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Virginia Has Improved The Tax Treatment of Low-Income Families, And an EITC Modeled on The Federal EITC Would Go Further

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Introduction

Each year the Center on Budget and Policy Priorities releases a report that assesses the state income tax burden on low-income families. Virginia annually ranks among the states that imposes one of the highest income tax burdens on low-income families. However, during the most recent legislative session, Virginia enacted a low-income credit that provides significant tax relief to families with below poverty incomes. As a result of this change, in tax year 2000 Virginia will rank among the many states that exempt most of the income of poor families from the income tax. Virginia could further improve its tax treatment of low-income families by adopting a refundable state Earned Income Tax Credit (EITC) modeled on the federal EITC.

Virginia Income Tax Burdens on Low-Income Families

In our report released this year entitled *State Income Tax Burdens on Low-Income Families in 1999: Assessing the Burden and Opportunities for Relief*, we reported that Virginia had the 4th lowest income tax threshold for both single-parent families of three and two-parent families of four. An income tax threshold is the lowest income level at which a family has state income tax liability. In 1999, Virginia imposed income taxes on single-parent families of three with incomes above $5,400 and two-parent families of four with incomes above $8,200. Both of these income tax thresholds fall significantly below the poverty line for a family of three of $13,290 and a family of four of $17,029. Essentially, Virginia has been taxing low-income families deeper into poverty.

Earlier this year Virginia enacted a low-income credit effective in tax year 2000.[1] The new law provides a non-refundable credit against state income taxes of $300 for each member of the family. Families whose income does not exceed the federal poverty guidelines are eligible for the credit. The law effectively eliminates most state income tax for families with incomes below the federal poverty guidelines.

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[1] The legislation enacted in Virginia this year has been referred to as an Earned Income Tax Credit (EITC) as well as an income tax credit for low-income taxpayers. Virginia's credit is not an EITC because the amount of the credit is not based on the federal EITC and thus the value of the credit does not change as earnings change. To avoid confusion with the Federal EITC and state EITCs that are based on the federal EITC, Virginia's credit is referred to as a low-income credit throughout this document.

If Virginia's new low-income credit had been in effect in tax year 1999, then Virginia's tax threshold would have moved from 4th lowest to 19th lowest for both families of three and families of four (See Tables VA-1 and VA-2 which are attached).[2] Utilizing the new low-income credit, a single-parent family of three would begin owing income tax at about $13,900, just above the poverty line of $13,290. A two-parent family of four would begin owing income tax at about $16,700, just below the poverty line of $17,029.[3]

Problems with Virginia's Recently Enacted Low-income Credit

While Virginia's low-income credit is a significant improvement in the tax treatment of low-income families, several problems still remain. First, even with the low-income credit, Virginia places a high tax income tax burden on near-poor families. Many families with children who have incomes just above the poverty line continue to struggle to make ends meet due to the high cost of child care, health care, housing and transportation. Federal and state governments recognize the challenges faced by low-income families with incomes slightly above the poverty line and have set the eligibility levels for many low-income assistance programs at amounts above the poverty threshold.[4]

In our report on state income tax burdens, we also looked at state income taxes on families with incomes at 125 percent of poverty. Virginia levies the 5th highest income tax on single-parent families of three at 125 percent of the poverty line and the 6th highest on two-parent families of four; these families pay income taxes of $431 and $525, respectively. Virginia's newly enacted low-income credit will provide no tax relief to these families because the new credit only provides relief to families with incomes below the federal poverty guidelines.

A second weakness of the low-income credit is that it creates an income tax "cliff" whereby when a family's income exceeds the federal poverty guidelines by a single dollar they

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[2] In tax year 2000, when the credit is effective, Virginia's ranking will be different as a result of changes in other states.

[3] The official poverty threshold produced by the Census Bureau differs somewhat from the "poverty guideline" set by the United States Department of Health and Human Services. For instance, in 1999 the poverty threshold for a family of four was $17,029 compared with the poverty guideline of $16,700. The poverty thresholds are used for statistical purposes while the poverty guidelines are used for administrative purposes such as determining eligibility for benefits in federal means-tested programs.

[4] For example, the income guidelines for food stamps and school lunch eligibility are both set at 130 percent of poverty. In addition, 38 states set the eligibility guidelines for the Low Income Home Energy Assistance Program (LIHEAP) at 125 percent of poverty or higher. Similarly, states must cover under Medicaid children age 1-5 in families with incomes below 133 percent of poverty.

owe the full amount of Virginia income tax. As the table below shows, if the Virginia's low-income credit had been effect in tax year 1999 a two-parent family of four with income at the federal poverty guideline of $16,700 would have received a non-refundable credit of $1,200, which is enough to fully offset the usual tax liability at that income level. By contrast, if such a family earned $16,701 — one dollar above the poverty guideline — it would no longer be eligible for the tax credit and would face tax liability of $295. One additional dollar of income increases tax liability by $295.

