one child in six still lived in poverty. Most poor children lived in families with a working parent.

- Some 4.6 million families with children in which the parents were not elderly or disabled had incomes below the federal poverty line.[1] In 68 percent of these families, at least one parent was working.
- About 12.2 million people, including 7 million children, lived in working poor families. In 2003 dollars, that means living on less than about $14,600 for a family of three or $18,800 for a family of four.
- High unemployment and declining real wages have likely increased poverty among working families since 2001.

Earned Income Tax Credits can lift families out of poverty by supplementing their wages.

- For example, a family of four with two children and a full-time, year-round worker earning about $7 per hour (well above minimum wage) has wages after payroll taxes of about $13,600 per year, several thousand dollars below the poverty line.
- Such a family in 2003 qualifies for a federal EITC of $4,204 and a small federal child tax credit of $420, bringing its income close to the poverty line.
- If the family lived in a state that offered a state EITC set at 15 percent of the federal credit, the family would receive an additional $631, for total cash income of $18,830 — slightly above the poverty line. An EITC set at a larger percent of the federal credit could raise the family's income further above the poverty line.

State EITCs Complement Welfare Reform

Although large numbers of welfare recipients have entered the workforce, many cannot make ends meet on their earnings alone. State EITCs support families who enter and remain in the workforce.

- Many welfare recipients who take jobs continue to have very low incomes, often below poverty. Studies show that welfare recipients who find jobs typically earn $2,000 to $3,000 per quarter, or $8,000 to $12,000 per year, well below the poverty line for a family of three. The combination of the federal EITC and a state EITC can close the poverty gap for many welfare recipients as they move into the workforce.
- State EITCs also support the work efforts of low- and moderate-income families who have long since left the welfare rolls or who have never received welfare benefits. EITCs help meet the

ongoing expenses associated with working, such as transportation, and may allow families to cope with unforeseen costs that otherwise might drive them onto public assistance.

- Emerging research shows that many EITC recipients use their EITC refunds not only to meet day-to-day expenses but also to make the kinds of investments — paying off debt, investing in education, obtaining housing — that enhance economic security and promote economic opportunity.

State EITCs Provide Needed Tax Relief during Times of Fiscal Stress

State EITCs also pay a role in shaping state tax systems. A number of states are responding to weak fiscal conditions by increasing taxes and fees. Enacting a state EITC is a way to reduce, or at least avoid increasing, the already-substantial burden of state and local taxes on the poor.

- In 19 of 42 states with a personal income tax, working poor families with children may pay income taxes. For a two-parent family of four in the states that taxed the poor in 2001, the average income tax threshold — the point at which families began owing tax — was $12,900, some $5,000 below the poverty line for a family of four. The average tax on a family with income at the poverty line was $244.[2]

- In addition, most states rely heavily on sales, excise, and property taxes, with the result that state tax systems are quire regressive. In 2002, the average state and local tax burden on the poorest fifth of married, non-elderly families was 11.4 percent of income. By contrast, the average burden on the wealthiest one percent of such families was 7.3 percent of income.[3]

- When states face difficult fiscal times, they often increase these regressive taxes. State EITCs help reduce tax regressivity and help poor families meet their tax obligations.

Designing a State EITC

Table 1 lists the states that have enacted Earned Income Tax Credits.

- **Colorado,** the **District of Columbia, Illinois, Indiana, Iowa, Kansas, Maine, Maryland, Massachusetts, New Jersey, New York, Oklahoma, Oregon, Rhode Island, Vermont** and **Wisconsin** offer EITCs that piggyback on the federal EITC; these 16 states use federal eligibility rules and express the state credit as a specified percentage (anywhere from 5 percent to 50 percent) of the federal credit. By setting the state credit as a flat percentage of the federal credit, states make the state credit fairly simple for taxpayers to compute. A 17th state, **Minnesota**, also offers an EITC based on federal eligibility rules with a structure very closely related to that of the federal credit.

