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# STATE EARNED INCOME TAX CREDITS: 2008 LEGISLATIVE UPDATE

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Twenty-four states (counting the District of Columbia) have enacted an Earned Income Tax Credit (EITC), a tax reduction and a wage supplement for low- and moderate-income working families. State EITCs are based on the federal EITC, which a large body of evidence has shown to serve a number of important public policy goals. 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

Since 2006, five states have enacted new EITCs — Washington in 2008, North Carolina, Louisiana, and New Mexico in 2007, and Michigan in late 2006 — bringing the total number of states with an EITC to 24. Eight other states improved their credits: Illinois, Indiana, Iowa, Kansas, Nebraska, New Jersey, Oregon, and the District of Columbia. Furthermore, New Mexico and North Carolina followed up in 2008 by expanding their recently enacted credits.

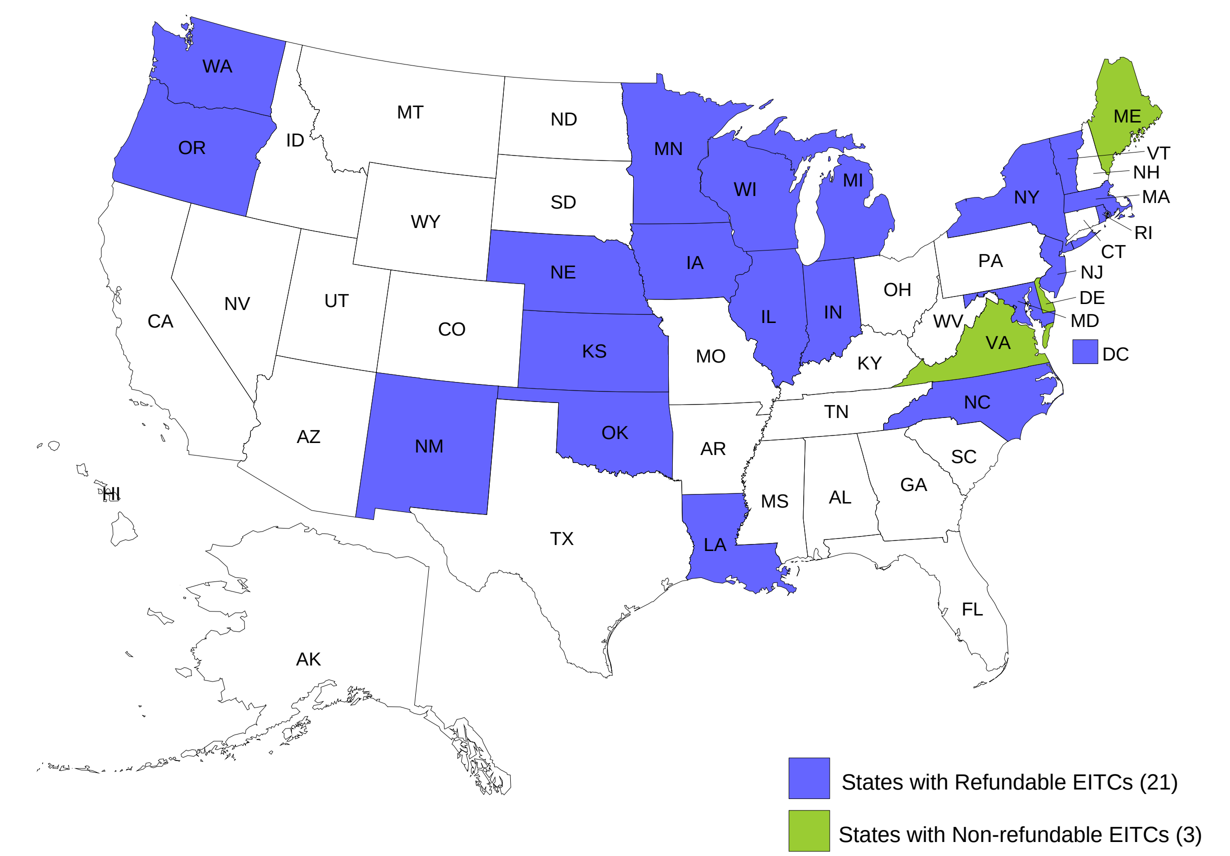
When these new and improved EITCs are fully implemented, nearly two out of five recipients of the federal EITC will live in a state with an EITC. Annual state EITC benefits will exceed $2 billion.