1999 Virginia Tax Liability (Assuming the low-income credit is effective in tax year 1999)	
Income	**Tax Liability**
$16,700	$0
$16,701	$295

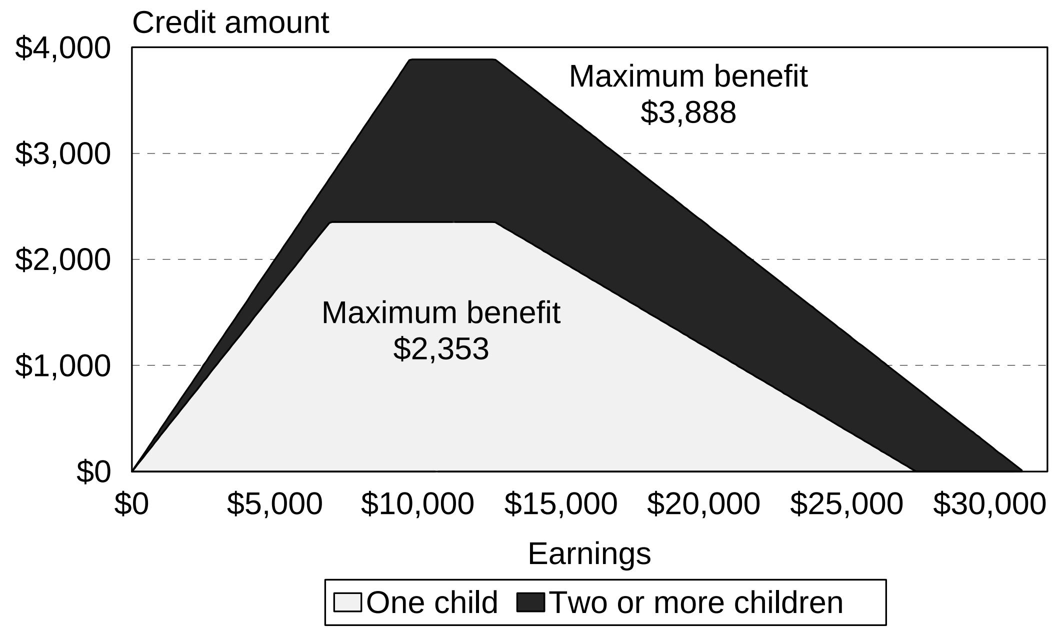
A third weakness of Virginia's newly enacted low-income credit is that it is non-refundable. The distinction between refundable and non-refundable credits is important. Under a refundable credit, a family receives a refund check if the size of the credit exceeds its tax bill. A non-refundable credit, such as Virginia's, does not supplement a family's income above its earnings and thus does not lift any families with poverty-level wages out of poverty. A refundable credit, by contrast, can be used to boost the incomes of low-income working families, including those making the transition from welfare to work, and serves to offset other state and local taxes.

A Virginia EITC that Piggy-backs on the Federal EITC Would be an Improvement

A Virginia Earned Income Tax Credit (EITC) set at 25 percent of the federal EITC would go much further. It would address each of the weaknesses of Virginia's newly enacted low-income credit. The federal EITC is a tax credit for low- and moderate-income workers, primarily those with children, designed to offset the burden of Social Security taxes, supplement earnings, and complement efforts to help families make the transition from welfare to work. The EITC has been widely praised for its success in supporting work and reducing poverty. Nationally, some 4.8 million people, including 2.6 million children, are removed from poverty as a result of the federal EITC. The federal EITC lifts more children out of poverty than any other federal program.

The success of the federal EITC has led a number of states to enact state Earned Income Tax Credits that supplement the federal credit. Altogether, 15 states — including Maryland and the District of Columbia — now offer state EITCs based on the federal credit. In addition, one

The Federal Earned Income Tax Credit in Tax Year 2000



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local government — Montgomery County, Maryland — offers a local EITC. 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.

State EITCs generally are set as a percentage of the federal EITC and thus share its structure. The federal EITC benefit that an eligible family receives depends on the family's income. For families with very low earnings, the value of the federal EITC *increases* as earnings rise. Families with two or more children receive a federal EITC equal to 40 cents for each dollar up to $9,720 earned in 2000, for a maximum benefit of $3,888. Families with one child receive a federal EITC equal to 34 cents for each dollar earned up to $6,920 of earnings, for a maximum benefit of $2,353. Both types of families continue to be eligible for the maximum credit until income reaches $12,690. For families with incomes above $12,690, the federal EITC phases out as earnings rise. Families with two or more children are eligible for some federal EITC benefit until income exceeds $31,152, while families with one child remain eligible for some EITC benefit until income exceeds $27,413.

