CALIFORNIA BUDGET PROJECT

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HOW CAN A STATE EARNED INCOME TAX CREDIT HELP CALIFORNIA'S WORKING POOR MAKE ENDS MEET?

Economic trends have made it harder for many families to make ends meet despite the presence of one or even two working parents. The prevalence of poverty among California's working families is striking. Over two million Californians live in families that are working, but poor, and an additional 1.4 million live in families hovering just above the poverty line.[1] Over a quarter (28.7 percent) of the California workforce earned poverty level wages in 1999, up from 24.0 percent a decade before.[2] In California, the earnings from full-time minimum wage work fail to provide sufficient income to lift a family of three or more above the federal poverty line. In previous decades, economic growth could be relied upon to produce rising incomes. More recently, families at the lower end of the wage scale, particularly those supported by earners without a college education, have seen the purchasing power of their wages decline and have experienced diminished prospects of moving up the economic ladder.

One of the most powerful tools available to boost the incomes of the working poor is the federal Earned Income Tax Credit (EITC). In 1998, 2.4 million California households, one out of every six tax returns filed, claimed $3.8 billion in federal EITC benefits.[3] An EITC works by using the tax system to target cash assistance to low income households with earnings from work. The amount of assistance provided by the credit is based on a family's size and its income. Fourteen states and the District of Columbia – Colorado, Illinois, Iowa, Kansas, Maryland, Maine, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Wisconsin, and Vermont – currently have state Earned Income Tax Credits that complement the federal credit and boost the incomes of the working poor. Nine states – Colorado, Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Wisconsin, and Vermont – and the District of Columbia have refundable credits.

Recent attention to the growth in the number of California's families who are working, but poor, has increased interest in proposals to enact a state EITC. This paper explores the feasibility of using a state EITC to further supplement the earnings of low income working families.

How Does the Federal Earned Income Tax Credit Work?

Eligibility for the federal EITC is limited to low income families and individuals with earnings from work. The amount of credit available depends on family size and income. The credit varies with income in three ranges: (1) the phase-in range where EITC benefits increase with earnings; (2) a plateau where the maximum EITC amount remains constant; and (3) the phase-out range where benefits decline as earnings increase (Figure 1). In 2000, a family with two or more dependents is eligible for a maximum EITC of $3,888. The credit declines as household income rises above $12,690, with an eligibility cap of $31,152. A family with one dependent is eligible for a maximum credit of $2,353, with an income cap of $27,413. The EITC provides a maximum credit of $353 for childless workers at least 25 years of age, based on their share of payroll taxes – 7.65 percent – with an income limit of $10,380.[4]

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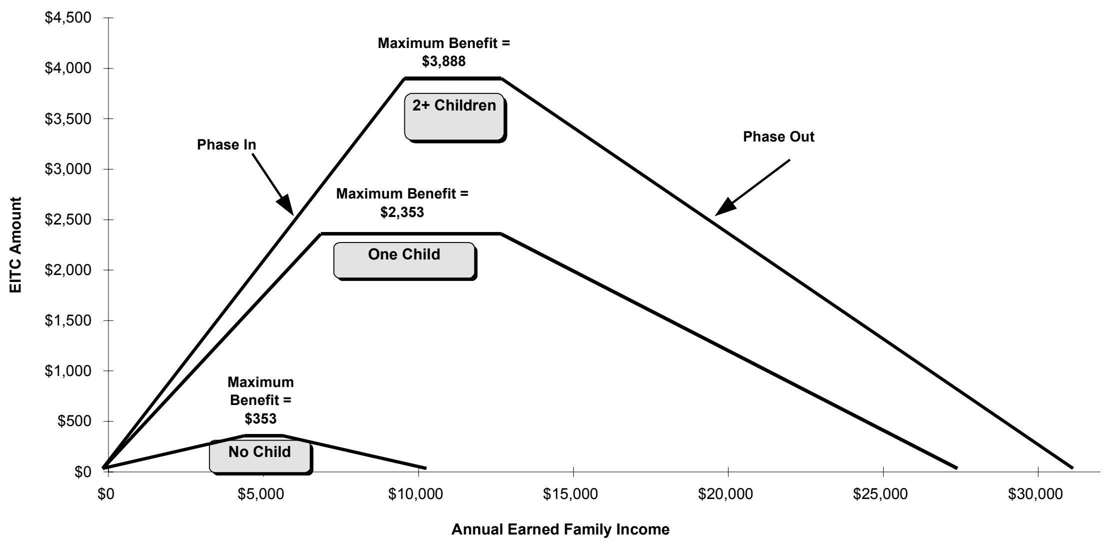
Figure 1