The 24 states with EITCs include 23 of the 42 states with broad-based income taxes — well over half. In addition, two local governments — New York City and Montgomery County, Maryland — offer local EITCs. States without income taxes are also starting to offer them. In 2008, Washington became the first of the nine states without a broad-based income tax to enact a state EITC, setting an important precedent. Other states without income taxes are considering the EITC as an option.

### KEY FINDINGS

- Five states have enacted new Earned Income Tax Credits since autumn 2006, bringing the total number of states to 24.
- 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-one states have made their credits refundable, ensuring the broadest impact on poverty and maximizing the work incentive.
- A newly-passed credit in Washington demonstrates that states without an income tax can also offer a state EITC.

FIGURE 1. Twenty-four States Have Enacted EITCs, June 2008




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

## Why Consider an EITC?

Several developments explain the popularity of state EITCs.

- *Continued child poverty and economic hardship.* Many children in working families live in poverty — some 8.6 million children in 2006. And many families with incomes modestly above the official poverty line, which is roughly $22,000 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 about 4.4 million people — over half of them children — out of poverty each year; it is the nation's most effective antipoverty program for working families.[1] State EITCs can supplement this effect.

- *Low wages and welfare reform.* Wage and salary growth was weak during the economic recovery that began in 2001 and has remained weak during the current slowdown. Since welfare reform

[1] CBPP estimates based on Census data covering 2003 through 2005.

in the mid-1990s, several million welfare recipients have left welfare and become employed, most of them for low wages. 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 minimum wages recently, but even with those increases, low-wage jobs may not provide a sufficient income on which to live.[2] State EITCs support families who enter and remain in the workforce.

- *Regressive tax systems.* In most states, low- and moderate-income families pay higher state and local taxes than do upper-income families as a share of their income. This regressivity results from states relying heavily on regressive taxes such as sales, excise, and property taxes. With revenues falling in many states, policymakers are considering enacting tax increases — including increases in regressive taxes — potentially hurting working families even more. A state EITC can help offset the impact of 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.[3]

- *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.[4]

## How Does a State EITC Work?

State EITCs are 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 40 percent — of the federal credit. As a result, states can take advantage of the 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.

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 2008 tax year is $4,824 for families with two or more children and $2,917 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

