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TESTIMONY BEFORE THE PENNSYLVANIA HOUSE OF REPRESENTATIVES FINANCE COMMITTEE ON STATE EARNED INCOME TAX CREDITS

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Chairman Leh, Chairman Levdansky and members of the committee:

Thank you for the opportunity to testify today about the Earned Income Tax Credit, or EITC. My name is Nicholas Johnson. I am Director of the State Fiscal Project at the Center on Budget and Policy Priorities. The Center is a non-profit, non-partisan research institute in Washington. Our policy work addresses a range of government policies, with a particular focus on their impacts on low- and moderate-income families. My work for the last ten years has focused on state tax and budget policies. A major area of concentration for me has been the design and implementation of state tax policies that are targeted to poor families, particularly working-poor families.

My remarks today focus on three areas:

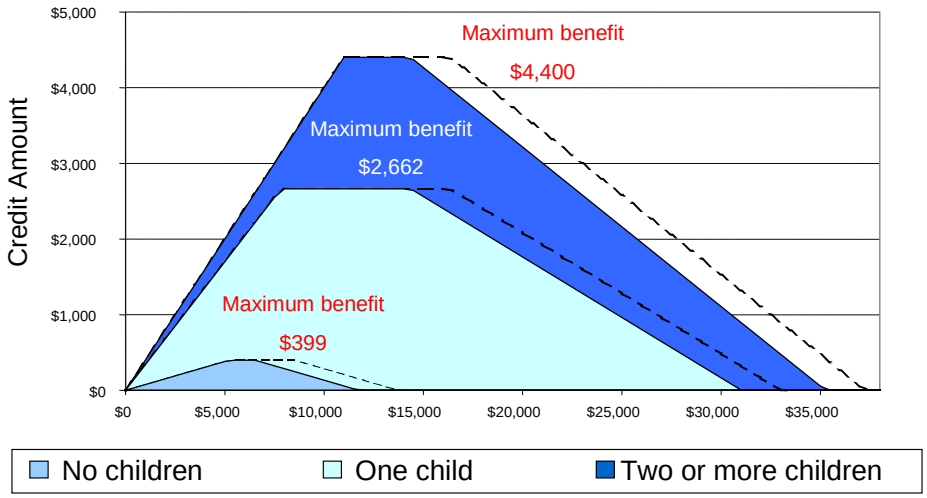
- I will describe the federal EITC and the state EITCs that have been enacted in 19 states.
- I will explain how a Pennsylvania state EITC might operate and who would benefit.
- I will place the possibility of a Pennsylvania state EITC in the context of current discussions of an increase in the state minimum wage.

Federal and State EITCs

The Earned Income Tax Credit addresses a fundamental problem: many working families do not earn enough to live on. Their wages are low and the costs of supporting a family — food, clothing, housing, transportation, job-related costs, health care and so on — are substantial. Some of those costs may be defrayed through various forms of public programs. But most low-income families who are working receive only limited help from public programs.

FIGURE 1

The Federal Earned Income Tax Credit in Tax Year 2005



Note: Married couples with income in the phaseout range qualify for a higher credit than single parents — shown by dashed lines.

In Pennsylvania in 2003, there were about 163,000 *working* families with children whose incomes fell below the federal poverty line. (The federal poverty line varies by family size and is adjusted each year for inflation; in 2006 dollars, the poverty line for a family of four is roughly $20,000.) Several hundred thousand more working families in Pennsylvania have incomes slightly above the federal poverty line but still have difficulty making ends meet.

One cost that low-income Pennsylvania families face to a greater extent than families in other states is state and local taxes. I should note that Pennsylvania no longer levies *income* tax on low-income families, because of the "tax forgiveness" credit which is claimed on Schedule SP of the Pennsylvania income tax form. This credit has been expanded substantially since the mid-1990s; it now eliminates income tax liability for a family of four with income up to $32,000.

However, Pennsylvania families – particularly working families with relatively low incomes – pay substantial amounts of *other* state and local taxes. These include general sales taxes, excise taxes, property taxes, and local wage taxes, among others. The Institute on Taxation and Economic Policy estimates that the lowest-income 20 percent of Pennsylvania households in 2002 paid, on average, 11.4 percent of their incomes in state and local taxes, a higher share than any other income group.

The Federal EITC

The Earned Income Tax Credit is a wage supplement for low- and moderate-income working families, administered through the income tax. The federal Earned Income Tax Credit was enacted in 1975, and major expansions were enacted in 1986, 1990, and 1993. Today it is widely recognized as the single most important public source of income support for working families with children.

The EITC is available, by design, only to working families. The maximum EITC benefit for the 2006 tax year is $4,520 for families with two or more children and $2,737 for families with one child. The greater EITC benefit for larger families reflects recognition that larger families face higher living expenses than smaller families.