Federal Earned Income Tax Credit for 2000 Tax Year



Most families claim their EITC when they file their federal income tax return. A small number of families choose to receive the credit throughout the year as a supplement to their paycheck through the advance payment option.

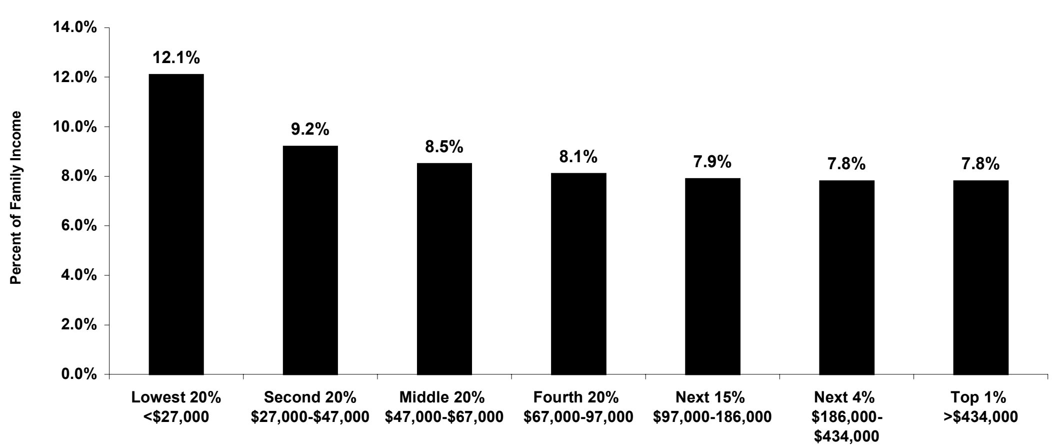
How Would A State Earned Income Tax Credit Work?

Most state EITCs are patterned after the federal credit. By linking state eligibility rules to those of the federal credit, California can take advantage of federal compliance efforts and coordinated efforts to publicize the availability of the credit so that families receive the benefits for which they are eligible.

Refundability is a key feature of the EITC. Refundable tax credits are paid to families regardless of whether or not they owe income tax. The EITC is first used to reduce a family's tax liability, with any

Figure 2

Low Income Families Pay A Larger Share of Their Income in California State and Local Taxes (1998)



Note: Calculated for non-elderly, married couples. Reflects federal deductibility of state taxes.
Source: Institute on Taxation & Economic Policy Microsimulation Tax Model, April 1998.

remainder returned to the family in the form of a refund. For California, refundability is particularly critical since the state's personal income tax threshold — the income level at which families begin to owe taxes — is so high. A married couple with two children will have no 2000 state income tax liability unless their income exceeded $39,790, while a single mother with one child would not pay state income taxes unless she earned in excess of $32,041.[5] Thus a nonrefundable credit would provide minimal or no relief to most California families that qualify for the federal EITC. While lower income California families have no income tax liability, they do pay payroll, sales, and excise taxes. In fact, the lowest income 20 percent of California families pay a greater share of their income in the form of California state and local taxes than do any other income group (Figure 2).

WHAT WOULD A STATE EITC MEAN FOR CALIFORNIA FAMILIES?

A state EITC would work in tandem with the federal credit to boost the earnings that low income families receive from work. The income of a family of three supported by a full-time minimum wage worker still falls below the poverty level, despite the recent increase in California's minimum wage to $6.25 per hour. The same family would be raised out of poverty by the combination of a state and federal EITC (Table 1). A state credit equal to 15 percent of the federal credit, for example, would provide a maximum of $583 per year to a family with more than one child and up to $353 per year for a family with one child.

