A HAND UP

How State Earned Income Tax Credits Help Working Families Escape Poverty In 2006

By

Ami Nagle
Nicholas Johnson

The **Center on Budget and Policy Priorities**, located in Washington, DC, is a non-profit research and policy institute that conducts research and analysis of government policies and the programs and public policy issues that affect low- and middle-income households. The Center is supported by foundations, individual contributions, and publications sales.

Board of Directors

David de Ferranti, Chair
Brookings Institution
UN Foundation

John R. Kramer, Vice Chair
Tulane Law School

Henry Aaron
Brookings Institution

Kenneth Apfel
University of Texas at Austin

Barbara B. Blum
National Center for
Children in Poverty
Columbia University

Marian Wright Edelman
Children's Defense Fund

James O. Gibson
Center for the Study of
Social Policy

Beatrix A. Hamburg, M.D.
Cornell Medical College

Frank Mankiewicz
Hill and Knowlton

Richard P. Nathan
Nelson A. Rockefeller
Institute of Government

Marion Pines
Johns Hopkins University

Sol Price
The Price Company (Retired)

Robert D. Reischauer
Urban Institute

Audrey Rowe
AR Consulting

Susan Sechler
German Marshall Fund

Juan Sepulveda, Jr.
The Common Enterprise/
San Antonio

William Julius Wilson
Harvard University

Robert Greenstein
Executive Director

Iris J. Lav
Deputy Director

March 2006

Center on Budget & Policy Priorities
820 First Street, NE, Suite 510
Washington, DC 20002
(202) 408-1080

E-mail: center@cbpp.org
Web: www.cbpp.org

ACKNOWLEDGEMENTS

This report draws on the work of all the staff of the State Fiscal Project of the Center on Budget and Policy Priorities. This edition of *A Hand Up* was written by CBPP consultant Ami Nagle and State Fiscal Project Director Nicholas Johnson. Research and data analysis were contributed by Joseph Llobrera and Robert Zahradnik. Julie Gathers assisted with data collection. Ed Lazere wrote the original edition of this report. Tina Marshall prepared this edition for publication.

We wish to thank the Annie E. Casey Foundation, the Ford Foundation, the John S. and James L. Knight Foundation, the Charles Stewart Mott Foundation, the Open Society Institute, The Piton Foundation, and the Stoneman Family Fund for their support of our state fiscal work.

TABLE OF CONTENTS

Executive Summary

I. The Problem: Poverty Despite Work 5

II. Helping Make Work Pay: The Federal Earned Income Tax Credit 7

III. Why Enact a State Earned Income Tax Credit? 15

IV. Designing a State Earned Income Tax Credit 21

V. Financing a State Earned Income Credit 29

VI. Getting It Done: Advice from Advocates Who Have Worked to Enact a State EITC 35

Figures and Tables

TABLE 1: FEDERAL EARNED INCOME TAX CREDIT PARAMETERS 3

TABLE 2: NUMBER OF FAMILIES AND INDIVIDUALS THAT RECEIVED THE FEDERAL EITC FOR TAX YAR 2002, BY STATE 8

TABLE 3A: STATE INCOME TAX THRESHOLDS FOR SINGLE-PARENT FAMILIES OF THREE, 2005 19

TABLE 3B: STATE INCOME TAX THRESHOLDS FOR TWO-PARENT FAMILIES OF FOUR, 2005 19

TABLE 4: STATE EARNED INCOME TAX CREDITS BASED ON THE FEDERAL EITC 22

TABLE 5: STATE EITC PARTICIPATION 23

TABLE 6: EARNED INCOME TAX CREDIT AMOUNTS BY FAMILY INCOME LEVELS, 2005 .. 26

TABLE 7: PROJECTIONS OF FEDERAL EITC COSTS 29

TABLE 8: ESTIMATED COST OF REFUNDABLE STATE EARNED INCOME TAX CREDITS 31

FIGURE 1: POOR FAMILIES WITH CHILDREN, 2004 5

FIGURE 2: THE FEDERAL EARNED INCOME TAX CREDIT IN TAX YEAR 2005 9

Executive Summary

An Earned Income Tax Credit is a tax reduction and a wage supplement for low- and moderate-income working families. The federal government administers an EITC through the income tax. So do many states. States that enact EITCs can reduce child poverty, increase effective wages, and cut taxes for families struggling to make ends meet.

Rising Number of States Offer EITCs

As of January 2006, nineteen states (counting the District of Columbia as a state) have passed Earned Income Tax Credits. Most recently, Delaware and Virginia enacted new EITCs, Illinois and Oregon changed their state EITC from non-refundable to refundable, and several states, including the District of Columbia, expanded existing EITCs. In addition, three local governments – Montgomery County, Maryland, New York City, and San Francisco – offer local EITCs.

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 are supported by business groups as well as by social service advocates.

State Earned Income Tax Credits Based on the Federal Credit

Refundable Credits
Colorado
District of Columbia
Illinois
Indiana
Kansas
Maryland
Massachusetts
New Jersey
New York
Oklahoma
Oregon
Rhode Island
Vermont
Wisconsin

Non-refundable Credits
Delaware
Iowa
Maine
Virginia

Why Consider an EITC?

Several developments explain the popularity of state EITCs.

- *Continued child poverty and economic hardship.* In 2004, some 7.7 million children in working families remained poor. And many families with incomes modestly above the official poverty line – roughly $19,800 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. State EITCs can help reduce poverty and hardship among families with children.

- *Welfare reform and low wages.* Over the last several years, several million welfare recipients have left welfare and entered the workforce; many other families have accepted the challenge of making ends meet on low-paying jobs without seeking public assistance. Many such families, however, cannot make ends meet on their earnings alone. A full-time job at the federal minimum wage of $5.15 per hour often is not sufficient to lift a family out of poverty. In part this is because the federal minimum wage has not been adjusted for inflation in many years. Even state minimum wages that are higher than the federal may fall short of providing a sufficient income on which to live. State EITCs support families who enter and remain in the workforce.

- *Tax changes.* Rising revenues in many states are leading policymakers to consider enacting tax cuts. Enacting a state EITC is a way to ensure that low- and moderate-income families share in the benefits of tax cuts. This is particularly important because most state tax systems rely heavily on sales, excise, and property taxes, the burden of which falls most heavily on low- and middle-income families. Moreover, nearly half of the states impose an income tax on working-poor families, and most states levy income tax on families with incomes only slightly above the poverty line. A state EITC can help offset such taxes.

Why Model a State Credit on 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 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.

- Research 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.

Designing a State EITC

Eighteen state EITCs piggyback directly on the federal EITC; those 18 states use federal eligibility rules and express the state credit as a specified percentage of the federal credit. (The percentages

TABLE 1: FEDERAL EARNED INCOME TAX CREDIT PARAMETERS					
				Phase-out Range	
Tax Year	Credit Percentage	Maximum Benefit	Phase-out Rate	(Single/head of household)	(Married filing jointly)
Families with two or more children:					
2005	40% of first $11,000	$4,400	21.06%	$14,370 to $35,263	$16,370 to $37,263
2006	40% of first $11,300	$4,520	21.06%	$14,760 to $36,222	$16,760 to $38,222
Families with one child:					
2005	34% of first $7,830	$2,663	15.98%	$14,370 to $31,030	$16,370 to $33,030
2006	34% of first $8,050	$2,737	15.98%	$14,760 to $31,888	$16,760 to $33,888
Families with no children:					
2005	7.65% of first $5,220	$399	7.65%	$6,530 to $11,750	$8,530 to $13,750
2005	7.65% of first $5,370	$411	7.65%	$6,710 to $12,080	$8,710 to $14,080

Source: Internal Revenue Service

are shown in Table 4 on page 22.) The nineteenth state with an EITC, Minnesota, also uses federal eligibility rules, and its credit parallels major elements of the federal structure.

Fifteen of the 19 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 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. All low-income working families with children can participate in a refundable EITC. Refundable credits have passed in Colorado, the District of Columbia, Illinois, Indiana, Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oklahoma, Oregon, Rhode Island, Vermont, and Wisconsin.

The remaining four states — Delaware, Iowa, Maine, and Virginia — offer credits that are non-refundable. Such a credit is available only to the extent that it offsets a family's 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. Thus a non-refundable credit assists somewhat fewer working-poor families with children and is likely to be less effective as a work incentive.

Financing a State Credit

The annual cost of refundable state EITCs in recent years has ranged from about $17.3 million in Vermont to $591 million in New York, less than 1 percent of state tax revenue in each state. 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 also learn about and claim the state credit. Because state EITCs are more specifically targeted to low- and moderate-income working families than many other major tax cuts, the cost may be relatively modest. A relatively straightforward procedure for estimating the cost of a refundable credit in any state is outlined on pages 27 to 30 of this report.

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 block grant, but most states have very limited availability of such funds, 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, however, an EITC can complement a state's welfare program by assisting low-income working families with children.

