POLICY BRIEF SEPTEMBER 2018

INSTITUTE ON TAXATION AND ECONOMIC POLICY

Rewarding Work Through State Earned Income Tax Credits in 2018

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OVERVIEW

The Earned Income Tax Credit (EITC) is a policy designed to bolster the earnings of low-wage workers and offset some of the taxes they pay, providing the opportunity for struggling families to step up and out of poverty toward meaningful economic security. The federal EITC has kept millions of Americans out of poverty since its enactment in the mid-1970s. Over the past several decades, the effectiveness of the EITC has been magnified as many states have enacted and later expanded their own credits.

The continued expansion of the EITC is as important as ever given the continuing challenges facing our country's growing class of low-wage workers. Despite recent productivity gains, too many workers are facing low- and slow-growing wages, while simultaneously feeling the squeeze of the growing costs of food, housing, child care, and other basic household expenses. To make matters worse, in all but one state, low-wage workers pay a higher share of their incomes in state and local taxes than the highest earners in that state.[1] This leaves working families with even fewer resources to make ends meet.

The effectiveness of the EITC as an anti-poverty policy can be increased by expanding the credit at both the federal and state levels. To this end, this policy brief provides an overview of the federal and state EITCs and highlights recent trends to strengthen these credits.

THE FEDERAL EARNED INCOME TAX CREDIT

The federal EITC has been rewarding work and boosting the income of low-wage workers since it was introduced in 1975. Since that time, the EITC has been improved to lift and keep more working families out of poverty. The most recent improvements enhanced the credit for families with three or more children and for married couples. First enacted temporarily as part of the American Recovery and Reinvestment Act (ARRA) in 2009, these changes were made permanent in late 2015.

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The federal EITC returned nearly $65 billion in wages to 27 million working families and individuals in 2017.[2] Used mostly as a source of temporary support, the EITC helps millions of families each year—including veterans making their way back into the civilian workforce—cope with job loss, reduced hours, or reduced pay. Recognized widely as an effective anti-poverty tool, the federal EITC also lifted an estimated 8.3 million people, including 4.5 million children, out of poverty in 2017, according to data from the Census Bureau.

To encourage greater participation in the workforce, the EITC is based on earned income, such as salaries and wages. For example, for each dollar earned up to $14,040 in 2018, families with three or more children will receive a tax credit equal to 45 percent of those earnings, up to a maximum credit of $6,431. Because the credit is designed to provide targeted tax cuts to the working poor, there are income limits that restrict eligibility for the credit. Families continue to be eligible for the maximum credit until income reaches $18,340. Above this income level, the value of the credit is gradually reduced to zero and is unavailable when family income exceeds the maximum eligibility level. In 2018, the maximum income eligibility for a family with three or more children and an unmarried head of household is $49,194 and $54,884 if the head of household is married. For taxpayers without children, the credit is less generous: the maximum credit is $519 and single filers earning more than $15,270 (or $20,950 for married couples without children) are ineligible.

STATE EARNED INCOME TAX CREDITS

In addition to helping working families afford the necessities that keep them working, EITCs at the state level play a very important function in improving the fairness of upside down state and local tax systems. Unlike federal taxes, state and local taxes are regressive, requiring low- and moderate-income families to pay more of their income in taxes than wealthier taxpayers. According to ITEP's 2015 *Who Pays?* report, the poorest 20 percent of Americans pay 10.9 percent of their incomes in state and local taxes. By contrast, middle-income taxpayers pay 9.7 percent and the wealthiest 1 percent of taxpayers pay just 7 percent of their incomes in state and local taxes. Heavy use of regressive sales and property taxes (all of which working families pay) drive the high state and local tax rates faced by the poorest Americans. A refundable state EITC is among the most effective and targeted tax reduction strategies to help offset these regressive taxes.

Refundability is key to the EITC's success, especially at the state level. If a credit is refundable, taxpayers receive a refund for the portion of the credit that exceeds their income tax bill. Refundable credits therefore can be used to help offset all taxes paid, not just income taxes, thereby offsetting some of the regressive effects of state and local sales, excise, and property taxes.

To date, nearly two-thirds of the states (29 states plus D.C.) offer state EITCs based on the federal credit (see Appendix A). This approach makes the credit easy for state taxpayers to claim (since they have already calculated the amount of their federal credit) and straightforward for state tax administrators. However, states vary dramatically in the generosity of their credits. The EITC provided by the District of Columbia and New Jersey, for example, amounts to 40 percent of the federal credit (D.C. also provides a credit of 100 percent for workers without dependents in the home), while six states have credits that are worth less than 10 percent of the federal credit. Five states (Hawaii, Ohio, Oklahoma, South Carolina and Virginia) allow only a non-refundable credit, limiting the ability of the credit to offset regressive state and local taxes.

