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ABSTRACT

This special report of the Voices for Illinois Children argues that a refundable state earned income tax credit (EITC) would foster employment and reduce taxes for low-income Illinois families. The report maintains that many low-income working families and those beginning the transition from welfare to work confront ongoing poverty despite having an income. However, the report argues, the state income tax system places a substantial burden on low- income working families. The report describes the development of the federal EITC and its impact on lifting people out of poverty, discusses the efforts of other states to complement the federal EITC with a state EITC, and presents information on state EITC benefit levels and state income tax burdens by family income levels. Further, the report provides information on the estimated costs of a state EITC and identifies possible approaches to funding a state EITC with existing dollars. The report concludes by asserting that a state EITC is a targeted and cost-effective alternative for enhancing tax equity without requiring a wholesale constitutional change in the tax system or resulting in immense revenue losses, and thereby serves as an income security policy. (KB)

VOICES FOR ILLINOIS CHILDREN

Special Report

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Generating Resources for Families

A State EITC would foster employment and reduce taxes for low-income families

As the economy grows, unemployment remains low and welfare caseloads rapidly decline, initiatives to enable and sustain self-sufficiency have received attention from policymakers across the political spectrum. Yet, many low-income working families and those just beginning the welfare to work transition confront ongoing poverty in spite of a paycheck—proving that work in and of itself is not a guaranteed pathway to economic independence.

This dilemma is neither new nor unique to Illinois. Through Work Pays, child care subsidies and most recently, the KidCare health insurance program, several new public policy investments have reflected an employment-centered consensus. These programs represent critical progress in encouraging employment and supporting families.

Unfortunately, our state income tax system continues to represent a departure from other initiatives designed to foster income security. By placing a substantial burden on low-income working families—the same population we seek to support and expect to be self-sufficient—our state income tax introduces another hurdle for families struggling to make ends meet.

In the last legislative session, Illinois lawmakers passed the first alteration to our tax threshold since its enactment in 1969. As a result, the personal exemption will increase from $1,000 to $2,000 over the next three years. This change will only move Illinois from the lowest tax threshold in the United States to the fifth lowest—from taxing a two-parent family of four at 48 percent instead of 24 percent of poverty. Nonetheless, doubling the personal exemption was an important first step toward tax equity. We believe Illinois can continue to move forward with innovation.

This *Special Report* describes how a refundable state Earned Income Tax Credit (EITC) can serve as a targeted and cost-effective tool to bolster existing income security policies by reducing low-income families' tax burden and rewarding work.

National Success: The Federal EITC as Anti-Poverty Policy

Existing state level EITCs are based on a percentage of the federal Earned Income Tax Credit, which was created as an income support policy in 1975. The federal EITC can literally create and add thousands of dollars to family income. Because it is refundable, a family receives a refund check if the credit amount is larger than a family's income tax bill. The federal EITC was significantly expanded in 1993 and a recent report from the Council of Economic Advisers found the EITC was responsible for lifting more than four million people out of poverty, including over two million children in 1997.[1] Research studies also find increased labor force participation among single mothers strongly correlated with EITC expansion.[2]

The EITC benefit that an eligible family receives depends on the family's income. For example, low-income families with two or more children receive an EITC equal to 40 cents for each dollar earned up to $9,540, for a maximum benefit of $3,816. Families with one child receive an EITC equal to 34 cents for each dollar earned up to $6,800, for a maximum benefit of $2,312. Both families continue to be eligible for their maximum benefits until income reaches $12,460. As their earnings increase above $12,460, the EITC phases out when income reaches $26,928 for families with one child, and at $30,580 for families with two or more children.[3]

EITCs in Other States

Complementing the federal EITC with a refundable state EITC is not unprecedented. Nine states now have refundable state EITCs, seven of which follow federal eligibility rules and express the state credit as a percentage of the federal credit. Minnesota mirrors federal eligibility rules, but for families with children the state and federal benefit structures are slightly different. Table 1 describes the structures of the seven refundable state EITCs.

Table 1
State Earned Income Tax Credits

States with Refundable Credits*	Percentage of Federal Credit	Workers Without Qualifying Children Eligible?
Colorado	8.5%	Yes
Maryland	10% in 1998 12.5% in 1999 & 2000 15% in 2001	No
Massachusetts	10% 15% in 2001	Yes
Minnesota**	15% no qualifying children 22% to 46% families with children	Yes
New York	20% in 1999 22.5% in 2000 25% in 2001	Yes
Vermont	25%	Yes
Wisconsin	4% one child 14% two children 43% three children	No
Kansas	10%	Yes

Notes
* In addition to the eight states shown here, a ninth state, Indiana, has enacted a refundable tax credit for working poor families with children described in statute as an "earned income tax credit." Unlike the tax credits listed in this table, the Indiana credit is unavailable to a large portion of the recipients of the federal credit
** 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 may range from 22 percent to 46 percent of the federal credit; the average state credit is about 29 percent of the federal credit.

