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Rewarding Work Through Earned Income Tax Credits

Low-wage workers often face a dual challenge as they struggle to make ends meet. In many instances, the wages they earn are insufficient to encourage additional hours of work or long-term attachment to the labor force. At the same time, most state and local tax systems impose greater responsibilities on poor families than on wealthy ones, making it even harder for low-wage workers to move above the poverty line and achieve meaningful economic security. The Earned Income Tax Credit (EITC) is designed to help low-wage workers meet both those challenges. This policy brief explains how the credit works at the federal level and what policymakers can do to build upon it at the state level.

The Federal Earned Income Tax Credit

The federal EITC was introduced in 1975 to provide targeted tax reductions to low-income workers. Workers with and without children are eligible for the credit, but the credit is worth more for families with children. The credit also varies with income levels and was recently temporarily expanded by President Obama to include families with three or more children.

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 \$12,780 in 2011, families with three children receive a tax credit equal to 45 percent of those earnings, up to a maximum credit of \$5,751.

Because the credit is designed to provide tax relief 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 \$16,690 (or \$21,770 for married-couple families). After this point, the amount families receive goes down until it reaches zero when family income goes beyond the eligibility level. The credit is entirely unavailable to families with three or more children earning more than \$43,998 if they are single and \$49,078 if married.

For taxpayers without children the credit is less generous: the maximum credit is \$464 and singles earning more than \$13,660 (\$18,740 for married couples without children) are ineligible.

Why a State EITC?

The case for an Earned Income Tax Credit is even stronger at the state level than at the federal level. Unlike federal taxes, state and local taxes are regressive, requiring low-income taxpayers to pay more of their income in taxes than wealthier taxpayers. According to ITEP's Who Pays report, nationwide the poorest twenty percent of Americans paid 10.9 percent of their incomes in state and local taxes in 2007. By contrast, middle-income taxpayers put 9.4 percent of their incomes toward those taxes, and the wealthiest one percent taxpayers paid just 5.2 percent of their incomes in state and local taxes. The high state and local tax burden on the poorest Americans is primarily due to the heavy use of regressive sales and property taxes. A refundable EITC is the most effective targeted tax relief strategy currently used by states to reduce the unfairness of these taxes.

Twenty-four states (and the District of Columbia) have enacted an Earned Income Tax Credit to reduce the unfairness of their tax systems. All but one of these states allow taxpayers to calculate their EITC as a

percentage of the federal credit. This approach makes the credit easy for state taxpayers to claim (since they have already calculated the amount of their federal credit) and easy for state tax administrators to monitor.

However, these states vary dramatically in the generosity of their credits. The credit provided by the District of Columbia amounts to 40 percent of the federal credit, while eight states have credits that are worth less than 10 percent of the federal credit. Moreover, three states (Delaware, Maine and Virginia) allow non-refundable credits. Non-refundable credits can only be used to offset income tax liability, even though sales and property taxes are usually more burdensome for low-income working taxpayers. The chart below shows the EITC's states are expected to offer in 2011. (Note: Washington's credit is set to begin in 2012 and Wisconsin's credit is dependent on family size.)

Refundability is Key to EITC's Success

The federal Earned Income Tax Credit is refundable: if the credit exceeds a taxpayer's income tax bill, the excess amount is paid as a tax refund. The credit was designed this way because policymakers recognized that the income tax is not the only federal tax paid by low- and middle-income workers. These taxpayers usually pay much more in payroll taxes than in income taxes. By making the EITC refundable, Congress ensured that it could be used to help offset all federal taxes paid, not just the income tax.

Refundability is an especially important component as well of state EITCs or any targeted low-income tax credit to ensure deserving families get the full benefit of the credit. Refundable credits do not depend on the amount of income taxes paid: if the credit amount exceeds your income tax liability, the excess amount is given as a refund. Thus, refundable credits are useful in offsetting the regressive nature of sales and property taxes (which all working families pay), and can provide a much needed income boost to help families pay for basic necessities.

The EITC: An Effective Anti-Poverty Tool

The Earned Income Tax Credit is widely recognized as an effective tool for preventing low-income working families from slipping into poverty. In fact, the credit lifts roughly five million people each year above the federal poverty line. The EITC is recognized by lawmakers of all political affiliations as an important way of rewarding work; legislation expanding the federal EITC has been approved by each of the last five Presidents, beginning with President Reagan and including President Obama.

Enacting such a credit is also one of the most cost-effective strategies available to lawmakers seeking to improve the fairness of state and local taxes while at the same time rewarding work.