NEW TRENDS AND FORWARD MOMENTUM

There have been a number of advancements in EITC policy at the state and federal level in recent years. 2017 saw the addition of EITCs in Hawaii, Montana and South Carolina. Montana enacted a refundable credit at 3 percent of the federal credit. Hawaii's non-refundable credit,

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which is set to expire at the end of tax year 2022, is set at 20 percent of the federal credit. South Carolina's non-refundable credit is set to 125 percent of the federal credit, but because of the way the South Carolina credit is constructed much less of the credit will be taken up.

Louisiana, Massachusetts, New Jersey and Vermont all increased the size of their EITCs in 2018. Louisiana upped its state's EITC from 3.5 percent to 5 percent of the federal credit for tax years 2019 through 2025. Massachusetts increased its EITC from 23 percent to 30 percent of the federal credit, up from 15 percent in 2015. In New Jersey, lawmakers enacted an EITC increase from 35 percent to 40 percent of the federal credit to be phased in by 2020. And lawmakers in Vermont increased their EITC, currently at 32 percent of the federal credit, to 36 percent.

Delaware legislators passed a bill that would change the state's nonrefundable 20 percent credit to a refundable 5.9 percent credit. The shift will benefit the state's lowest income workers and their families, those who earn too little owe state income taxes, but to date it has not been signed by the governor.

There have also been some recent efforts to expand the EITC for workers without children. While the federal EITC provides a great deal of help for families with children, its impact is quite limited for those without children; the maximum credit is much smaller and the income limits are more restrictive. For instance, under current law, a worker without dependent children in the home who is working full-time at the federal minimum wage is ineligible for the EITC. Yet, if the same worker had children they would receive the maximum EITC. Under the current system, these low-wage workers continue to be taxed deeper into poverty.

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At the state level, the District of Columbia is leading the way. Since January 2015, more childless workers qualify for D.C.'s EITC thanks to higher income eligibility thresholds and a credit expanded to 100 percent of federal (up from 40 percent). California and Maryland join the District of Columbia in their recent expansion of the credit to younger workers. In 2018, California eliminated the age requirement for its EITC for workers without dependents in the home. This action expanded the EITC to young workers between 18 and 24 and workers over 65. California also adjusted its state-level EITC income limits to reflect the state's minimum wage increase to ensure that those working full-time for minimum wage are eligible to receive the credit. Maryland legislators also removed the state EITC's minimum age requirement by using some of the revenue gained from the federal tax cut.

IMPROVING TAX FAIRNESS WITH STATE EITCS

Whether enacting an EITC in states that do not yet have one or expanding an existing credit to more workers trying to get by on low wages, lawmakers would be wise to continue the positive trend of strengthening and enacting state EITCs and, as a result, improving the fairness of state and local taxes, rewarding work and helping families meet their basic needs.

ENDNOTES

1 Carl Davis, Kelly Davis, Matthew Gardner, Harley Heimovitz, Sebastion Johnson, Robert S. McIntyre, Richard Phillips, Alla Sapozhinkova and Meg Wiehe. “Who Pays? A Distributional Analysis of the Tax System in All 0 States, 5th Edition,” Institute on Taxation and Economic Policy, January 2015. **http://www.whopays.org**.