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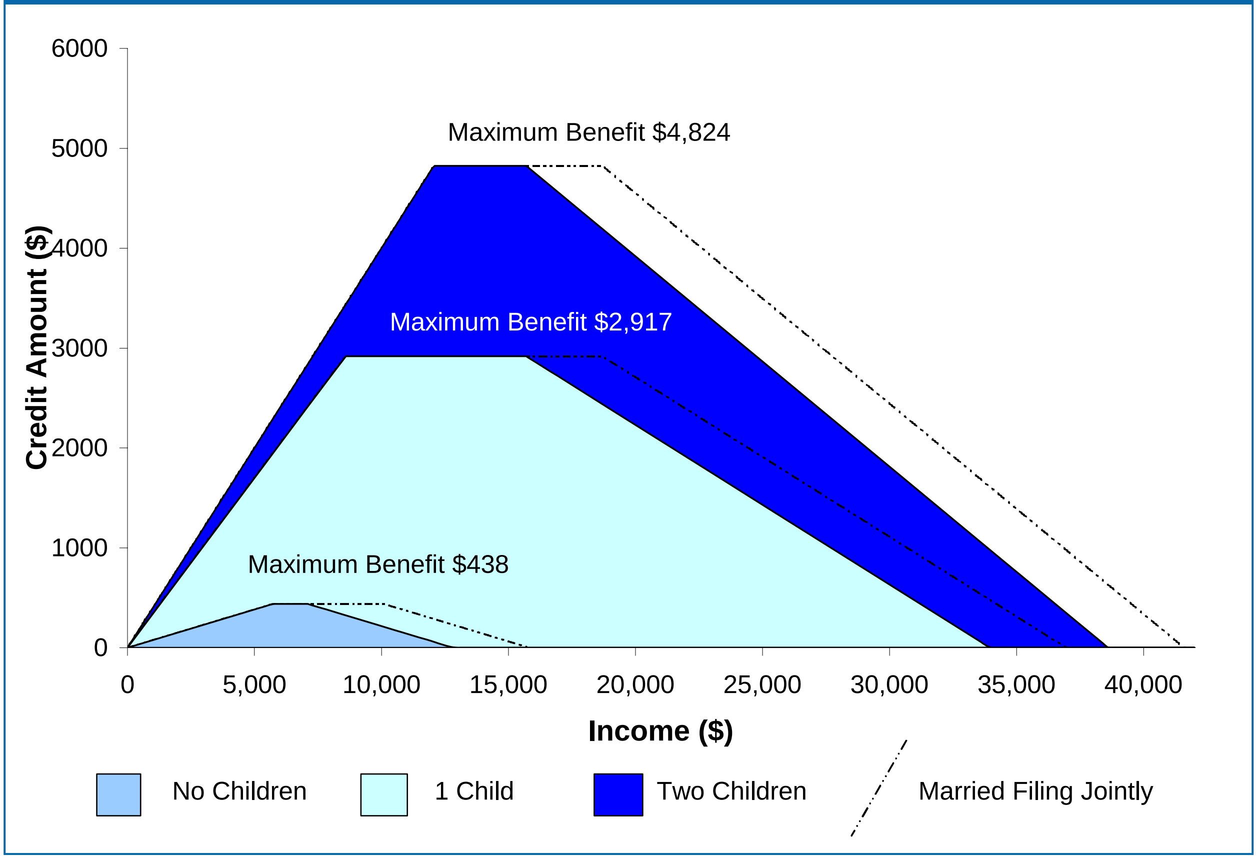
[2] See Jason A. Levitis and Nicholas Johnson, "Together, State Minimum Wages and State Earned Income Tax Credits Make Work Pay," Center on Budget and Policy Priorities, revised November 20, 2006. Available at [www.cbpp.org/7-12-06sfp.htm](www.cbpp.org/7-12-06sfp.htm).
[3] For a review of the research around the impact of the EITC on workforce participation, see Timothy Holt, "The Earned Income Tax Credit at 30: What We Know," The Brookings Institution, February 2006.
[4] 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. Value of Federal Earned Income Tax Credit, 2008




without children is $438 in 2008, 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 2008.)

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 $12,060 earned, for a maximum benefit of $4,824. Families with one child receive an EITC equal to 34 cents for each dollar earned up to $8,580 of earnings, for a maximum benefit of $2,917. Families continue to be eligible for the maximum credit until income reaches $15,740 (or $18,740 for married-couple families).

The largest 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 2008 federal poverty line is about $22,000 for a family of four.) This is because the EITC phases out gradually as income rises above $15,740 for single-parent families or $18,740 for married couples. Single-parent families with two or more children are eligible for some EITC benefit until income exceeds $38,646, while such families with one child remain eligible for some EITC benefit until income exceeds $33,995. For married couples, the maximum eligibility levels are $41,646 for two or more children and $36,995 for one child.