Table 1: How Would A State Earned Income Tax Credit Help A Family Supported by A Low Wage Earner? (for a wage earning family with two children)

	Gross Earnings	Percent of 2001 Poverty Guideline	Federal EITC	State EITC Equal to 15% of Federal Credit	Total	Percent of 2001 Poverty Guideline
Family of Four Supported by:						
Full-time minimum wage work	$13,000	74%	$3,817	$ 573	$17,390	99%
Earnings equivalent to the federal poverty line	$17,650	100%	$2,838	$426	$20,914	118%
Two full-time minimum wage workers	$26,000	147%	$1,080	$162	$27,242	154%
Family of Three Supported by:						
Full-time minimum wage work	$13,000	89%	$3,817	$573	$17,390	119%
Earnings equivalent to the federal poverty line	$14,630	100%	$3,480	$522	$18,632	127%
Full-time work at 150% of the minimum wage	$19,500	133%	$2,449	$367	$22,316	153%

How Do Families Use Their EITC?

Families that claim the EITC use it to make major purchases, including investments in education and housing that can help boost their families economic well-being. One study found that over half of the families surveyed purchased furniture or appliances, with a sizeable fraction using their credit to purchase a car or save for a downpayment on a home.[6] Other researchers found that paying outstanding bills accounted for the most prevalent use of families' EITC, while approximately one out of six use the money they received for tuition or other education related expenses.[7] Both groups of researchers found that many families save at least a portion of their credit for major investments or emergencies.

How Much Would A State Earned Income Tax Credit Cost?

Because of the large number of California's working poor, the cost of implementing a state EITC is significant. A state credit equal to 15 percent of the federal credit would cost an estimated $605 million in 2000-01. Almost all of the benefits of the credit would accrue to taxpayers in the form of a refund. A smaller credit would reduce the cost to the state, while a larger credit would provide additional assistance (Table 2).

Table 2: How Much Would A State Earned Income Tax Credit Cost?

Size of State Credit (% of Federal EITC)	**Cost of Credit** (2001-02, in millions)	**Average Credit***	**Maximum Credit One Child** (2000)	**Maximum Credit More Than One Child** (2000)
10%	$404	$160	$235	$389
15%	$605	$240	$353	$583
20%	$806	$320	$471	$778

* Based on 1998 federal credits actually claimed

The EITC Helps Families Leave Welfare for Work

A number of studies suggest that the EITC has helped encourage single parents to leave welfare and enter the workforce. UCLA Researcher Joseph Hotz and his colleagues found that the expansion of the federal EITC could account for a sizeable fraction of the increased employment of California welfare recipients between 1993 and 1998.[8] Other researchers have found larger employment increases among single parents in states with state EITCs than in states without.[9]

Federal TANF Regulations Offer New Opportunities

On April 12, 1999, the Department of Health and Human Services (DHHS) released the final regulations implementing the federal Temporary Assistance for Needy Families (TANF) program. The regulations give states additional flexibility to tailor state welfare programs to meet the needs of low income families, including the ability to use federal TANF funds to support state EITCs. The new rule allows amounts spent on state refundable EITCs (and other refundable credits) to count toward states' MOE requirements. However, only the refunded portion of the credit (i.e. the amount that exceeds a family's tax liability) counts toward the MOE. If a credit only reduces a family's tax liability but the family still pays a positive tax bill, the amount of the reduction does not count toward the state's MOE requirement. Since nearly all of the cost of a California EITC is attributable to refunded credits, this provision is particularly significant. California carried over $491 million in unspent CalWORKs funds from the 1999-00 budget to 2000-01.[10] While some of these funds may be needed to meet basic program needs in the event of an economic downturn, a portion of the unspent balance could help finance a state EITC.

How Difficult Would A State EITC Be to Administer?