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. A family with two or more children, for example, receives an EITC equal to 40 cents for each dollar earned if their earnings are $11,000 or less. The rate is slightly lower, 34 cents, for one-child families. In this way, the EITC acts as a wage subsidy.

The maximum credit is available to single-parent families with incomes up to $14,760, or two-parent families with incomes up to $16,760. Above those income levels, the EITC gradually phases out, so that families with incomes as high as $37,000 may receive some benefit from the credit.

Workers without a qualifying child also may receive an EITC, but the maximum credit for individuals or couples without children is $411 in 2006, much lower than the credit for families with children, and the income eligibility range is much smaller.

The effectiveness of the federal EITC both in supporting work and in alleviating child poverty has been confirmed by a number of recent studies.

- The EITC 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.

- A substantial body of academic research now shows that the credit has contributed to a significant increase in labor force participation among single mothers.

- 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.

State EITCs

Since the late 1980s, some 19 states have enacted EITCs of their own. 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 typically are supported by business groups, social service advocates, faith-based groups, labor unions, and others.

State EITCs are very simple. They are nearly always set at a flat percentage of the federal credit. In other words, a family's state EITC equals its federal credit multiplied by a given percentage rate — for example, 30 percent in New York, 20 percent in New Jersey, 6 percent in Indiana, 15 percent in Kansas. A New York family that receives a $3,000 federal EITC, for example, would qualify for a $900 New York State EITC.

TABLE 1: RECEIPT OF FEDERAL EITC IN PENNSYLVANIA (TY2002)					
County	**Number of Tax Filers Receiving EITC**	**Total EITC Amounts Received ($)**	**County**	**Number of Tax Filers Receiving EITC**	**Total EITC Amounts Received ($)**
Adams	4,708	7,357,774	*Continued from previous column*		
Allegheny	67,613	105,396,379	Lackawanna	12,477	19,652,328
Armstrong	4,390	6,850,350	Lancaster	23,672	38,317,465
Beaver	9,942	15,373,804	Lawrence	6,470	10,341,358
Bedford	3,605	5,728,388	Lebanon	6,755	10,713,828
Berks	22,080	35,755,109	Lehigh	18,554	31,163,838
Blair	9,173	14,520,607	Luzerne	18,535	28,937,675
Bradford	4,631	7,459,643	Lycoming	8,373	13,544,104
Bucks	19,654	28,405,078	McKean	3,128	5,182,892
Butler	8,626	12,849,342	Mercer	7,624	12,663,395
Cambria	10,242	15,935,878	Mifflin	2,996	4,606,777
Cameron	407	659,060	Monroe	8,448	13,792,214
Carbon	3,711	5,874,061	Montgomery	22,604	32,647,095
Centre	5,100	7,385,921	Montour	976	1,519,949
Chester	12,656	18,842,811	Northampton	14,205	22,599,474
Clarion	2,570	3,942,024	Northumberland	6,131	9,779,044
Clearfield	5,938	9,226,476	Perry	2,511	3,835,987
Clinton	2,259	3,675,681	Philadelphia	156,733	280,901,522
Columbia	3,963	6,124,371	Pike	2,256	3,774,596
Crawford	6,178	10,033,961	Potter	1,331	2,162,004
Cumberland	8,366	12,436,617	Schuylkill	8,758	13,265,045
Dauphin	17,014	27,532,522	Snyder	2,264	3,472,962
Delaware	28,424	45,945,558	Somerset	5,583	8,632,496
Elk	1,900	2,761,754	Sullivan	428	634,833
Erie	20,584	34,426,825	Susquehanna	3,099	5,128,733
Fayette	11,962	19,855,856	Tioga	3,249	5,448,765
Forest	413	648,502	Union	1,862	2,862,935
Franklin	7,525	11,665,370	Venango	4,104	6,665,931
Fulton	1,036	1,507,073	Warren	2,855	4,619,663
Greene	2,917	4,916,657	Washington	11,512	17,813,377
Huntingdon	3,009	4,783,770	Wayne	3,726	5,995,425
Indiana	5,230	8,000,115	Westmoreland	19,863	30,233,082
Jefferson	3,376	5,319,284	Wyoming	2,125	3,479,579
Juniata	1,350	2,076,395	York	21,359	33,985,583
			All counties, total	**735,118**	**1,191,646,970**

Source: The Brookings Institution, Metropolitan Policy Program, Earned Income Tax Credit data from Internal Revenue Service, TY2002; Center on Budget and Policy Priorities.

Because it is administered through the income tax, compliance and administrative costs of the EITC are quite low. Administrative costs for the federal EITC are less than 1 percent of total cost, much lower than the costs of other federally funded income support programs such as Food Stamps. For states, the administrative cost of an EITC is even lower because the Internal Revenue Service does much of the work. For instance, the federal government uses mechanisms such as large databases of social security numbers to screen for ineligible EITC applicants and reject their claims. States, in effect, piggyback on these federal enforcement mechanisms.