Center on Budget and Policy Priorities

Illinois' Potential: Enhancing Income Security for Low-Income Families

While the federal EITC furnishes a sizeable supplement to more than 765,000 low and moderate-income families in Illinois, most of these families still struggle to get ahead, not just survive amid low-wages and a state income tax system with a threshold well below poverty. A refundable Illinois EITC can augment the merits of the federal EITC in three ways:

- Supporting work-first principles of welfare reform by increasing the incomes of families transitioning off caseloads and into employment.
- Reducing poverty among working families.
- Mitigating the burden of our state income tax system, which will tax a two-parent family of four at 48 percent of poverty even after doubling the personal exemption.

Given Illinois low tax threshold, a state EITC would possess the dual benefits of reducing families' tax burden and rewarding work with higher incomes. Table 2 displays EITC benefit levels and state income tax burden by family income levels.[4] As the table demonstrates, low-income Illinois families could be given a greater opportunity to make ends meet and move above the poverty line with a state EITC.

Table 2—EITC Benefit Levels by Family Income Levels, 1999

	Gross Earnings	Federal EITC	State Income Tax	FICA Payroll Taxes	20% State EITC	15% State EITC	10% State EITC
Family of four with two children							
Full-time minimum wage	$10,700	$3,816	$81	$819	$763	$572	$382
Wages equal federal poverty line	$16,700	$2,918	$261	$1278	$584	$438	$292
Wages equal 125% of poverty line	$20,875	$2,044	$386	$1597	$409	$307	$204
Wages equal 150% of poverty line	$25,050	$1,159	$512	$1916	$232	$174	$116
Wages equal 200% of poverty line	$33,400	$0	$762	$2555	$0	$0	$0
Single parent with one child							
Full-time minimum wage	$10,700	$2,312	$201	$819	$462	$347	$231
Wages equal federal poverty line	$11,060	$2,312	$212	$846	$462	$347	$231
Wages equal 125% of poverty line	$13,825	$2,094	$295	$1058	$419	$314	$209
Wages equal 150% of poverty line	$16,590	$1,654	$378	$1269	$331	$248	$165
Wages equal 200% of poverty line	$22,120	$768	$544	$1692	$154	$115	$77
Single parent with two children							
Full-time minimum wage	$10,700	$3,816	$141	$819	$763	$572	$382
Wages equal federal poverty line	$13,880	$3,518	$236	$1062	$704	$528	$352
Wages equal 125% of poverty line	$17,350	$2,791	$341	$1327	$558	$419	$279
Wages equal 150% of poverty line	$20,820	$2,054	$445	$1593	$411	$308	$205
Wages equal 200% of poverty line	$27,760	$591	$653	$2124	$118	$89	$59

Consider the following examples:

- A single parent with one child earns $10,700 from full-time minimum wage employment. Although this family's earnings are too low to pay federal income tax, they receive the maximum federal EITC of $2,312, offsetting the parent's $819 in FICA payroll taxes and providing $1,493 as a wage supplement. After doubling the personal exemption, this family will begin paying state income taxes at 36 percent of poverty—a liability of $201. With a $462 state EITC based on 20 percent of the federal credit, however, this family would not owe state income taxes, but would receive a $261 refund. The fusion of wages and the state and federal EITCs equals $12,454 in disposable income and moves the family above the poverty line.

- Similarly, a two-parent family of four earns $16,700 in wages equal to the poverty line. This family also pays no federal income tax but receives a federal EITC of $2,918, offsetting $1,278 paid in FICA payroll taxes and providing $1,640 as a wage supplement. While this family will owe $261 in state income taxes, a $438 state EITC based on 15 percent of the federal credit would eliminate their tax burden and provide a $176 refund—increasing the family's disposable income to $18,516.

The Price Tag: Estimated State EITC Costs

A state EITC is an investment worth making. It would powerfully complement welfare reform and current income support policies, such as child care subsidies and the new KidCare health insurance program.