The EITC benefit structure solves the problem of the income tax “cliff” created by the low-income credit because the benefits gradually phase-out as opposed to abruptly ending at a specified income level. The benefit structure is also an improvement over the low-income credit in the tax treatment of families as they work there way out of poverty. The EITC provides benefits to families with incomes up to about $30,000. Thus, as families move out of poverty they continue to receive benefits from the EITC.

A Virginia EITC would be a further improvement over the low-income credit if it were refundable. The federal EITC, ten of the fifteen state EITCs, and the Montgomery County EITC are refundable. Under a refundable credit, a family receives a refund check if the size of the credit exceeds its tax bill. Thus the EITC provides both tax relief and lifts families out of poverty by providing a wage supplement. Low-income working families frequently struggle with the additional costs associated with making the transition from welfare to work such as health care, transportation and child care. A refundable EITC can provide an income supplement and assist in meeting these expenses.

As noted above, a single-parent family of three in Virginia with income at 125 percent of poverty owes $431 in state income taxes — more than in all but 4 other states. Virginia's low-income credit provides no tax relief to this family. If a Virginia EITC set at 25 percent of the federal EITC had been in effect in 1999, a two-parent family of three with income at 125 percent of poverty would have received a refund of $304 improving Virginia's ranking to 38th in the country.

Cost of a Virginia EITC

The projected net cost of a 25 percent refundable Virginia EITC to replace the low-income credit in fiscal year 2001 is $126 million. This estimate is based on three data sources. The first data source is Internal Revenue Service data on the amount of federal EITC claims filed by residents of each state. The second data source is the U.S. Department of Treasury's projections of the cost of the federal EITC in future years. Based on this data, the estimated cost of the federal EITC going to Virginia residents in FY 2001 is $685 million. The third data source is the cost estimate of the low-income credit enacted this year of $20 million.[5] A refundable EITC set at 25 percent of the federal EITC would replace the current low-income credit. The savings that result from replacing the low-income credit of $20 million can be applied to the cost of the EITC, thus lowering the net cost.

The cost estimate of the Virginia EITC reflects the 25 percent rate for the Virginia credit, and an assumption that approximately 85 percent of Virginia residents who claim the federal credit would also claim the Virginia credit ($685 million X 25% X 85% = $146 million). Other states that have enacted EITCs, including New York, Wisconsin, and Vermont, have found that the participation rate for a state EITC in the first year after enactment was 80 to 85 percent of

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[5] Senate Finance Committee, Virginia General Assembly, "Special Report on Tax Policy (Senate Bill 30, As Introduced)," February 20, 2000.

participation in the federal credit by state residents.[6] Finally, the savings associated with replacing the current low-income credit of $20 million are applied to the gross cost estimate resulting in a net cost estimate of $126 million.

Examples of How a Virginia EITC Would Affect Families

As shown below, families with incomes below 200 percent of poverty would be better off under a 25 percent EITC compared to the low-income credit:

Comparison of Virginia Tax Liability, 1999
Assuming Low-Income Credit Enacted in 2000
Had Been Effective in Tax Year 1999

	Gross Earnings	Tax Liability Before Credits	Virginia Tax Liability with Low-Income Credit	Virginia Tax Liability Under Virginia EITC Set at 25% of Federal Credit*
Family of four with two children				
No earnings	$0	$0	$0	$0
Half-time minimum wage	$5,356	$0	$0	($536)
Full-time minimum wage	$10,712	$50	$0	($904)
Wages equal federal poverty line	$17,029	$311	$311	($402)
Wages equal 125% of poverty line	$21,286	$525	$525	$36
Wages equal 200% of poverty line	$34,058	$1,229	$1,229	$1,229
Family of three with two children				
No earnings	$0	$0	$0	$0
Half-time minimum wage	$5,356	$0	$0	($536)
Full-time minimum wage	$10,712	$135	$0	($819)
Wages equal federal poverty line	$13,290	$265	$0	($645)
Wages equal 125% of poverty line	$16,613	$431	$431	($304)
Wages equal 200% of poverty line	$26,580	$959	$959	$749
Family of three with one child				
No earnings	$0	$0	$0	$0
Half-time minimum wage	$5,356	$0	$0	($455)
Full-time minimum wage	$10,712	$69	$0	($509)
Wages equal federal poverty line	$13,290	$165	$0	($380)
Wages equal 125% of poverty line	$16,613	$331	$331	($81)
Wages equal 200% of poverty line	$26,580	$845	$845	$832

*These estimates are the tax liability without the newly enacted low-income credit.