Fifteen of the existing 19 state EITCs follow federal practice of offering credits that are *refundable*. This means a family receives the full amount of its credit even if the credit amount is greater than its 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. This enables the EITC to operate as a wage subsidy and an offset to *all* state and local taxes, not simply an offset to state income tax liability.

Among Pennsylvania's neighbors, New York, New Jersey, and Maryland offer refundable EITCs, while Delaware offers a non-refundable EITC. Among 20 Northeastern, Mid-Atlantic and Great Lakes states, Pennsylvania is among only six that do not offer an EITC.

A Pennsylvania EITC

More than 700,000 Pennsylvania tax filers each year benefit from the federal EITC and therefore would receive a Pennsylvania EITC. Table 1 lists the number of Pennsylvania tax filers receiving the credit by county.

I noted earlier that Pennsylvania already offers a tax credit, known as "tax forgiveness," that eliminates income tax liability for families with incomes below specific thresholds. Unlike the federal EITC and most state EITCs, however, tax forgiveness is not refundable, and so it does not function as a wage subsidy or offset other taxes. It merely eliminates income tax liability, an important but limited feature. In addition, the top income at which a family benefits from tax forgiveness tend to be slightly lower than for the EITC. (Example: for a two-parent, two-child family, the income cut-off is $34,250 for tax forgiveness but about $38,000 for the EITC.)

A Pennsylvania state EITC would augment the tax forgiveness credit by providing a refund to many families with children.

For families that qualify for both full tax forgiveness and the EITC, the EITC most likely would be structured as a refund to be applied after tax forgiveness is applied to the income tax. Tax forgiveness would eliminate income tax liability; the EITC then would provide a refund.

TABLE 2: WHICH STATES HAVE EITCS AND/OR MINIMUM WAGE HIGHER THAN FEDERAL?

***Both* Minimum Wage Higher than Federal *and* State EITC**	**Minimum Wage Higher than Federal Only**	**State EITC Only**
Delaware	Alaska	Colorado*
District of Columbia	California	Indiana
Illinois	Connecticut	Iowa
Maine	Florida	Kansas
Maryland	Hawaii	Oklahoma
Massachusetts	Washington	Virginia
Minnesota		
New Jersey		
New York		
Oregon		
Rhode Island		
Vermont		
Wisconsin		

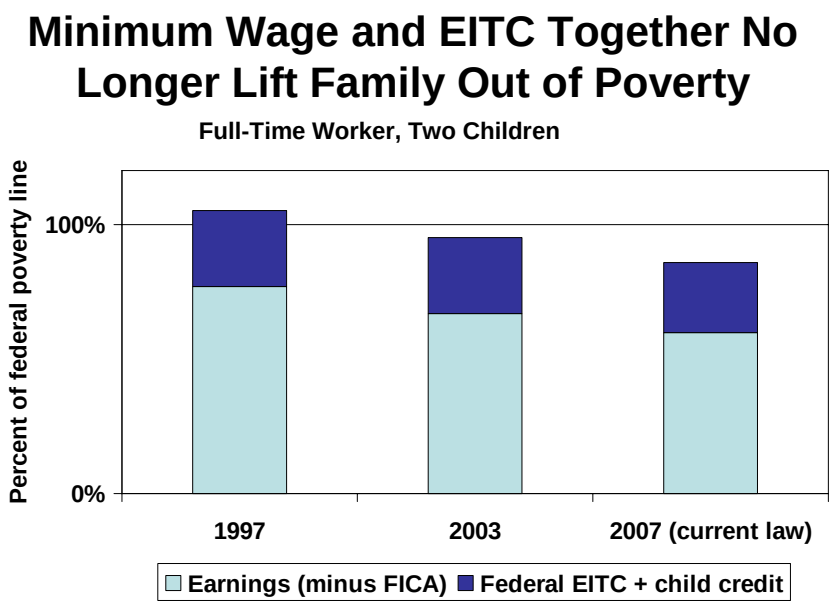
*Colorado EITC is presently suspended.
Sources: U.S. Department of Labor, Employment Standards Administration, Wage and Hour Division; Center on Budget and Policy Priorities.

For families for whom tax forgiveness reduces but does not eliminate income tax liability, or for those who do not qualify for tax forgiveness, the EITC would count against remaining tax liability.[1]

Pennsylvania EITC refunds could be used to offset the burden of other state and local taxes, such as sales, excise or property taxes, or to meet other costs associated with working such as transportation, child care, and so on.

[1] An alternative approach would provide a state EITC benefit only to the extent that the benefit exceeds a family's tax forgiveness. This would reduce the EITC's benefit for most families as well as the overall fiscal cost to the state.