| TABLE 1: STATE EARNED INCOME TAX CREDITS BASED ON THE FEDERAL EITC | | | |
|---|---|---|---|
| **State** | **Percentage of Federal Credit (Tax Year 2008 Except as Noted)** | **Refundable?** | **Workers Without Qualifying Children Eligible?** |
| Delaware | 20% | No | Yes |
| District of Columbia | 40% | Yes | Yes |
| Indiana | 6% (to 9% in 2009) | Yes | Yes |
| Illinois | 5% | Yes | Yes |
| Iowa | 7% | Yes | Yes |
| Kansas | 17% | Yes | Yes |
| Louisiana | 3.5% | Yes | Yes |
| Maine | 5% | No | Yes |
| Maryland[a] | 25% | Yes | Yes |
| Massachusetts | 15% | Yes | Yes |
| Michigan | 10% (to 20% in 2009) | Yes | Yes |
| Minnesota[b] | Average 33% | Yes | Yes |
| Nebraska | 10% | Yes | Yes |
| New Jersey | 22.5% (to 25% in 2009) | Yes | Yes |
| New Mexico | 10% | Yes | Yes |
| New York[c] | 30% | Yes | Yes |
| North Carolina[d] | 3.5% (to 5% in 2009) | Yes | Yes |
| Oklahoma | 5% | Yes | Yes |
| Oregon[e] | 6% | Yes | Yes |
| Rhode Island | 25% | Partially[f] | Yes |
| Vermont | 32% | Yes | Yes |
| Virginia | 20% | No | Yes |
| Washington | 5% (to 10% in 2010)[g] | Yes | 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.

[a] 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.
[b] 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.
[c] 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.
[d] North Carolina's EITC is scheduled to expire in 2013.
[e] Oregon's EITC is scheduled to expire at the end of 2013.
[f] 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)
[g] Washington's EITC is worth five percent of the federal EITC or $25, whichever is greater. When the matching rate rises to ten percent in 2010, the minimum value will rise to $50.

## Designing a State EITC

Twenty-three state EITCs (including the District of Columbia's) piggyback directly on the federal EITC; those 23 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-fourth state with an EITC, Minnesota, also uses federal eligibility rules, and its credit parallels major elements of the federal structure.

Twenty-one of the 24 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.[5]

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.

## States Without an Income Tax Can Offer a State EITC

States EITCs have a long, successful history in states with income taxes. But there has been some debate about whether a state without an income tax could offer one. The reason is that the revenue departments in such states do not typically collect information about family income and structure — the information necessary to determine EITC eligibility. Thus it was feared that offering an EITC would require establishing a large new screening and enforcement effort. In becoming the first state without an income tax to enact an EITC, Washington seems to have solved this dilemma.

The new Washington program — which is equal to 5 percent of the federal EITC in 2008 and 2009 and rises to 10 percent in 2010 — will be straightforward to administer. The state will use federal IRS data on EITC claimants — which the IRS provides to state revenue departments under a common data-sharing arrangement — to confirm eligibility. By piggybacking on federal efforts, Washington will save a great deal on enforcement. When the credit is fully phased in, state officials estimate that administrative costs will constitute about 4 percent of the cost of its EITC.[6] If Washington were to increase the size of the credit, this share would be even smaller.

Other states that lack broad-based income taxes (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, and Wyoming) potentially could follow suit. Offering state EITCs in these states would benefit millions of low-income working families. State EITCs could be particularly helpful in these states because they all have tax systems that are extremely regressive,

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[5] Since Washington State lacks a personal income tax, the full value of its EITC will be refunded to those claiming it.
[6] Fiscal note for Washington State ESSB 6809. Note that administrative cost in a state that already has an income tax would be substantially lower, typically well below 1 percent of credit value.

meaning that low- and moderate-income families pay more than upper-income families as a share of income, because these states rely heavily for revenue collections on excise taxes, property taxes, and in most cases sales taxes.

## Financing a State EITC

Existing refundable state EITCs cost less than 1 percent of state tax revenues each year, although their dollar cost varies considerably from state to state largely 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.) Four other factors affect the cost of a state EITC: 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 targeted more specifically to low- and moderate-income working families than many other major tax cuts are, the cost may be relatively modest.[7]

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 (TANF) 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 financed, 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/3-8-06sfp.pdf.*

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7 For further information about estimating the cost of a 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.