I. The Problem: Poverty Despite Work

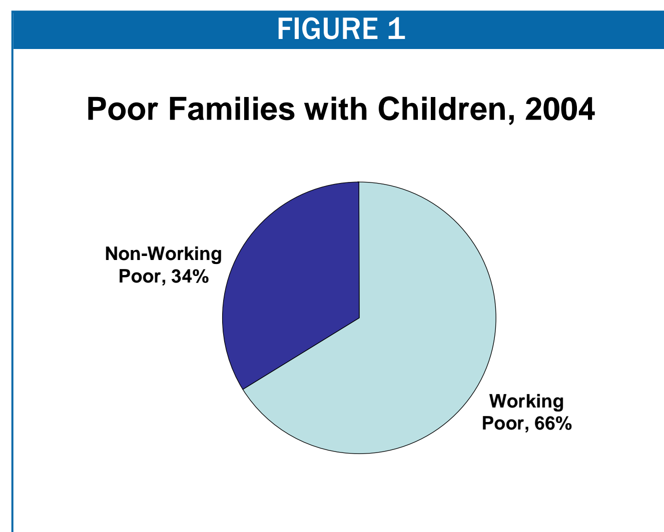
It is common to believe that most poor families with children include parents who could work but do not. Yet this is not an accurate picture of poor families in the United States. To the contrary, work is the norm among poor families with children.

- In 2004, some 5.3 million families with children in which the parents were not elderly or disabled had incomes below the federal poverty line.[1] Of these families, 3.5 million — or 66 percent — included at least one working parent.

- Some 13.5 million people — including 7.7 million children — lived in a working-poor family in 2004. In 2005 dollars, that means living on an income of less than about $15,400 for a family of three or about $19,800 for a family of four.

- Among poor families with children in which one or both parents were employed at any time during the year, the parents worked a combined average of 44 weeks throughout the year, or about 11 months.

- Even among families that received welfare income at some point in 2004 — either TANF cash assistance, SSI, or general assistance — 74 percent had a parent who worked part of the year. This includes families that used public assistance when a parent's job was lost, families that left welfare when a parent found work, and families in which a parent worked but remained eligible for welfare due to low earnings.



[1] An additional 760,000 poor families had parents who were ill, elderly or disabled, and thus were not able to work.

An even larger number of families with incomes slightly above the federal poverty line may be having difficulty making ends meet. The official federal poverty line of about $19,800 for a family of four in most if not all parts of the country falls well short of what it takes to provide a family with even the most basic necessities.[2]

The problem of poverty despite work has grown substantially over the past 25 years. The poverty rate among families with children in which a family member worked was 10.9 percent in 2004, substantially higher than it was in the late 1970s.

---

[2] The cost of basic necessities in various parts of the country for families with children is documented in Sylvia A. Allegretto, *Basic Family Budgets*, Economic Policy Institute Briefing Paper #165, September 1, 2005.

II. Helping Make Work Pay: The Federal Earned Income Tax 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 payroll taxes, supplement earnings, and complement efforts to help families make the transition from welfare to work. The EITC was enacted in 1975 primarily as a means of tax relief; for a decade, the credit received little attention and was not altered significantly. From the mid-1980s to the late 1990s, however, the EITC was expanded significantly as a result of legislation enacted in 1986, 1990, and 1993. The credit was expanded further specifically for some married couples as a result of 2001 legislation. Through these expansions, the EITC became a central element of federal efforts to boost income from work and lessen poverty among working families with children, a set of goals often called the "make work pay" strategy. Support for the EITC has come from across the political spectrum, with conservatives such as former President Ronald Reagan among its strong supporters.

EITC Receipt Is Highest in Large Cities and Rural Areas

In tax year 2001, 15.1 percent of all tax filers claimed the EITC. There is variation across communities. For example:

- In large cities, 20.4 percent of tax filers claimed the EITC.
- In small metro areas, 15.7 percent of tax filers claimed the EITC.
- In large suburbs, 11.5 percent of tax filers claimed the EITC.
- In rural areas, 18.2 percent of tax filers claimed the EITC.

Source: Brookings Institution, *The State of Low-Wage Workers: How the EITC Benefits Urban and Rural Communities*

The maximum EITC benefit for the 2005 tax year is $4,400 for families with two or more children and $2,662 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 without children is $399 in 2005, much lower than the credit for families with children.

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 $11,000 earned in

TABLE 2: NUMBER OF FAMILIES AND INDIVIDUALS THAT RECEIVED THE FEDERAL EITC FOR TAX YEAR 2002, BY STATE

State	EITC Recipients	State	EITC Recipients
Alabama	477,939	Montana	73,372
Alaska	36,636	Nebraska	108,289
Arizona	385,768	Nevada	153,487
Arkansas	275,662	New Hampshire	60,461
California	2,478,552	New Jersey	486,811
Colorado	256,627	New Mexico	195,404
Connecticut	162,541	New York	1,478,526
Delaware	55,276	North Carolina	728,321
District of Columbia	52,903	North Dakota	39,829
Florida	1,521,714	Ohio	766,972
Georgia	814,412	Oklahoma	306,513
Hawaii	83,741	Oregon	220,957
Idaho	97,659	Pennsylvania	752,491
Illinois	837,255	Rhode Island	64,418
Indiana	414,869	South Carolina	416,142
Iowa	167,854	South Dakota	54,573
Kansas	171,112	Tennessee	532,746
Kentucky	335,192	Texas	2,095,148
Louisiana	525,255	Utah	132,453
Maine	85,204	Vermont	37,139
Maryland	341,783	Virginia	486,551
Massachusetts	296,411	Washington	343,911
Michigan	627,394	West Virginia	144,103
Minnesota	248,357	Wisconsin	284,956
Mississippi	369,767	Wyoming	33,557
Missouri	423,787		

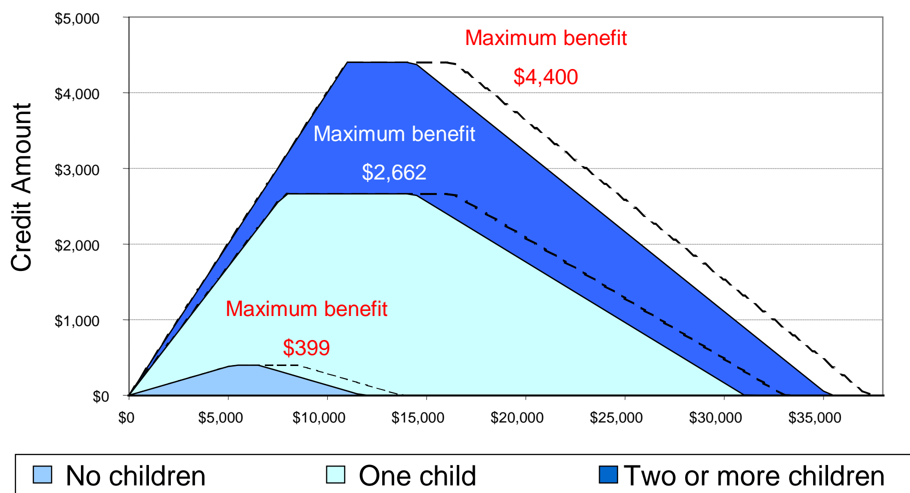
Source: Internal Revenue Service, *SOI Bulletin*, Spring 2005. Center on Budget and Policy Priorities.

2005, for a maximum benefit of $4,400. Families with one child receive an EITC equal to 34 cents for each dollar earned up to $7,830 of earnings, for a maximum benefit of $2,662. Both types of families continue to be eligible for the maximum credit until income reaches $14,370.

The largest EITC benefits go to working families with incomes slightly below the federal poverty line (about $19,800 for a family of four), but many families with incomes well above the poverty line benefit to at least some degree. For single-parent families with incomes above $14,370 in 2005, the EITC phases out as earnings rise. Single-parent families with two or more children are eligible for some EITC benefit until income exceeds $35,263, while families with one child remain eligible for some EITC benefit until income exceeds $31,030. Figure 2 shows the EITC benefit structure for families with children. The exact parameters for tax years 2005 and 2006 are shown on page 3.

FIGURE 2

The Federal Earned Income Tax Credit in Tax Year 2005



No children One child Two or more children

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

For married couples, the phase-out of the EITC does not begin until total family income exceeds $16,370. Married couples with two or more children and incomes up to $37,263 are eligible for the EITC; eligibility goes to $33,030 for those with one child.

EITC parameters are adjusted for inflation each year by the IRS. About 21.6 million U.S. families and individuals claimed the federal EITC in tax year 2002. Table 2 shows state-by-state participation levels.

The federal EITC is a *refundable* credit, which means that if the credit amount is larger than a family's income tax bill, the family receives a refund check. This refundability allows families to take full advantage of the credit even if they owe little or nothing in federal income taxes, as is the case for most poor working families.

Because the EITC is administered through the tax code, most recipients claim the credit when they file an income tax return. Families also have the option to receive a portion of their EITC benefit throughout the year with each paycheck, although few families exercise that option.

The EITC is available to both single-parent and two-parent families with children. Two-parent families can receive the EITC whether both parents work or whether one parent works while the other parent stays home to care for the children, so long as the family's income is below the EITC limit.

