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## STRATEGIES TO REWARD WORK: HOW CAN A STATE EARNED INCOME TAX CREDIT ASSIST CALIFORNIA'S WORKING POOR?

Economic trends have made it harder for many families to rise out of poverty 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.<sup>1</sup> 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 their incomes decline and have experienced diminished prospects of moving up the income 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 1997, 2.4 million California households claimed \$3.7 billion in federal EITC benefits.<sup>2</sup> 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. Eleven states -- Colorado, Iowa, Kansas, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, and Wisconsin -- currently have state Earned Income Tax Credits that complement the federal credit and boost the incomes of the working poor. Eight of these states -- Colorado, Kansas, Maryland, Massachusetts, Minnesota, New York, Vermont, and Wisconsin -- have refundable credits.

Recent attention to the prevalence of poverty among California's working families has increased interest in proposals to enact a state EITC. This *Budget Brief* explores the feasibility of using a state EITC to further supplement the earnings of low-income working families.

### THE POVERTY GAP

Failure of the minimum wage to keep pace with inflation, coupled with economic trends that have led to a growth in the number of low wage jobs, has increased the share of working families living below the poverty line. In California, 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. This is true even at California's

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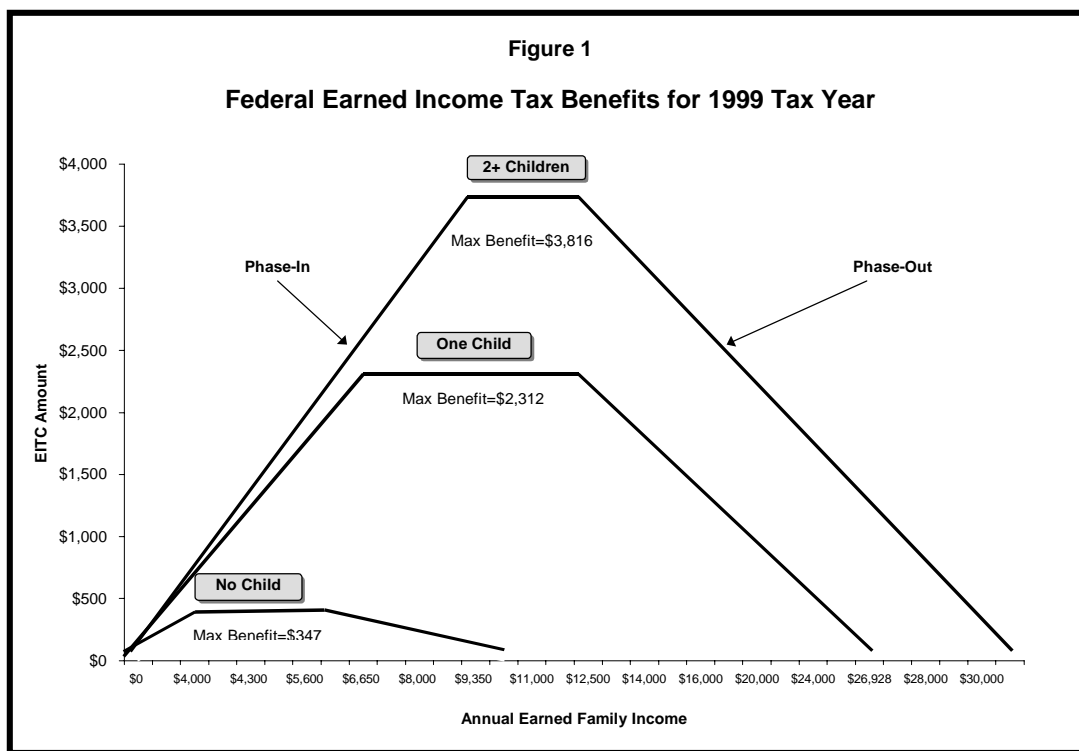
<sup>1</sup> For a detailed profile of California's working poor, see the California Budget Project's *Working, But Poor, In California* (Sacramento: California Budget Project, 1996).

<sup>2</sup> Internal Revenue Service, Table 2--*Individual Income and Tax Data, Tax Year 1997*, Statistics of Income Bulletin, Spring 1999.