[6]For more information on state EITC cost estimates, see Nicholas Johnson, *How Much Would a State Earned Income Tax Credit Cost*, Center on Budget and Policy Priorities, September, 2000.

Table VA-1
State Income Tax Thresholds for Single-Parent Families of Three, 1999
Assuming Virginia's Low Income Credit Was Effective in 1999

Poverty line: $13,290

Rank	State	Threshold
1	Alabama	$4,600
2	Illinois	5,000
2	Kentucky	5,000
4	Montana	7,500
5	Indiana	9,000
5	Michigan	9,000
7	Oklahoma	9,100
8	Hawaii	9,200
9	New Jersey	10,000
9	Ohio	10,000
9	West Virginia	10,000
12	Louisiana	11,800
13	Georgia	12,100
14	Missouri	12,400
14	Oregon	12,400
16	Utah	12,600
17	Arkansas	13,000
Average Threshold 1999		**$9,571**
Amount Below Poverty		**$3,719**

Rank	State	Threshold
18	Delaware	$13,400
19	North Carolina	13,900
19	**Virginia**	**13,900**
21	Mississippi	14,400
22	District of Columbia	14,600
22	Idaho	14,600
22	South Carolina	14,600
25	Nebraska	15,100
25	North Dakota	15,100
27	Wisconsin	15,700
28	Maine	16,600
29	Iowa	17,300
30	New Mexico	18,000
31	Massachusetts	18,900
32	Connecticut	19,100
33	Pennsylvania	19,500
34	Kansas	19,900
35	Arizona	20,100
36	New York	21,800
37	Colorado	22,000
38	Rhode Island	23,900
38	Vermont	23,900
40	Maryland	24,200
41	Minnesota	24,700
42	California	$33,700
Average Threshold 1999		**$18,756**
Amount Above Poverty		**$5,466**

Note: A threshold is the lowest income level at which a family has state income tax liability. In this table thresholds are rounded to the nearest $100. The 1999 poverty line is a Census Bureau estimate based on the actual 1998 line adjusted for inflation. The threshold calculations include earned income tax credits, other general tax credits, exemptions, and standard deductions. Credits that are intended to offset the effects of taxes other than the income tax or that are not available to all low-income families are not taken into account.

Source: Center on Budget and Policy Priorities

Table VA-2
State Income Tax Thresholds for Two-Parent Families of Four, 1999
Assuming Virginia's Low Income Credit Was Effective in 1999

Poverty line: $17,029

Rank	State	Threshold
1	Alabama	$4,600
2	Kentucky	5,200
3	Illinois	6,600
4	Montana	9,100
5	Indiana	9,500
6	New Jersey	10,000
6	West Virginia	10,000
8	Hawaii	11,000
9	Michigan	11,800
10	Ohio	12,300
11	Louisiana	12,700
12	Oklahoma	12,700
13	Missouri	13,900
14	Oregon	14,400
15	Georgia	15,300
16	Utah	15,500
17	Arkansas	15,600
18	Delaware	16,100
19	**Virginia**	**16,700**
20	North Carolina	17,000
Average Threshold 1999		**$12,000**
Amount Below Poverty		**$5,028**

Rank	State	Threshold
21	Iowa	$17,300
22	District of Columbia	18,200
22	South Carolina	18,200
24	Idaho	18,400
25	Mississippi	18,600
25	Nebraska	18,600
27	North Dakota	18,700
28	Wisconsin	18,800
29	Maine	20,200
30	Massachusetts	20,500
31	New Mexico	20,600
32	Kansas	20,900
33	New York	23,000
34	Arizona	23,600
35	Connecticut	24,100
36	Colorado	24,600
37	Maryland	24,800
38	Rhode Island	25,400
38	Vermont	25,400
40	Minnesota	26,000
40	Pennsylvania	26,000
42	California	35,500
Average Threshold 1999		**$22,155**
Amount Above Poverty		**$5,127**

Note: A threshold is the lowest income level at which a family has state income tax liability. In this table thresholds are rounded to the nearest $100. The 1999 poverty line is a Census Bureau estimate based on the actual 1998 line adjusted for inflation. The threshold calculations include earned income tax credits, other general tax credits, exemptions, and standard deductions. Credits that are intended to offset the effects of taxes other than the income tax or that are not available to all low-income families are not taken into account.

Source: Center on Budget and Policy Priorities