How the Federal EITC Achieves Its Goals

The structure of the federal EITC enables it to accomplish several policy goals, as illustrated by the following examples.

- The federal EITC **reduces the tax burden** on low- and moderate-income families both by offsetting federal income taxes and by offsetting some or all of the federal payroll taxes that finance the Social Security and Medicare programs.

  Example One. A single parent with one child, working full time throughout the year at a wage of $10 per hour, earns $20,800 per year. This worker owes $710 in 2005 federal income taxes which are withheld from the paycheck during the year. The family also qualifies for an EITC of $1,635. The EITC allows the family to get back the $710 it paid in income taxes and to receive an additional refund of $925. The EITC refund serves to offset some of the worker's $1,591 in payroll taxes that also were paid during the year.[3]

- For many recipients, especially families just entering the workforce and those with very low earnings, the EITC goes beyond offsetting taxes paid. In so doing, it effectively acts as a **wage supplement**.

  Example Two. A single parent with one child working full-time at the minimum wage of $5.15 per hour earns about $10,700 annually. This worker does not owe any federal income tax, but qualifies for a 2005 EITC of $2,662. The parent pays $819 in payroll taxes, so the EITC refund offsets those taxes and provides an additional $1,843 as a wage supplement.[4]

- The EITC **lifts families out of poverty** and reduces the extent of poverty and economic hardship. For instance, a minimum-wage job plus the EITC provides enough cash income to some families to support a family at a level above the poverty line.

  An example of how the EITC lifts a family out of poverty may be provided by the full-time minimum-wage worker with one child described above. Without the federal EITC, this family would have after-tax income of $9,881, about $2,949 below the federal poverty line of $12,830. The EITC lifts the family's cash income to $13,362, about $532 *above* the poverty line.[5]

---

[3] The calculations of payroll tax in this analysis do not include the portion of the payroll tax paid directly by the employer that matches the employee's share; the employee and employer each pay 7.65 percent of earnings. Although the employer share of the tax is not reflected in workers' nominal earnings — in this case $10 an hour — economists generally hold that both the employer and employee share of the payroll tax are in effect reductions in employee wages. The history of the EITC indicates it was designed specifically to offset both shares of the payroll tax.
[4] As in the preceding example, the calculation of payroll taxes does not include the employer share of payroll taxes.
[5] This calculation reflects earnings of $10,700, minus $819 for the employee share of payroll tax, plus the $2,428 EITC and the $70 child tax credit. (The federal child tax credit is refundable, but only up to 15 percent of a family's earnings above $10,000.) This income measurement differs from the measurement used by the Census Bureau in its official poverty calculations. The official federal poverty threshold is based on cash income; both earned and unearned, but does not include the value of in-kind benefits or the effects of taxes on disposable income. Nevertheless, many analysts agree that the payroll taxes and EITC benefits should be counted in addition to wages for the purpose of determining how far a family with a full-time minimum wage worker falls below the poverty line.

For larger families, however, even a full-time job at the federal minimum wage and the EITC together are not sufficient to lift the family from poverty. As discussed in the next chapter, a state EITC can help bridge the gap.

These examples also help illustrate the importance of the refundability of the EITC. If it were not refundable, the EITC could not offset payroll taxes — which represent a much larger burden on low-income working families than the income tax — nor serve as a wage supplement to families with little or no income tax liability.

Research evidence confirms that the EITC has been effective at meeting the goals of making work pay better and reducing poverty among working families.

- The wage supplement offered by the EITC has encouraged hundreds of thousands of welfare recipients to enter the workforce. Several academic studies, using a variety of sources of data, show that the EITC more than any other factor accounted for the increase in workforce participation among single mothers since the late 1990s. (See box on page 12.)

- The additional income provided by the EITC in 2004 lifted 4.1 million people out of poverty according to Census Bureau data. The EITC lifts more working families out of poverty than any other government program.[6]

- Families can use their EITCs to make investments that may over the long term reduce their dependence on government benefits. In 1996, a team of researchers from Syracuse University and the Center for Law and Human Services surveyed close to 1,000 EITC recipients. Over half of those surveyed spent some or all their EITC refunds on financial investments or human capital investments, including paying for tuition or other education expenses, increasing access to jobs through car repairs and other transportation improvements, moving to a new neighborhood, or putting money in a savings account.[7] 2005 research conducted in the Cleveland area found that half of EITC filers would use the funds to pay bills, and one-fifth would dedicate the funds for savings, clothing or furniture purchases or pay for housing.[8]

- Research indicates that tax refunds, including state EITC refunds, can be used to promote asset building in low-income families.[9] Data from various studies indicate that many low-income individuals value saving and assets. For example, research suggests that low-income individuals can save and accumulate assets in Individual Development Accounts (IDAs).[10] IDAs are special savings accounts designed to help low-income individuals build assets to reach certain

---

[6] See the Center on Budget and Policy Priorities publication *What Does the Safety Net Accomplish?,* July 2005.
[7] Timothy M. Smeeding, Katherin E. Ross, and Michael O'Connor, "The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility," *National Tax Journal*, December 2000.
[8] David Rothstein, *Who Takes Credit? Earned Income Tax Credit Recipients in Cleveland.*, Policy Matters Ohio, November 2005.
[9] For more information see *"Promoting Asset Building Through the Earned Income Tax Credit,"* State IDA Policy Briefs, Vol. 1, No. 1, Center for Social Development and Corporation for Enterprise Development.
[10] M. Schreiner, M. Clancy, & M. Sherraden, *Saving performance in the American Dream Demonstration,* St. Louis, MO: Washington University in St. Louis, Center for Social Development, 2002.

Research Findings on the Effectiveness of the EITC

Several recent studies indicate that the EITC has positive effects in inducing more single parents to go to work, reducing welfare receipt, and moderating the growing income gaps between rich and poor Americans. According to this research, the EITC:

- **Increases Work Among Single Parents** – The 1990s expansions to the federal EITC increased the employment of single parents substantially, according to a number of studies. For example, Harvard economist Jeffrey Liebman conducted a series of studies on the EITC. He noted that workforce participation among single women with children has risen dramatically since the mid-1980s.[a] In 1984, some 72.7 percent of single women with children worked during the year. In 1996, some 82.1 percent did. The increase has been most pronounced among women with less than high school education. During this same period there was *no* increase in work effort among single women *without* children.

  A number of researchers have found that the large expansions of the EITC since the mid-1980s have been a major factor behind the trend toward greater workforce participation. Studies by Liebman and University of California economist Nada Eissa find a sizable EITC effect in inducing more single women with children to work.[b] In addition, a study by Northwestern University economists Bruce Meyer and Dan Rosenbaum finds that a large share of the increase in employment of single mothers in recent years can be attributed to expansions of the EITC. They find that the EITC expansions explain more than half of the increase in employment among single mothers over the 1984-1996 period. Of note, Meyer and Rosenbaum found evidence that *state* EITCs also contributed to workforce participation increases in the states where credits were available.

  A very recent study confirms a very strong connection between the size of a family's EITC benefit and its likelihood of employment. Authors V. Joseph Holtz, Charles H. Mullin, and John Karl Scholz examined administrative data and IRS records for several hundred thousand California welfare recipients during the 1990s. They found that families with two or more children experienced noticeably faster rates of employment growth than families with one child because the larger families were eligible for greater EITC payments. The study found that an EITC increase of roughly $400 increased rates of employment by 3.2 percentage points. "Our paper shows that the EITC can be an important tool in efforts to increase employment of welfare recipients," the authors concluded.[d]

- **Reduces Poverty and Income Disparities** – Census data show that in 2003, the EITC lifted 4.4 million people out of poverty. Without the EITC the poverty rate among children would have been nearly one-fourth higher. Census data show that the EITC lifts more children out of poverty than any other single program or category of programs.

  Research by Liebman also has found that the EITC moderates the gap between rich and poor. During the past 20 years, the share of national income received by the poorest fifth of households with children has declined, while the share of income received by the top fifth has risen sharply. Liebman found that the EITC offsets between one-fourth and one-third of the decline that occurred during this period in the share of income the poorest fifth of households with children receive.

(Continued on next page)

goals such as buying a home, pursuing post-secondary education, or starting a business. In addition, there is evidence that some low-income families save part of their tax refunds; the Chicago study described above, for instance found, that 33 percent of EITC recipients planned to save a portion of their tax refunds. This suggests that tax refunds might be effectively linked to a variety of asset-building initiatives.

Research Findings on the Effectiveness of the EITC, continued.

- **Helps Families Make Ends Meet** – A majority of the families with children who receive EITCs are not technically poor, but may nonetheless face significant economic challenges. Research shows that many families that receive the EITC use it to pay for basic necessities like housing, utilities, food, and basic household appliances. The research also suggests that some families use their EITC to make purchases or investments that can help them maintain their jobs and their homes or to improve their employability so they have a better chance of moving into the middle class. The research indicates, for example, that a significant share of families use part of their EITC to repair or replace a car needed to get to work, to make essential but costly repairs to a home such as repairing a leaking roof, or to pay for more education or job training.[f]

Sources:

[a] Jeffrey B. Liebman, "The Impact of the Earned Income Tax Credit on Incentives and Income Distribution," in James M. Poterba, ed., *Tax Policy and the Economy,* Vol. 12, MIT Press, 1998.