- Twelve states — **Colorado,** the **District of Columbia, Indiana, Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oklahoma, Vermont** and **Wisconsin** — follow the federal practice of making the credit "refundable." Because the federal credit is refundable, a family receives the full amount of its credit even if the credit amount is greater than the family's

Table 1
State Earned Income Tax Credits Based on the Federal EITC

State	Percentage of Federal Credit
Refundable credits:	
Colorado	10% (suspended for 2002; may be suspended for 2003)
Dist. of Columbia	25%
Indiana	6%
Kansas	15%
Maryland*	18% in 2003; 20% thereafter
Massachusetts	15%
Minnesota	Varies with earnings; average 33%
New Jersey	20% (if income < $20,000)
New York	30%
Oklahoma	5%
Vermont	32%
Wisconsin	4% — one child 14% — two children 43% — three children
Non refundable credits	
Illinois	5% (expires after 2002 unless extended by legislature)
Iowa	6.5%
Maine	5%
Oregon	5%
Rhode Island	25%

*Maryland also offers a non-refundable EITC set at 50 percent of the credit. Taxpayers in effect may claim either the refundable credit or the non-refundable credit, but not both.
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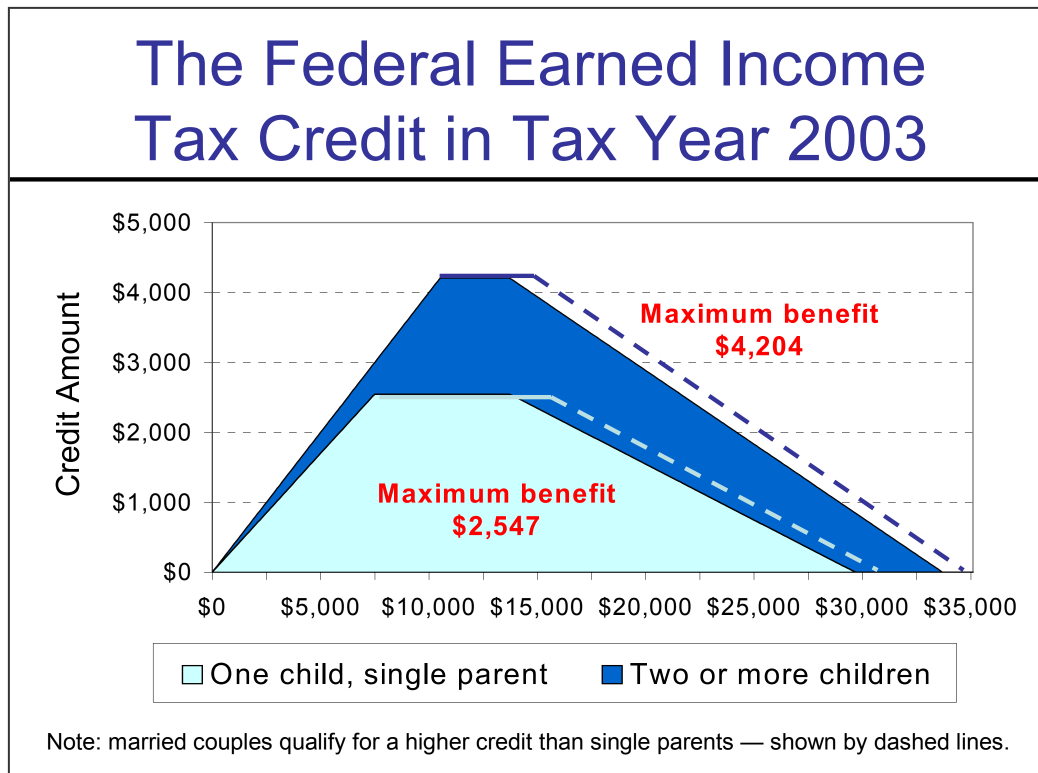
income tax liability. If a state follows the federal practice of making its state EITC refundable, the credit will benefit a wide range of low-income working families with children, including workers just entering the work force and those with very low earnings.

- Five other states — **Illinois, Iowa, Maine, Oregon,** and **Rhode Island** — offer "non-refundable" credits that limit the amount of a credit to a family's income tax liability. A non-refundable EITC can provide substantial tax relief to some families that have income too low to owe states income taxes. A non-refundable credit assists fewer working-poor families with children and is less likely effective as a work incentive.