An EITC offers a relatively efficient and cost effective means of targeting assistance to low income working families. Estimates suggest that the cost of administering the federal credit is approximately one percent of the program's costs, extremely low compared to administrative costs of other income support programs such as CalWORKs and Food Stamps.[11] California's Franchise Tax Board previously administered a refundable renters' tax credit and a refundable child care credit was established as part of the 2000 budget agreement. Administrative costs attributable to the added workload of the renters' tax credit were less than one percent of the total cost of the credit.[12]

Recent changes to the federal EITC have helped ensure that the credit is only claimed by eligible families. In previous years, reports suggested that significant numbers of taxpayers erroneously claimed the EITC. In response to this criticism, the IRS now requires taxpayers to submit Social Security numbers for all parents and children claiming eligibility for the credit; imposes strict scrutiny of returns filed claiming the EITC; and has changed the rules which allowed taxpayers to claim the refundable portion of the EITC as a "rapid refund." These steps have greatly reduced error rates and fraud once associated with the EITC.

Would the Working Poor Benefit More by A Reduction in Tax Rates?

As an alternative to an EITC, some propose increasing the "zero bracket" amount (the level at which income first becomes subject to tax) or reducing the tax rate on earnings of low income families. California's tax threshold – the income level at which families are subject to tax – is the highest in the nation. As discussed above, the lowest income working families already pay no state income tax as a result of California's progressive rate structure, personal and dependent tax credits, and standard deduction. A married couple with two children would have no state income tax liability unless they earned more than $39,790 in 2000 – 233 percent of the federal poverty threshold. Families with incomes below the zero bracket amount would receive no benefits from a reduction in tax rates. Only those families with incomes between the current zero bracket level and a new, higher zero bracket would benefit from a change that increased the income level at which a family became subject to taxation. While changes of this type would provide relief for some lower income households, they would not help the millions of working families whose incomes are already so low as to have no tax liability.

Conclusion

A state EITC would help California's working poor move toward self-sufficiency and would provide needed tax relief to the low income families who experience the heaviest burden from state and local taxes. Research findings suggest that the EITC can play a powerful role in helping families leave welfare for work and make major purchases that can boost their long-term economic well-being. As one component of a comprehensive anti-poverty strategy, a state EITC provides a means to successfully boost the income of millions of low income California workers by building on a federal program that has a history of strong bipartisan support.

The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low and middle income Californians. Publication of this Brief was supported by grants from The Rosenberg, Ford, Charles Stewart Mott, and Friedman Family Foundations. Support for the CBP comes from foundation grants, publications, and individual contributions. Jean Ross prepared this Brief. Please visit the CBP's web site at www.cbp.org.

ENDNOTES

[1] For a detailed profile of California's working poor, see the California Budget Project's *Working, But Poor, In California* (September 1996).
[2] California Budget Project, *Falling Behind: California Workers and the New Economy* (September 2000). Poverty level wages are defined as the hourly equivalent of the poverty threshold for a family of four for a full-time worker, equivalent to $8.19 per hour in 1999.
[3] Internal Revenue Service, Table 2 - *Individual Income and Tax Data, Tax Year 1998,* Statistics of Income Bulletin (Spring 2000).
[4] Internal Revenue Service, *Earned Income Credit (EIC) Publication 596* (no date).
[5] Assumes households claim the renters' tax credit and do not itemize their deductions.
[6] Jennifer Romich and Thomas Weisner, *How Families View and Use the EITC: The Case for Lump Sum Delivery* (November 15, 2000).
[7] Timothy M. Smeeding, et al, *The Economic Impact of the Earned Income Tax Credit* (1999).
[8] V. Joseph Hotz, et al, *The Earned Income Tax Credit and Labor Market Participation of Families on Welfare* (December 5, 2000).
[9] Bruce D. Meyer and Dan T. Rosenbaum, *Making Single Mothers Work* (October 1999).
[10] California Department of Social Services, *Local Assistance Estimates for the 2001-02 Governor's Budget* (January 2001).
[11] Robert Greenstein, *The Earned Income Tax Credit: A Target for Budget Cuts?* (Center on Budget and Policy Priorities, 1995), p. 19.
[12] State of California, *Governor's Budget 1994*-95 (Sacramento: 1994). Based on budgeted savings attributable to workload reductions from the elimination of the renters' tax credit.