[b] Nada Eissa and Jeffrey B. Liebman, "Labor Supply Response to the Earned Income Tax Credit," *Quarterly Journal of Economics,* May 1996, 112(2), pp. 605-637

[c] Bruce D. Meyer and Dan T. Rosenbaum, "Welfare, The Earned Income Tax Credit, and the Labor Supply of Single Mothers," September 1999, and "Making Single Mothers Work," *National Tax Journal* 53 (4, part 2), December 2000.

[d] V. Joseph Holtz, Charles H. Mullin, and John Karl Scholz, "Examining the Effects of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare," NBER Working Paper #11968, January 2006.

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

[f] Timothy M. Smeeding, Katherin E. Ross, and Michael O'Connor, "The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility," *National Tax Journal*, December 2000.

III. Why Enact a State Earned Income Tax Credit?

State Earned Income Tax Credits can further the goals of the federal EITC by bringing working families closer to or above the poverty line. And just as the federal EITC helps offset *federal* taxes paid by low-income working families, state EITCs can help relieve the substantial burden of *state and local* taxes levied on working-poor families in every state.

Federal EITC Does Not Lift All Working Families Out of Poverty

Despite the success of the federal EITC in reducing poverty among working families, wages plus the EITC do not guarantee an escape from poverty for all families. Even many families with a full-time, year-round worker remain poor. Other families with working parents remain poor because parents are unable to find full-time, year-round employment.

One problem is that the wages of low-earning U.S. workers have been stagnant for some time; the wages of workers at the 20th percentile, for instance, have grown at an average rate of 0.3 percent since 1978 after adjusting for inflation. A reason is the lackluster performance of the federal minimum wage, which has not been increased since 1997 and therefore has declined substantially in inflation-adjusted terms.[11]

- Full-time, year-round work, even at wages above the federal minimum wage, is not always sufficient to bring a family above the poverty line even after the federal EITC is taken into account.

  Example Three. A family of four with two children and a full-time, year-round worker earning $7.50 per hour has earnings of about $15,600 per year. (This wage rate is well above the current federal minimum wage. Even in the 19 states that have enacted their own minimums higher than the federal, very few exceed $7.50 per hour.) After subtracting the employee share of payroll taxes and adding the 2005 EITC for which the family qualifies of $4,400 (plus a federal

[11] Calculated from data in Lawrence Mishel, Jared Bernstein, and Sylvia Allegretto, *The State of Working America*, Economic Policy Institute, 2005.

child tax credit of $690), the family's cash income equals $19,497, or about $276 below the poverty line for a family of four.

If the worker earned the federal minimum wage instead of $7.50 per hour, or if the family had five or more members, the "poverty gap"— the amount by which income falls short of the poverty line — would be several thousand dollars.[12]

- Many low-wage working parents are unable to work every day of the year or are unable to work full-time. Census Bureau data indicate that in 2004 nearly half of the working parents in poor families with children — 1.6 million working-poor parents — either worked part-time because they could not find full-time work or spent a portion of the year unemployed. In addition to economic factors, many parents lose earnings when they take unpaid leave to fulfil their child-rearing responsibilities. Families in which parents work less than full time or less than all year can fall into poverty even if they receive the federal EITC and even if the parent earns above the minimum wage.

  Example Four. A single parent with two children working nearly full-time — 50 weeks per year at 38 hours per week — at the minimum wage of $5.15 per hour has an annual income of about $9,800. After subtracting payroll tax and adding the $3,920 federal EITC for which that family qualifies, the family's cash income totals $12,970, or about $2,461 below the 2005 poverty line for a family of three.[13] If the parent works fewer weeks in the year or fewer hours per week, the poverty gap is larger.

State EITCs Lift Additional Families Out of Poverty and Boost Living Standards

State EITCs can build on the success of the federal EITC in combating poverty and economic hardship among working families with children. Closing or at least substantially reducing the poverty gap for many working families, such as the families described in the examples above, is within the reach of many states.

- The family of four earning $14,600 per year described in Example Three above falls about $276 below the federal poverty line even with the federal EITC. A state EITC equal to 15 percent of the federal EITC would lift the family's income above the poverty line.

---

[12] This estimate of the "poverty gap" and the one that follows do not include the value of food stamps, which are nearly equivalent to cash, because many working-poor families do not receive food stamp benefits. The low rate of food stamp participation partly reflects the fact that many working-poor families do not meet the program's somewhat stringent asset limits, including a limit on the value of a family car. In addition, some eligible families do not apply for food stamps, in part because they face barriers to participation such as a limited number of food stamp offices and limited hours of operation at these offices. For example, according to the USDA 44% of those eligible for Food Stamps are not receiving them. For some families that receive food stamps, the EITC plus the cash value of food stamps can lift them above the poverty line. But for others, the EITC and food stamps are not enough. For instance, earnings from a full-time job at the current federal minimum wage of $5.15 an hour in 2005 are insufficient to lift the income of a family of four above the poverty line even counting both the EITC and the value of food stamps.

[13] This example does not include cash assistance a family may receive either while working or unemployed. In a majority of states, such a family would be ineligible for cash assistance while the parent is working. If the parent received cash assistance during a period of unemployment, the typical state's welfare benefits would fail to make up for the lost wages, leaving the family well below poverty for the year.

- The family of three with annual earnings of $9,800 described in Example Four falls about $2,461 below the poverty line. A state EITC equal to 65 percent of the federal EITC would lift that family's income above the poverty line.

State EITCs are also well-designed to assist the many families with incomes somewhat above the poverty line who continue to experience economic hardship. The EITC phases out gradually as income rises, with benefits accruing to families with incomes with incomes up to about $31,000 to $37,000 depending on household type and number of children. For this reason, a majority of families with children who receive the EITC have incomes above the poverty line.

The details of how such state EITC programs work are described in Chapters IV and V beginning on page 21.

State EITCs Complement Welfare-to-Work Strategies

The effectiveness of state EITCs in enabling low-wage workers to escape poverty is of particular relevance to the design of state welfare programs. Many welfare recipients who take jobs continue to have very low incomes, often below the poverty line. Recent evidence from several states shows that although most welfare recipients who find jobs are employed close to full-time, many of them earn wages at or only slightly above the minimum wage. Moreover, many do not qualify for paid vacation or sick leave, forcing them to take unpaid leave for reasons such as a child's illness. A number of 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; many earn less.[14] Earnings in that income range are insufficient to lift a single-parent family of three above the poverty line even with the federal EITC. A combination of the federal EITC *and* a state EITC, however, can close the poverty gap for many welfare recipients as they move into the workforce.

States have demonstrated a strong policy interest in subsidizing the efforts of welfare recipients to enter and remain in the workforce. For example, the vast majority of states have adopted "enhanced earnings disregards" in their welfare programs, under which welfare benefits phase out gradually as family earnings increase, thereby helping ease the transition from welfare to work. Many states also have expanded access to child care and to health insurance for working-poor families.

States also have an interest in supporting the work efforts of low- and moderate-income families who have 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.

---

[14] See U.S. General Accounting Office, *Welfare Reform: Information on Former Recipients' Status*, April 1999; Sarah Brauner and Pamela Loprest, *Where Are They Now? What States' Studies of People Who Left Welfare Tell Us*, Urban Institute, May 1999; and Sharon Parrott, *Welfare Recipients Who Find Jobs: What Do We Know About Their Employment and Earnings?*, Center on Budget and Policy Priorities, November 1998. More recent studies confirm those results.

Federal policies encourage use of a state EITC to assist families as parents enter the workforce and to support the work efforts of lower-income families. The federal rules for the Temporary Assistance to Needy Families program, the welfare block grant to states enacted in 1996, allow the refundable portion of state EITCs to be financed with federal TANF funds or with the "maintenance of effort" funds states must spend to access the federal TANF funds. Using TANF or MOE funds to help finance state EITCs is discussed in greater detail in Chapter V.

Changes to the federal TANF law that are expected to be enacted in February 2006 will increase further the importance of supporting work efforts by low-income families. These changes will require states to place more welfare recipients in jobs than before, increasing the importance of work-related supports.

State EITCs Provide Needed Tax Relief

In addition to boosting living standards among working families, state EITCs can play an important role in providing relief from state and local taxes paid by low-income working families, just as the federal EITC serves to relieve the burden of payroll taxes on such families. In every state, low-income working families pay a substantial share of their income in state and local taxes. State EITCs thus can help ensure that state tax systems do not push working families closer to,or deeper into, poverty.

Reduce Income Taxes

In 2005, income taxes were levied on below-poverty families in 19 of the 42 states with a personal income tax. The average tax burden in these states was $274 for a family of four with earnings at the poverty line.[15] (See Table 3.) Offering an EITC is an effective way to reduce income taxes on such families.