\$5.75 per hour minimum wage, which exceeds the national minimum wage of \$5.15. For example, the income of a family of four supported by a full-time worker earning \$5.75 per hour equals 70 percent of the 2000 federal poverty threshold. For a family of three, full-time minimum wage work brings a family's income to 85 percent of the poverty level. Moreover, a large number of families have incomes just above the federal poverty line, but still so low as to be considered poor by any reasonable standard.

## 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 flat range where the maximum EITC amount remains constant; and (3) the phase-out range where benefits decline as earnings increase (Figure 1). In 1999, a family with two or more dependents can receive a maximum EITC of \$3,816. The credit declines as household income rises above \$12,500, with an eligibility cap of \$30,580. A family with one dependent is eligible for a maximum credit of \$2,312, with an income cap of \$26,928. The EITC provides a maximum credit of \$347 for childless workers, based on their share of payroll taxes -- 7.65 percent -- with an income limit of \$10,200.<sup>3</sup>



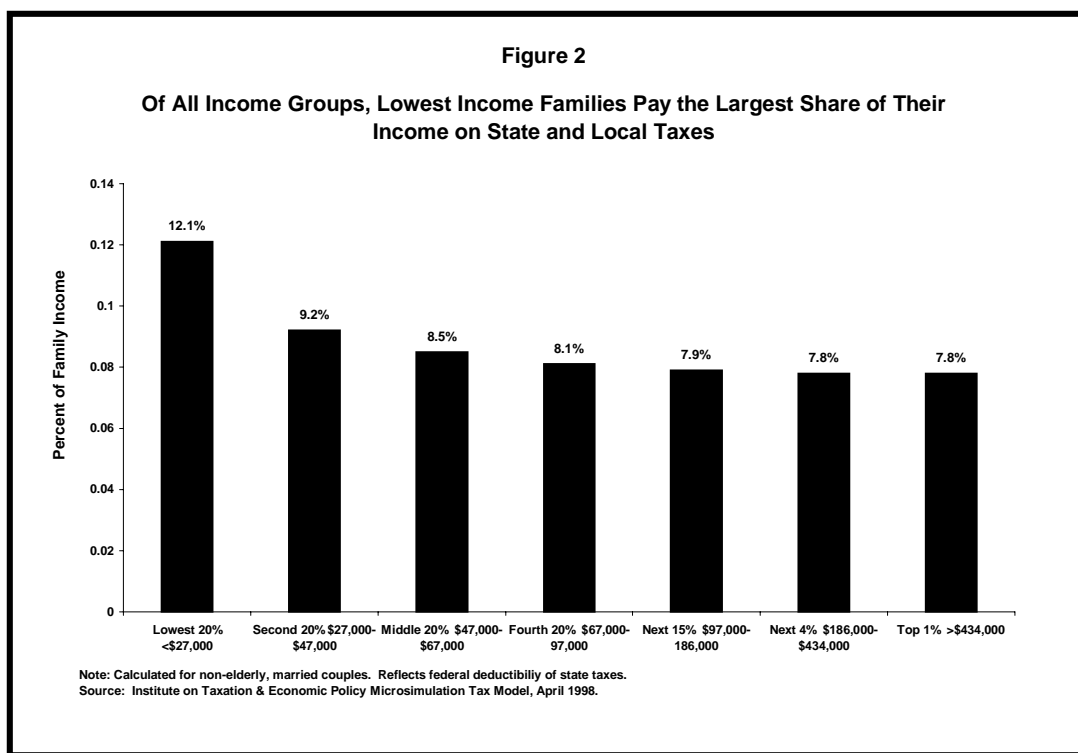
## HOW WOULD A STATE EARNED INCOME TAX CREDIT WORK?