- States increasingly prefer the advantages of a refundable credit. Ten of the 12 state credits that were enacted or expanded in 2000, 2001 or 2002 — the credits in **Colorado,** the **District of Columbia, Indiana, Kansas, Maryland, Massachusetts, New Jersey, New York, Oklahoma** and **Vermont** — are refundable.

- The federal EITC provides a somewhat larger credit to families with two or



more children than to families with just one child, in recognition of the increased cost of living for large families. One state, **Wisconsin,** goes further: It provides a small state EITC to families with one child, a larger state EITC to families with two children, and a much larger state EITC to families with three or more children.

Financing a State EITC

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 learn about and claim the state credit. Because state EITCs are well targeted to low- and moderate-income working families, the cost may be relatively modest. The annual cost of refundable EITCs ranges from about $14 million in **Vermont** to $423 million in **New York.** (A relatively straightforward procedure for estimating the cost of a refundable credit in each state is described in a forthcoming paper entitled *How Much Would a State EITC Cost?*)

Most state credits to date have been financed 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, as it has been in **Indiana** and **Kansas,** such as a sales tax increase, a part of the proceeds of the revenue increase may be set aside for the EITC. New federal regulations offer the opportunity to finance a portion of the cost of a refundable credit from the federal Temporary Assistance to Needy Families block grant. Whether general funds or block-grant funds are the most appropriate

How the EITC Works

The federal Earned Income Tax Credit goes only to households with earnings, with the size of the credit initially rising as earnings increase. The credit is capped at $4,204 for a family with two children and $2,547 for a family with one child; the credit then phases out gradually. Families with two children may qualify if their incomes are as high as $34,692. The credit is phased out at a slightly higher income level for married couple families than for other families. Low-income workers without a qualifying child also may receive a federal EITC, but the maximum credit for individuals or couple without children is $382 in 2003, much lower than the credit for families with children. The chart above illustrates the structure of the credit for families with children.

Most state EITCs are structured in the same way as the federal credit except that the amount of credit at each income level is lower. The table below shows the amount of federal and state credit for families at various income levels.

Earned Income Tax Credit Amounts by Family Income Levels, 2003

	Gross Earnings	Federal EITC	25% State EITC	15% State EITC
Family of four with two children				
Half-time minimum wage	$5,350	$2,140	$535	$321
Full-time minimum wage	$10,700	$4,204	$1,051	$631
Wages equal federal poverty line	$18,800	$3,347	$837	$502
Wages equal 150% of poverty line	$28,200	$1,367	$342	$205
Family of three with one child				
Half-time minimum wage	$5,350	$1,819	$455	$273
Full-time minimum wage	$10,700	$2,547	$637	$382
Wages equal federal poverty line	$14,600	$2,547	$637	$382
Wages equal 150% of poverty line	$21,900	$1,401	$350	$210

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funding stream to use to finance the credit will depend on a number of factors, including the specifics of a state's budget situation, the amount of unallocated TANF funds or "maintenance of effort" funds available to the state, and the state's priorities for use of TANF funds. No matter how it is financed, however, an EITC can complement a state's welfare program by assisting low-income working families with children.

For More Information

A more detailed description of state Earned Income Tax Credits is provided in the Center on Budget and Policy Priorities publication entitled *A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty, 2001 Edition.* This publication is available from the Center by calling (202) 408-1080 or by visiting the Center's Web site at www.cbpp.org.

[1] These figures were tabulated from the U.S. Census Bureau's Current Population Survey, March 2002. An additional 700,000 poor families had parents who were ill, elderly or disabled, and thus were not able to work.

[2] Center on Budget and Polity Priorities, *State Income Tax Burdens on Low-Income Families in 2001.* March 2002. This report is updated annually.

[3] Institute on Taxation and Economic Policy, *Who Pays?: A Distributed Analysis of the Tax Systems in All 50 States,* 2nd edition, January 2003.