Offset Sales, Excise and Property Taxes

While the personal income tax burden on poor families is notable in many states, other parts of state and local tax codes often contribute even more to the tax burden on poor families.

Most states rely to a large extent on revenue from sales and excise taxes. These taxes are regressive, which means they absorb a much larger proportion of the incomes of lower-income households than of higher-income households. 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 wealthiest one percent of such families spent an average of 7.3 percent of income for state and local taxes.[16] Sales and excise taxes alone accounted for more than two thirds of the state and local tax burden on the poorest families.

---

[15] Center on Budget and Policy Priorities, *The Impact of State Income Taxes on Low-Income Families in 2005, February* 2006. This report is updated annually.

[16] Citizens for Tax Justice and the Institute on Taxation and Economic Policy, *Who Pays?: A Distributional Analysis of the Tax Systems in All 50 States,* 2nd Edition, January 2003, p. 118.

Table 3A. State Income Tax Thresholds for Single-Parent Families of Three, 2005

Rank	State	Threshold
01	Alabama	$4,600
02	Montana	8,900
03	Hawaii	9,800
04	West Virginia	10,000
05	Michigan	10,800
06	Louisiana	11,000
07	Georgia	12,700
08	Arkansas	13,100
09	Missouri	13,300
10	Illinois	13,400
11	Indiana	13,800
12	Ohio	14,100
13	Oregon	14,200
14	Mississippi	14,400
15	Delaware	14,700
16	North Carolina	15,300
	Federal Poverty Line	15,577
17	Virginia	15,700
18	Oklahoma	16,000
19	Kentucky	16,100
20	Colorado	16,900
20	Utah	16,900
22	Idaho	17,000
23	Nebraska	17,100
24	North Dakota	17,400
25	Iowa	17,900
26	Connecticut	19,100
27	New Mexico	19,300
28	New Jersey	20,000
29	Arizona	20,100
29	South Carolina	20,100
31	Wisconsin	20,200
32	Maine	22,500
33	District of Columbia	22,900
34	Massachusetts	23,500
35	Kansas	23,900
36	Pennsylvania	25,500
37	New York	26,300
38	Rhode Island	27,700
39	Maryland	28,200
40	Minnesota	28,900
40	Vermont	28,900
42	California	40,500
Average Threshold		**$18,160**

Table 3B. State Income Tax Thresholds for Two-Parent Families of Four, 2005

Rank	State	Threshold
01	Alabama	$4,600
02	West Virginia	10,000
03	Montana	10,800
04	Hawaii	11,500
05	Michigan	14,000
06	Indiana	14,800
07	Illinois	15,349
08	Ohio	15,400
09	Arkansas	15,900
09	Georgia	15,900
11	Louisiana	16,400
12	Missouri	16,700
13	Oregon	16,900
14	Oklahoma	17,200
15	Iowa	18,200
16	Kentucky	19,400
16	North Carolina	19,400
16	Virginia	19,400
19	Mississippi	19,600
	Federal Poverty Line	19,961
20	New Jersey	20,000
21	Delaware	20,300
22	Colorado	22,800
22	Idaho	22,800
22	Nebraska	22,800
22	New Mexico	22,800
22	Utah	22,800
27	North Dakota	23,300
28	Arizona	23,600
29	District of Columbia	23,900
30	Connecticut	24,100
31	Wisconsin	24,300
32	Massachusetts	25,400
33	Kansas	25,600
34	Maine	25,700
35	South Carolina	27,000
36	New York	29,300
37	Maryland	30,300
38	Rhode Island	30,600
39	Minnesota	31,800
40	Pennsylvania	32,000
41	Vermont	32,200
42	California	42,700
Average Threshold		**$21,360**

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 2005 poverty line is a Census Bureau estimate based on the actual 2004 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

States are demonstrating little inclination to reduce their reliance on such regressive taxes. In fact, some states in recent years have enacted increases in sales and/or excise taxes. Because those taxes fall heavily on low-income residents, the increases in sales and excise taxes in many states are increasing the tax burden on working-poor families. State EITCs could serve to offset such tax increases for the poor. For example, in recent years, a number of states have raised cigarette taxes in part to raise revenues and in part to discourage smoking. EITCs are one way to offset the impact of that policy on low-income folks.

IV. Designing a State Earned Income Tax Credit

Nineteen states (counting the District of Columbia as a state) have enacted state EITCs that build on the strengths of the federal EITC. Table 4 describes the structures of existing state EITCs; Table 5 provides recent participation data.

Eighteen state EITCs piggyback on the federal EITC; these 18 states use federal eligibility rules for families with children and express the state credit as a specified percentage of the federal credit. The nineteenth state, Minnesota, follows federal eligibility rules but does not express its credit as a percentage of the federal credit. For families with children, the Minnesota benefit structure is slightly different from the structure of federal credit; families in Minnesota use a separate tax table in their state tax forms to determine their EITC amount. (See box on page 24 for discussion of the Minnesota EITC.)

An EITC that piggybacks on the federal credit is relatively easy for a state to administer and also is easy for families claiming the EITC. To determine its state EITC benefit, a family need only write its federal benefit on its state return and then multiply the federal amount by the state EITC percentage.

A state that chooses to piggyback on the federal credit has four decisions to make in designing a state EITC.

- Should the credit be refundable or non-refundable? That is, will taxpayers be able to receive the credit even if they have little or no state income tax liability?
- At what percentage of the federal credit will the state credit be set?
- Will low-income workers without children, who presently receive a small federal credit, be eligible for the state credit?
- Will the state credit be adjusted for family size beyond the federal family-size adjustment?

TABLE 4: STATE EARNED INCOME TAX CREDITS BASED ON THE FEDERAL EITC			
State	**Percentage of Federal Credit (Tax Year 2004 Except as Noted)**	**Refundable**	**Workers Without Qualifying Children Eligible?**
Colorado[a]	10%	Yes	Yes
Delaware	20% (effective in 2006)	No	Yes
District of Columbia	35%	Yes	Yes
Indiana[b]	6%	Yes	Yes
Illinois	5%	Yes	Yes
Iowa	6.5%	No	Yes
Kansas	15%	Yes	Yes
Maine	4.92%	No	Yes
Maryland[c]	20%	Yes	No
Massachusetts	15%	Yes	Yes
Minnesota[d]	Average 33%	Yes	Yes
New Jersey[e]	20%	Yes	No
New York[f]	30%	Yes	Yes
Oklahoma	5%	Yes	Yes
Oregon	5% (to 6% in 2008)	Yes (as of 2006)	Yes
Rhode Island	25%	Partially [g]	Yes
Vermont	32%	Yes	Yes
Virginia	20% (effective in 2006)	No	Yes
Wisconsin	4% — one child 14% — two children 43% — three children	4% — one child 14% — two children 43% — three children	No

Notes:
[a] The Colorado credit has been suspended since 2003 due to insufficient funds.
[b] Expires TY2011.
[c] 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.
[d] 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.
[e] The New Jersey credit is available only to families with incomes below $20,000.
[f] The New York credit will be reduced automatically to the 1999 level of 20 percent should the federal government reduce New York's share of the TANF block grant.
[g] Rhode Island made a very small portion of its EITC refundable effective in TY 2003. In 2005, the refundable portion was increased from 5% to 10%.

Each of these decisions will affect the cost of the credit; financing a state credit is discussed in the next chapter.

TABLE 5: STATE EITC PARTICIPATION			
State with EITC	**Amount of Credit Claimed (millions)**	**Number of EITC Claims**	**Year of Data**
Colorado[a]	$31.6	200,000	2001
Delaware	(effective 1/1/06)		
District of Columbia	$20.0	42,786	2004*
Illinois	$65.7	718,761	2003
Indiana	$40.5	385,000	2003
Iowa	$8.6	103,700	2003
Kansas	$40.8	163,711	2003
Maine	$2.0	33,303	2003
Maryland[b]	$55.2	176,124	2002
Massachusetts	$70.1	303,038	2003
Minnesota	$127.1	246,251	2003
New Jersey	$98.2	262,977	2002
New York	$590.9	1,308,021	1999
Oklahoma	$25.1	263,376	2003
Oregon	$11.9	170,145	2003
Rhode Island	n/a	n/a	
Vermont	$17.3	35,102	2003
Virginia	(effective 1/1/06)		
Wisconsin	$69.8	214,164	2003

Notes:
[a] 2001 was the last year the Colorado EITC was available.
[b] Maryland figures are for refundable credit only. Maryland also offers a non-refundable credit that cost $61.9 million and was claimed by 232,864 taxpayers.
n/a = not available.
*Data are preliminary.

Source: Published and unpublished data from state revenue offices.