FIGURE 2



Taxpayers that do not qualify for an EITC, of course, still would be fully eligible for tax forgiveness as under current law.

EITCs and the Minimum Wage

An Earned Income Tax Credit and a minimum wage are complementary policies, not alternatives to each other.

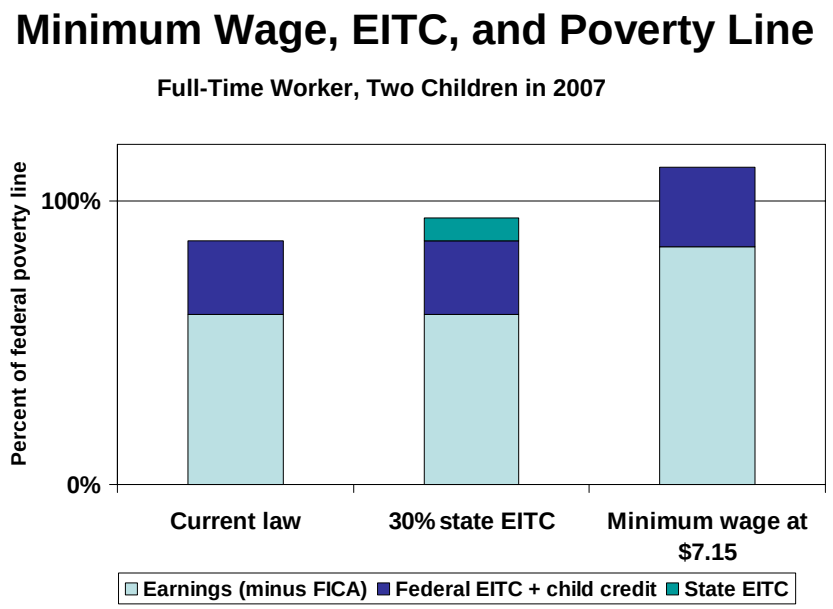
At the federal level, at least until just a few years ago, the EITC and the minimum wage worked together to lift families out of poverty. As recently as 1997, a full-time, year-round job at the minimum wage, combined with the federal EITC, was sufficient to lift a family's after-tax income above the federal poverty line for a family of three.

But with the erosion of the minimum wage over the last eight years, it is no longer the case that a minimum-wage job lifts a family out of poverty. Since 1997, the federal minimum wage has been frozen at a nominal level of $5.15 per hour. In inflation-adjusted terms, it has declined. (See Figure 2.)

A further problem is that a full-time worker at the federal minimum wage with two or more children no longer earns enough to qualify for the maximum EITC. This is because the parameters of the EITC are indexed for inflation; the minimum wage is not.

As a result, the combined effect of net wages and the EITC now fall substantially short of the federal poverty line for a family of three.

FIGURE 3



A state EITC, by itself, does not solve this fundamental problem caused by the eroding minimum wage. Figure 3 shows that increasing the minimum wage to $7.15 per hour in 2007, as has been proposed, would restore a full-time worker's after-tax income to roughly what it was in 1997. A state EITC set at 30 percent of the federal EITC – which would be among the nation's largest – by itself would go only about halfway to lifting income above the poverty line.

In addition to providing different amounts of benefits to a full-time minimum-wage worker, an EITC and an increased minimum wage differ in other important ways.

A somewhat larger number of families benefit from a state EITC than a minimum wage increase, for example. The Economic Policy Institute estimates that a $7.25 minimum wage in 2004 would have aided some 366,000 Pennsylvania workers. This number is roughly half the number of tax filers benefiting from an EITC.

The policies differ also in the types of families that are helped the most. Minimum wage increases assist the lowest-wage workers regardless of family structure. An EITC almost exclusively benefits families with children.

Another difference between the policies is that a state EITC is paid in a lump sum at the end of the year, when families file their tax returns. The benefits of minimum wage increases show up directly in families' paychecks and can be used to pay bills throughout the year.

One reasonable strategy pursued by many states is to enact *both* a minimum wage increase and a state EITC. Thirteen states – including a majority of Northeastern, Mid-Atlantic and Great Lakes states – now have both a state EITC and a state minimum wage above the federal minimum. In fact, the

number of states nationwide that have enacted both policies is greater than the number of states that have adopted only one or the other.

The increasingly widespread embrace of both EITCs and increased minimum wages suggests growing consensus that making work pay for low-income families should not be the responsibility of the private sector alone, nor the responsibility of the public sector alone. Rather, lifting working families out of poverty and toward the middle class should be a shared responsibility of employers, the government, and — of course — the working families themselves.

To conclude, the Earned Income Tax Credit is an administratively straightforward mechanism that has proven successful in supporting work and lifting low-income working families out of poverty. I welcome your questions.