And since a state EITC is targeted toward low and moderate-income families, the resulting revenue loss is significantly lower than adopting increases in the standard personal exemption for all Illinois taxpayers. For instance, increasing our tax threshold by $1,000 results in an annual revenue loss of more than $300 million.[5]

The procedure for determining the costs of a refundable EITC requires estimating the total amount of federal EITC benefits that Illinois residents will receive in a given year. Based on estimates from the IRS Statistics of Income Bulletin 1998 and the U.S. Office of Management and Budget, Illinois residents will claim $1.202 billion in federal EITC benefits in tax year 2000, $1.238 billion in 2001, $1.280 billion in 2002 and $1.323 billion in 2003.[6] Multiplying this figure by the percentage of the federal credit at which the state credit will be set gives us an estimated cost for the state credit if all Illinois residents currently receiving the federal credit also received the state credit. Table 3 displays the estimated costs of an Illinois EITC in tax years 2000 through 2003.

Table 3
Estimated Costs of Illinois EITC

	5% state EITC	10% state EITC	15% state EITC	20% state EITC
Estimated State Cost Tax Year 2000	$60,100,000	$120,200,000	$180,300,000	$240,400,000
Estimated State Cost Tax Year 2001	$61,900,000	$123,800,000	$185,700,000	$247,600,000
Estimated State Cost Tax Year 2002	$64,000,000	$128,000,000	$192,000,000	$256,000,000
Estimated State Cost Tax Year 2003	$66,150,000	$132,300,000	$198,450,000	$264,600,000

Because this formula assumes full participation in the state credit among residents who receive the federal EITC, it provides an upper-bound estimate of state EITC costs. Experiences in other states implementing an EITC suggest this is unlikely to occur during the first two years. For instance, when

New York implemented an EITC in 1994, the cost of the credit in the first year was approximately 83 percent of the full-participation estimate. In the second year of operation, state costs represented 90 percent of the estimate.[7] This can be attributed to several factors:

- Availability of a state credit must catch up with public awareness.

- Part-year residency can make families ineligible for all or part of the credit.

Financing a State EITC: Two Possible Revenue Streams

In addition to traditional revenue streams, there are several approaches to funding a state EITC with existing dollars.

- **Maintenance of Effort:** The federal Department of Health and Human Services' proposed TANF regulations allow states to apply part of the refundable portion of their state EITC toward maintenance of effort (MOE) spending requirements.[8] Already recognized as a work-first companion to welfare reform, Illinois could pursue this approach to partially fund a state EITC with an estimated $39 million of MOE funds.

- **Welfare Savings:** According to the Illinois Department of Human Services Budget Office, our estimated state MOE level for FY 1999 is $453 million, or 79 percent of welfare spending in 1994. Ultimately, this translates into $120 million of welfare savings. With declining caseloads and large numbers of former recipients presumably entering the work force, we believe reinvesting welfare savings into a state EITC would only enhance other income security policies.

Taking the Next Step in Family Support

We believe a state EITC is a forward-thinking investment. Without requiring a wholesale constitutional change in our tax system or resulting in immense revenue losses, a state EITC is a targeted and cost-effective alternative to enhance tax equity. By creating and adding to the financial resources of low-income families, a state EITC also serves as an income security policy—encouraging employment, supporting welfare reform and reducing poverty.

This *Special Report* was authored by Brian Matakis. For more information about this topic and other state fiscal issues please call Voices for Illinois Children at (312) 456-0600.

Voices is a non-profit, non-partisan, citizen-based advocacy group addressing problems faced by Illinois children and their families. Through research, public education and coalition-building, Voices generates support from civic, business and community leaders for cost-effective and practical proposals to improve the lives of Illinois children. Voices' President is Jerome Stermer and Chair of the Board is Lorraine Barba.

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Endnotes

[1] A Report by the Council of Economic Advisers. *Good News For Low Income Families.* December 1998.
[2] Bruce Meyer. *The Earned Income Tax Credit, Welfare and Work.* Joint Center for Poverty Research. December 1998.
[3] IRS Rev. Proc. 98-61, IRS Bulletin 1998-52, Dec. 28, 1998.
[4] State income tax rates are based on the full $2,000 personal exemption.
[5] The Illinois Economic & Fiscal Commission predicts a $326 million annual revenue loss from a $1,000 threshold increase.
[6] The Center on Budget and Policy Priorities conducts forecasting of estimated federal EITC benefits received by state.
[7] New York state EITC figures are from New York State Department of Taxation and Revenue, Office of Tax Policy Analysis, *Earned Income Tax Credit: Analysis of Credit Claims for 1995.* February 1997.
[8] Federal welfare reform legislation mandates states maintain minimum welfare spending levels of 75 percent of their 1994 welfare expenditures.

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