Refundable Versus Non-Refundable EITCs

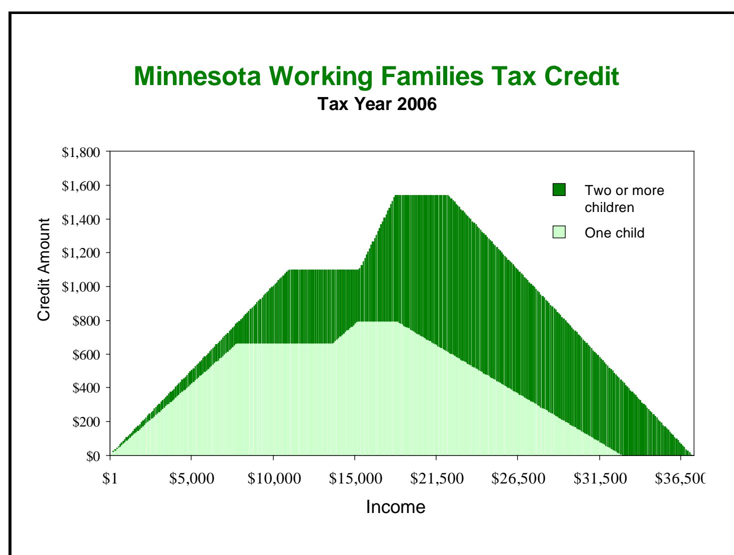
If a state EITC is refundable, a family receives a refund check if the size of its EITC exceeds its tax bill. For example, if a taxpayer owes $80 in state income taxes and qualifies for a $200 state EITC, the first $80 of the EITC offsets the income tax and the remaining $120 is received as a refund check. (If the $80 of income tax were withheld during the year, the taxpayer would receive the entire $200 as a check. Nevertheless, the EITC would offset $80 in tax liability and provide a $120 income supplement.)

If the credit were non-refundable, the family's $80 income tax liability would still be eliminated. The remaining $120 of the credit, however, would be forfeited.

The distinction between refundable and non-refundable credits is important because families with very low earnings, such as most families moving off welfare, owe little or nothing in state income taxes in many states. These families thus would receive little or no benefit from a non-refundable EITC. Moreover, because it only can offset taxes owed, a non-refundable EITC does not

Minnesota's EITC Phases Out at Higher Income Levels than Federal Credit

Until 1998, Minnesota's EITC was set at a straight percentage of the federal credit. But in 1998 the state changed the structure of its state EITC (known as the "Working Families Credit") to respond to a specific concern about the impact of tax and transfer programs on the state's working poor. A 1997 analysis of Minnesota welfare recipients had found that an increase in wages or hours beyond full-time minimum-wage work did not necessarily make families better off than they were when earning the minimum wage. The reason was that over certain income ranges, additional earnings were offset by increased taxes and the loss of cash assistance and food stamps. For instance, a single full-time worker with two children earning $6 per hour who received a pay raise to $8 per hour would not have any gain in disposable income after taking into account increased taxes and lost welfare benefits due to the wage increase. This became known as the "no net gain" problem.



The solution was to build into the state EITC an additional phase-in range for families facing the "no net gain" problem. For families with incomes below about $13,000, the Minnesota credit is the same as it would be if it were simply set at 25 percent of the federal credit. But while the federal credit begins to decline in value as a family's annual income exceeds about $13,000, the Minnesota credit *increases* in value until a family's earnings reach about $14,800 for a family with one child and about $18,500 for a family with two or more children. The credit does not begin to decline in value until a family's income exceeds about $17,500 for a family with one child and $20,800 for a family with two or more children.

The Minnesota credit is not completely decoupled from the federal credit. The credit for workers without children remains set at a flat rate of 25 percent of the federal credit. Eligibility rules still follow the federal eligibility rules, and the maximum income a family may have to qualify for the credit is the same as the federal maximum.

supplement a family's income above its earnings and thus does not lift any families with below-poverty wages out of poverty. A refundable EITC, by contrast, can be used to boost the incomes of low-income working families, including those making the transition from welfare to work, as the federal EITC does. Making a state EITC refundable also allows it to be used to offset sales and excise taxes paid by low-income families. In addition, a refundable credit can be financed in part with federal welfare block-grant funds; this option is discussed in the next chapter.

The importance of refundability is reflected in the decision of most states to make their EITCs refundable. Fifteen of the 19 states with a state EITC — Colorado, the District of Columbia, Illinois, Indiana, Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oklahoma, Oregon, Rhode Island, Vermont, and Wisconsin — have enacted refundable credits.[17] Note in particular that both Illinois and Oregon recently have switched from offering a non-refundable EITC to offering a refundable EITC.

Setting the Size of a State EITC

Choosing the percentage of the federal EITC at which the state credit is set should be based on several considerations. One consideration is the cost to the state treasury. Another is the level of state income tax relief desired. A third factor is the size of the desired income boost for poor families that qualify for a refund. The state may wish, for example, to enact a credit that lifts particular types of families above the poverty line.

EITCs in states with refundable credits generally range from 5 percent to 35 percent of the federal credit. The two exceptions are the credits in Wisconsin and Minnesota. The Wisconsin EITC, as discussed below, ranges from 4 percent of the federal credit for families with one child to 43 percent of the federal credit for families with three or more children. The Minnesota EITC, which is structured in part independently of the federal credit, effectively ranges from 25 percent to 45 percent of the federal credit, averaging about 33 percent.

Table 6 shows the benefit to families at various level of earnings of a refundable EITC set at 15 percent or 25 percent of the federal credit. For example, a family of four with two or three children and one minimum-wage worker qualifies for a federal EITC of $4,286 in 2005. If the family lives in a state with a 25 percent state EITC, the family receives a state credit of $1,070 ($1,070 equals 25 percent of $4,286). If the state credit is set at 15 percent of the federal credit, the family's state credit is $642 (15 percent of $4,286).

Adjustments for Family Size

A state EITC may be designed to provide greater adjustment for family size than is provided by the federal credit. This may be desirable, because the poverty rate for children in families with three or more children is more than double the poverty rate among children in smaller families. Although the federal EITC provides higher benefits to families with two or more children than to families with one child, it does not fully compensate for the higher cost of living for larger families. The maximum federal EITC for families with two children is about $1,700 higher than for families with one child, while the poverty line for a family of four is roughly $4,000 higher than for a family of three. Moreover, while the poverty line increases with family size, the federal credit provides no additional adjustment for larger families; the EITC makes no distinction between families with two children and families with three or more children.

---

[17] Colorado's EITC is presently suspended. Until 2002, it was financed from "surplus" funds that otherwise could have been part of a sales tax rebate. Those surplus funds were not available in 2003, 2004 or 2005 and are not expected to be available for at least five more years.

TABLE 6: EARNED INCOME TAX CREDIT AMOUNTS BY FAMILY INCOME LEVELS, 2005				
	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	$4,280	$1,070	$642
Wages equal federal poverty line	$19,700	$3,699	$925	$555
Wages equal 150% of poverty line	$29,550	$1,624	$406	$244
Family of three with one child				
Half-time minimum wage	$5,350	$1,819	$455	$273
Full-time minimum wage	$10,700	$2,662	$666	$399
Wages equal federal poverty line	$15,400	$2,498	$625	$375
Wages equal 150% of poverty line	$23,100	$1,267	$317	$190

Source: Center on Budget and Policy Priorities.

Because wages do not adjust for family size, larger low- and moderate-income working families often fall further below an adequate standard of living than smaller families with the same number of workers. Adjusting a state EITC for family size beyond the federal family-size adjustment thus can help larger working families keep pace with the cost of basic living expenses.

In most states with an EITC, the state EITC is set at the same percentage of the federal credit for all family sizes. In these states, the state EITC does not alter the family-size differential in the federal credit.

Wisconsin takes a different approach and varies its state EITC by family size. The Wisconsin EITC is set at four percent of the federal credit for families with one child, 14 percent for families with two children, and 43 percent of the federal credit for families with three or more children. This approach directs a greater share of EITC benefits to large families, while adding only modestly to the credit's complexity. Because large families are a modest share of all EITC-eligible families, Wisconsin's approach does not necessarily make the credit more costly. The average Wisconsin EITC benefit is roughly 18 percent of the federal credit, a level well within the range of other refundable state EITCs.

Workers Without Qualifying Children

Another decision that must be made in designing a state EITC is whether or not to extend the credit to low-income workers who do not have a qualifying child living with them. Such workers between the ages of 25 and 64 were made eligible for a modest federal EITC for the first time as part of the 1993 expansion.

On one hand, workers without qualifying children generally receive only small amounts from a state EITC. For example, in a state with an EITC established at 15 percent of the federal credit, the maximum state credit for a worker without a qualifying child is $60. Thus, some low-income

Local Earned Income Tax Credits

Like states, local governments may enact Earned Income Tax Credits. Three major local governments — Montgomery County, Maryland, San Francisco, California and New York City — presently are offering such credits.

- **Montgomery County, Maryland** – A large suburban county adjoining the District of Columbia, Montgomery County enacted a refundable EITC in 1999. The credit was enacted in response to growing concerns about the large number of working poor families in the county and the difficulty of making ends meet in a jurisdiction with a high cost of living. The credit equals the state's refundable credit, which in 2005 equals 20 percent of the federal credit.

  Unlike most localities nationwide, Maryland's counties levy their own income taxes. It should be noted, however, that having a local EITC does not depend on the local jurisdiction having an income tax. Initially, the state sent EITC checks to Montgomery County residents who claimed the state credit and the county reimbursed the state. Currently, the credit is administered as part of the state's tax form. These methods could work for any county or city in a state that has a state EITC. In FY2005, 20,700 Montgomery County taxpayers received credits for an average credit of $380.