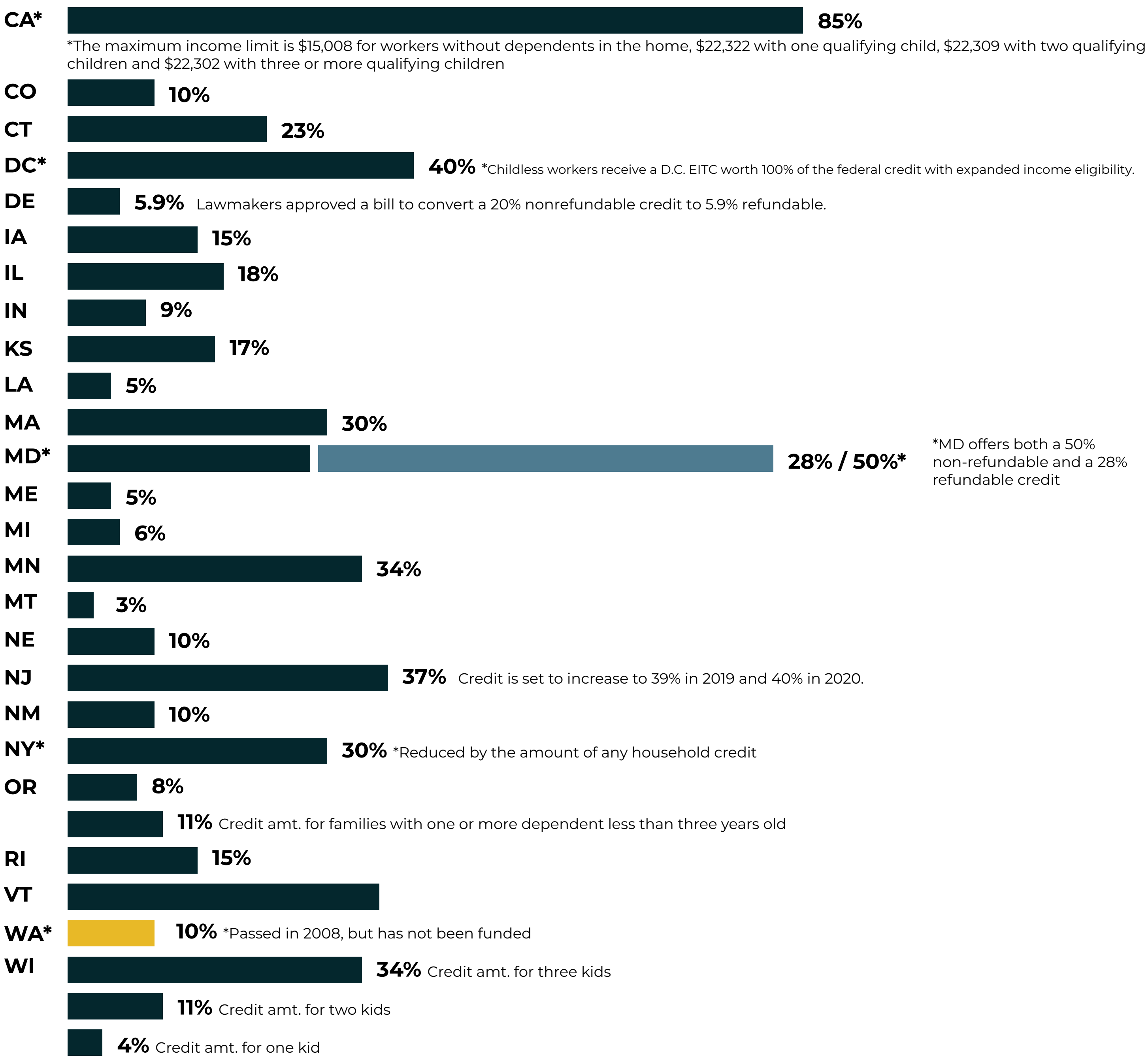
2 Internal Revenue Service. “Statistics for Tax Returns with EITC,” December 2017. **https://www.eitc.irs.gov/EITC-Central/eitc-stats**

APPENDIX A

State Earned Income Tax Credits in 2018

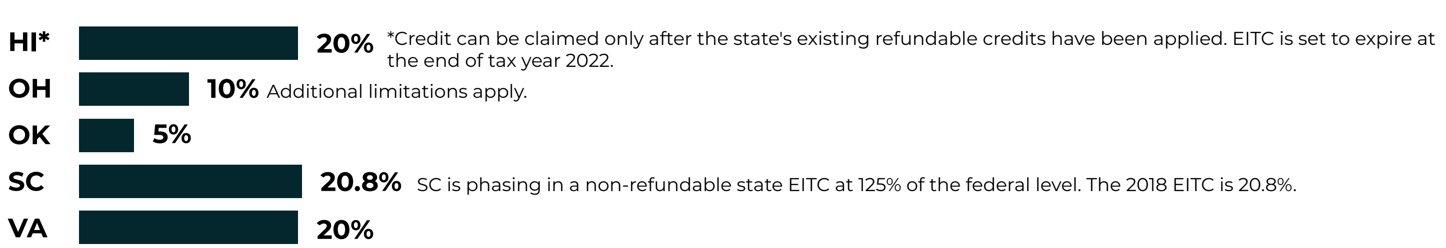
REFUNDABLE CREDITS

Refundable credits are one of the most effective and targeted tax reduction strategies. Taxpayers receive a refund for the portion of the credit that exceeds their income tax bill, offsetting some of the regressive effects of state and local sales, excise, and property taxes.



NON-REFUNDABLE CREDITS

Non-refundable credits limit the usefulness of the EITC to low-income families. Taxpayers earning too little to owe state income tax will receive no benefit from the credit, despite the upside-down nature of state and local tax systems.



Note: Washington's credit was passed in 2008, but has not yet been funded. Indiana's credit is not tied to the federal expansions made permanent in 2015; Minnesota and Ohio's credits are dependent on additional income criteria; Wisconsin's credit is dependent on family size.