- **San Francisco, California** – Available starting in tax year 2004, the City of San Francisco launched a city-level, refundable EITC. The credit is set between 10% and 12% of the federal credit depending on the amount of funding available. Eligible recipients complete a short form that is sent to City Hall. Recipients receive their credits through the mail. In its first year of the credit, almost 11,000 persons applied for the credit, totaling about $2.25 million. (Note that the state of California does not have an EITC.)

- **New York City** – Available starting in tax year 2004, the City of New York offers a tax credit applied to New York City income tax. The tax credit is set at 5% of the federal credit and is refundable. Eligible taxpayers complete a city EITC form as part of their city income tax filing.

workers without a qualifying child may find a state credit not worth the effort required to claim it, particularly if they owe no state income tax and are not otherwise required to file a state tax return. On the other hand, the cost of including workers without qualifying children in a state EITC is likely to be small, and some people are helped by it.

Ease of administration may be the key factor in a decision whether or not to include workers without a qualifying child in a state EITC. Excluding workers without qualifying children from a state EITC requires additional instructions on state tax forms, and it is likely that some workers without children miss the instructions and claim the credit anyway. At the same time, states may face an increase in the number of returns it must process if a refundable state EITC is extended to these residents, since federal EITC recipients without qualifying children have very low incomes and in many states owe no income tax.

At present, New Jersey, Wisconsin and Maryland are the only states in which workers without qualifying children are excluded by statute from their refundable EITCs. Maryland's non-refundable credit covers workers without qualifying children, but childless workers with incomes low enough to qualify for the credit generally do not owe Maryland income tax and thus do not derive any benefit from the non-refundable Maryland EITC.

V. Financing a State Earned Income Credit

Understanding the potential costs of a state EITC is important, because any such proposal will be considered in the context of the state's budget situation. State EITCs have been financed in a variety of ways: for example, from surplus General Fund dollars available due to revenue growth; from additional revenue generated by tax increases; or from funds freed up by forgoing other less well-targeted tax cuts. For example, states that are considering enacting a tax increase to cope with the fiscal downturn may choose to enact an EITC to offset the burden of that tax increase on low-income families. Another option for financing part of the cost of a refundable state EITC is to use funds made available through the federal welfare block grant; this option is discussed below.

Estimating the Cost of a Refundable State EITC

There is a simple three-step method to estimate the cost of a refundable state EITC if the credit is set at a flat percentage of the federal credit. The calculation is based on two sets of data. The first set is published Internal Revenue Service data on the total value of federal EITC claims filed by residents of each state. The most recent full-year data, shown in the second column of Table 7, are for claims made for the 2003 tax year.

TABLE 7: PROJECTIONS OF FEDERAL EITC COSTS

Fiscal Year	Cost (billions)
2005	$39.6
2006	$40.9
2007	$42.1
2008	$43.0
2009	$43.9
2010	$44.2

All but a tiny fraction of federal EITCs claimed for a given year are claimed and paid when taxes are filed in January through April of the following year. As a result, nearly all of the cost for tax year 2005 EITCs is incurred in federal fiscal year 2006. Similarly, in most states the cost of tax year 2005 claims would fall in the state fiscal year that ends in June 2006.

The second data source is Congressional Budget Office projections of the cost of the federal EITC in future years. For example, CBO projections released in July 2005 indicate that the federal EITC will cost $42.1 billion in federal fiscal year 2007.[18]

Using these data, the cost of a refundable state EITC is relatively easy to estimate.

Step 1: Estimate the total value of federal EITC claims in a given state for a future fiscal year.

The cost of the federal EITC in a state in a future fiscal year may be estimated by calculating the share of the federal EITC attributable to the state in the base year and applying that share to the expected total cost of the federal EITC in a future year. For example, for tax year 2003, Alabama EITC claims totaled $981 million, or 2.50 percent of the nationwide total. Assuming that Alabama's share of federal EITC claims remains approximately constant, Alabama's federal EITC claims in fiscal year 2007 would be 2.50 percent of $42.1 billion, or $1.05 billion, as shown in the fourth column of Table 8.

Step 2: Multiply the state's expected federal EITC claims by the percentage at which the state credit is to be set.

If the state EITC is set at a fixed percentage of the federal EITC, the cost of the federal credit in the state, as determined in Step 1, should be multiplied by the percentage rate. This yields an estimate of what the state credit would cost in a given fiscal year if everyone who receives the federal credit also receives the state credit.

Step 3: Adjust the estimate for the fact that not all federal EITC claimants will claim the state credit.

In practice, a substantial portion of federal EITC claimants fail to claim state EITCs, especially in the first few years after the state credit is enacted.[19] This appears to be true for several reasons. Awareness of the credit may be limited in the first few years after enactment of the state credit. In addition, some eligible families have the IRS compute their federal credit; such families may not receive a state EITC if the state does not compute the state credit amount for them. For these and other reasons, the cost of a refundable state EITC in its initial years after enactment is likely to be lower than the full cost of the federal credit multiplied by the state percentage. To reflect this difference, the cost estimate should be reduced by at least 10 percent.

The last three columns of Table 8 show the estimated 2007 costs to states of implementing refundable EITCs for tax year 2006, based on the method described above. The three columns show the cost for EITCs set respectively at 5 percent, 10 percent, and 20 percent of the federal credit.

---

[18] The CBO publishes projections for the refundable portion of the EITC only. The full cost of the EITC in future years is estimated here by using U.S. Treasury projections of the ratio of refundable and non-refundable portions of the EITC.

[19] Compared to the cost each state would have incurred if every family claiming the federal credit also claimed the state credit, the actual cost of a newly-enacted state EITC in its first year of availability was about 81 percent in Vermont, 83 percent in New York, 85 percent in Wisconsin, 88 percent in Oklahoma, 90 percent in Kansas and Minnesota, 91 percent in Colorado, and 97 percent in Massachusetts. In the second year of availability in each state, the cost in Vermont rose to 85 percent, the cost in New York rose to 90 percent and the cost in Minnesota rose to 93 percent relative to the full-participation cost.

TABLE 8: ESTIMATED COST OF REFUNDABLE STATE EARNED INCOME TAX CREDITS

State	Amount of Federal EITC Claims, TY 2003 ($ millions)	Percent of Total U.S. EITC Claims, TY 2003	Estimated Cost of Federal EITC in FY 2007 ($ millions)	Estimated Cost of State EITC in FY 2007		
				Set at 5% of Federal Credit* ($ millions)	Set at 10% of Federal Credit* ($ millions)	Set at 20% of Federal Credit* ($ millions)
Alabama	981	2.50%	1,053	47	95	190
Alaska	58	0.15%	62	3	6	11
Arizona	710	1.81%	762	34	69	137
Arkansas	529	1.35%	568	26	51	102
California	4,382	11.18%	4,706	212	424	847
Connecticut	263	0.67%	282	13	25	51
Delaware**	97	0.25%	104	5	9	19
Florida	2,807	7.16%	3,015	136	271	543
Georgia	1,643	4.19%	1,764	79	159	318
Hawaii	133	0.34%	143	6	13	26
Idaho	172	0.44%	184	8	17	33
Iowa**	271	0.69%	291	13	26	52
Kentucky	589	1.50%	632	28	57	114
Louisiana	1,116	2.85%	1,198	54	108	216
Maine**	135	0.35%	145	7	13	26
Michigan	1,102	2.81%	1,183	53	106	213
Mississippi	777	1.98%	834	38	75	150
Missouri	750	1.91%	806	36	73	145
Montana	121	0.31%	130	6	12	23
Nebraska	181	0.46%	195	9	18	35
Nevada	265	0.68%	284	13	26	51
New Hampshire	93	0.24%	100	4	9	18
New Mexico	357	0.91%	383	17	34	69
North Carolina	1,374	3.51%	1,476	66	133	266
North Dakota	63	0.16%	68	3	6	12
Ohio	1,344	3.43%	1,443	65	130	260
Pennsylvania	1,255	3.20%	1,347	61	121	243
South Carolina	790	2.01%	848	38	76	153
South Dakota	90	0.23%	97	4	9	17
Tennessee	988	2.52%	1,061	48	95	191
Texas	4,254	10.86%	4,568	206	411	822
Utah	238	0.61%	255	11	23	46
Virginia**	857	2.19%	920	41	83	166
Washington	573	1.46%	615	28	55	111
West Virginia	243	0.62%	261	12	24	47
Wyoming	55	0.14%	59	3	5	11
Other Areas	59	0.15%	63	3	6	11
States That Have Enacted Refundable EITCs						
Colorado	426	1.09%	457	*See Table 5 for actual costs for states that have enacted refundable EITCs.*		
District of Columbia	87	0.22%	93			
Illinois	1,501	3.83%	1,612			
Indiana	718	1.83%	771			
Kansas	295	0.75%	317			
Maryland	586	1.50%	629			
Massachusetts	468	1.20%	503			
Minnesota	397	1.01%	426			
New Jersey	838	2.14%	900			
New York	2,601	6.64%	2,794			
Oklahoma	567	1.45%	609			
Oregon	360	0.92%	387			
Rhode Island	108	0.27%	116			
Vermont	56	0.14%	61			
Wisconsin	465	1.19%	499			
U.S. Total	39,186	100.00%	42,082			

* Estimates of state EITCs assume participation rate equal to 90 percent of federal participation.
**For Delaware, Iowa, Maine, and Virginia, cost shown is the total cost of a refundable credit; since those states already offer non-refundable credits, the added cost of making the credit refundable would be substantially less than the amount shown here.

Sources: Internal Revenue Service Statistics on Income 2005 Spring Bulletin; Congressional Budget Office Factsheet: “Earned Income Tax Credit and Child Credit Outlays: July 2005 Baseline”; 2005 Budget of the United States Government - FY 2006, Analytical Perspectives; Center on Budget and Policy Priorities.

Additional Resources

There are many useful resources on the federal and state EITCs. A few include:

- **Brookings Institution** (www.brookings.edu/es/urban/eitc.htm) has a special section devoted to federal EITC usage, including an interactive site that shows EITC participation by zip code for past tax years.

- **Center on Budget and Policy Priories** (www.cbpp.org) has research papers on the EITC, information on changes to the federal EITC, and tool kits for organizations interested in operating an EITC outreach campaign.

- **National Conference of State Legislators** (www.ncsl.org/statefed/WELFARE/eitc.htm) provides an overview of the federal EITC and a recap of recent state EITC activity.

- **State EITC Online Resource Center** (www.stateeitc.com) provides information on state EITCs, recent campaigns, and a periodic newsletter on state EITC issues.

Other percentages may be calculated based on those numbers (for instance, the cost of a 15 percent credit would be one-and-a-half times the cost of a 10 percent credit). The same method may be used for other years, using the projections of federal cost shown in the table on the preceding page. None of these figures includes the costs of changing tax forms to include a space to claim an EITC or the costs of processing and administering EITC claims; these costs are likely to increase the overall cost of the credit by less than one percent.

Financing State EITCs Through the Temporary Assistance for Needy Families Block Grant

Several states finance a portion of the cost of their state EITC's by using federal funds from the Temporary Assistance for Needy Families block grant, or by counting some state funds expended for an EITC toward meeting the "maintenance of effort" required under TANF. Under federal regulations, states may use TANF or MOE funds only for the portion of an EITC that provides a refund in excess of tax liability. EITC benefits financed with TANF funds are not considered "assistance" under TANF rules; this means that the federal "time limit" (the requirement that most adult welfare recipients may not receive federally funded welfare payments for more than 60 months in their lifetimes) and the requirement that families assign their child support rights do not apply to EITC benefits funded with TANF. In addition, the TANF work requirements do not apply to those receiving TANF-funded EITC payments and, thus, when a state's TANF work participation rate is calculated to determine if the state has the required proportion of TANF assistance recipients engaged in work activities, families receiving TANF-funded EITC payments are not considered..

When welfare caseloads declined in the late 1990s, states developed surpluses in their TANF funds and looked for ways to use those funds to help families enter and remain in the workforce. At that time, financing a portion of a refundable EITC with TANF or MOE funds was an attractive option. Currently ten states — Illinois, Indiana, Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Vermont, and Wisconsin — have made use of this financing option, although

several of them used TANF funds to *replace* state funding for the EITC, not as a funding source for an EITC expansion.

The fact that refundable EITCs are a permissible use of welfare funds under the federal law, however, does *not* mean that TANF funds are necessarily an appropriate financing mechanism for state considering new EITCs or EITC expansions. Unlike in the late 1990s, few states still have large surpluses of TANF funds, in part because the federal TANF grant has declined in inflation-adjusted terms and in part because TANF funds have been committed to other purposes such as child care and child welfare.

Moreover, major changes to the TANF law were enacted in February 2006 that are likely to reduce the availability of TANF funds for state EITCs in most states. Under the new law, states must significantly increase the proportion of TANF assistance recipients who must be engaged in work activities. States that fail to meet these new work requirements are subject to fiscal penalties. Despite these new requirements — which the Congressional Budget Office estimated would cost states $8.4 billion over the next five years to meet — the federal legislation provided states with no additional TANF funding and only $200 million per year in additional child care funding. To meet the new requirements, or even make progress toward meeting the ambitious work standards, states will need to expand their welfare-to-work programs significantly.[20] This will require resources both for the employment services themselves and for the child care that parents will need when they participate in these programs.

Thus, while state EITCs can provide an important boost to low-income working families and improve employment incentives, states' limited TANF funds – funds which are declining in inflation-adjusted value each year – are unlikely to be a major source of new funding for most states.

[20] Alternatively, states could reduce the cost of meeting the work requirements by reducing the number of poor families to which they provide income assistance. However, restricting poor families' access to aid not only would leave families deeper in poverty but also would mean that parents would not have access to important employment services that could help them secure employment.

VI. Getting It Done: Advice from Advocates Who Have Worked to Enact a State EITC

Most state EITCs were enacted because citizen groups, advocacy organizations, business groups, human service providers, legislators, and/or executive branch officials identified poverty among working families as a problem and an EITC as an appropriate solution — and then organized campaigns to get them enacted. Interviews with participants in several recent campaigns suggest five key elements: clear information and messaging, strong coalition partners, effective political leadership, strategic use of opportunities, and perseverance.

- **Clear Information and Messaging.** Each effort working to enact a state EITC began the campaign by reviewing data on the impact of a state EITC and the potential cost. Often this information was pulled together in a report and distributed to the media, policy makers, and other advocates. For example, advocates in Maine produced a report providing statistics describing hours worked and wages earned by the working poor. This report also provided recommendations of policies to support the working poor, including a state EITC.

  But the numbers are not enough. Groups working on state EITCs collected other kinds of information to help make the case for enacting a state EITC. For example, advocates in Illinois conducted focus groups with residents and community leaders to gather information on perceptions of the EITC and to test out what messages helped them to best describe the impact of the EITC. This information was used in reports and campaign materials.

- **Strong Coalition Partners.** Getting a state to enact an EITC rarely can be done alone. Most successful efforts were undertaken by coalitions of organizations working together to raise awareness of the importance of the state EITC. Who participates in these coalitions varies widely and is influenced by historic partnerships, ability of core advocates to organize among their peers, time available to build a coalition, and other factors. For example, in Rhode Island 170 organizations and more than 450 individuals worked to establish and, later, make refundable the state EITC. Coalition members from a broad array of sectors including, health, consumer justice, children's services, religion, housing, higher education, mental health, and aging. Coalition members worked together on state EITC issues, each taking a different role from researching the issue to getting the word out across the state. For other states, the key

was establishing a small and pivotal group to work on the effort. For example, in Oklahoma, engaging a highly respected children's organization that does not usually take positions on fiscal issues was a key to the coalition. This unusual partner helped to open doors that often are closed to advocates working on economic security policy. In other states, including Illinois, business groups proved to be key.

- **Effective Political Leadership.** As with most state policy changes, political leadership can spearhead the issue, raise awareness among policy makers, and ensure that the issue stays in the forefront of policy debates. Advocates report that often a natural leader emerges — a policy maker with a history of championing policies to support low-wages workers. In other cases, advocates cultivated a relationship over a period of years with a policymaker to raise his or her understanding of the issues faced by his low-wage constituents, the importance of the EITC to their local economy, and the link between the EITC and state policy goals. In some cases it is most effective to identify a champion who is not routinely associated with low-income issues. For example, advocates in Virginia worked with a Republican state senator who was a leader in tax reform. The advocates talked with the senator about fiscal conditions on the state, the impact of fiscal policies on working poor, and policies, including the EITC, that help the working poor. When he was crafting a major tax reform package, the senator decided to include a state EITC into his tax reform package and became a loud, convincing voice for its passage.

- **Strategic Opportunities.** In some cases, advocates were able to take advantage of policy debates or actions and link the passage of EITC to other policy changes that seemed to have momentum. For example, in Delaware a state-sponsored Task Force for Financial Independence was meeting to debate changes to the tax code. Advocates worked to raise awareness of the EITC among members and a state EITC was ultimately part of the Task Force's recommendations. This helped lead to passage of a non-refundable state EITC.

  In Oregon, policy analysts and advocates raised awareness of corporate tax loopholes that needed to be closed. In their work they made the connection between the revenues that would be available to the state by closing the loopholes and dedicating the funds to enable the state's EITC to become refundable.

- **Perseverance.** Making a change in public policy can take a long time. Advocates who worked on state EITC policies report that it often took them several years of raising awareness, encouraging political leadership, and organizing at the local level before there was enough momentum to get a state EITC passed. In some places, advocates intentionally crafted a multi-year strategy to get a state EITC, starting with raising awareness of the issues faced by the working poor, raising awareness of high tax burdens, and the looking or strategic opportunities and political leadership to move a state EITC.