Most state EITCs are patterned after the federal credit. By linking state eligibility rules to those of the federal credit, California could take advantage of federal efforts to insure compliance and coordinate efforts to publicize the availability of credits so that families receive the benefits for which they are eligible. A state credit can be set at any percentage of the federal credit. While arguments can be made

<sup>3</sup> CCH Inc., *2000 US Master Tax Guide* (CCH, Inc: Chicago: 1999) and Franchise Tax Board, *Analysis of AB 1854*.

for mirroring the federal program, California could limit availability to a smaller group of taxpayers or modify the structure of the credit. Some of the key design issues in crafting a state EITC include:

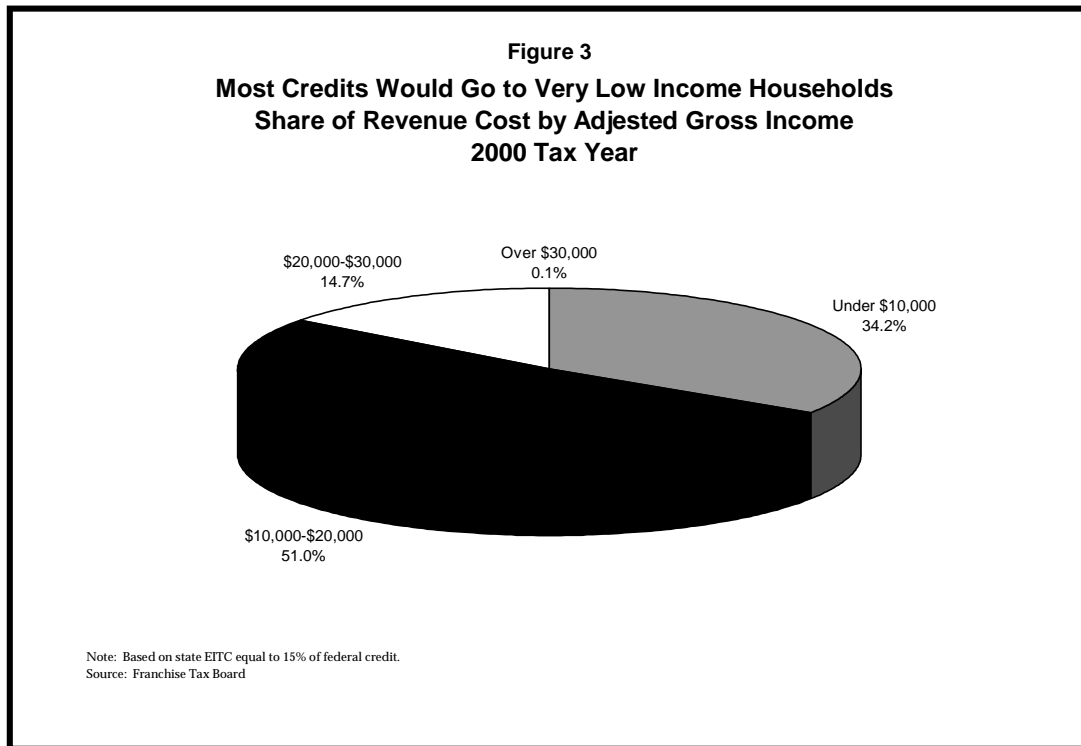
- Refundability.** A refundable credit is paid to a family regardless of whether or not they owe income tax. Credits are first used to reduce a family's tax liability, with any remainder returned to the family in the form of a refund. For California, refundability is particularly critical since the state's 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 1999 state income tax liability unless their income exceeded \$38,475, while a single mother with one child would not pay taxes unless she earned in excess of \$31,000.<sup>4</sup> 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).



- Eligibility.** The cost of a state EITC could be reduced by excluding childless households or by imposing a lower maximum income eligibility level than that established for the federal credit. Federal law provides a small credit to childless families with very low incomes -- less than \$10,200 in 1999. The federal EITC for childless workers is designed to offset the amount paid in federal payroll taxes. One option for California policymakers would be a credit designed to offset the additional burden of state payroll taxes -- the 0.5 percent state disability insurance tax. Estimates prepared by the Franchise Tax Board suggest that the savings from eliminating eligibility for childless families would be minimal. Similarly,

<sup>4</sup> Assumes households claim the renters' tax credit and do not itemize their deductions.

imposing a lower income eligibility level would result in only modest savings, since higher income households receive a relatively small credit due to the phase out (Figure 3).



- **Size of Credit.** Cost considerations will be the primary determinant of the size of any state credit. The size of the credit presents a direct trade-off between the benefits provided to poor families and the cost to the state. A credit patterned after the federal credit would cost approximately \$203 million in 2000 for each five percent increment of credit.<sup>5</sup> In other words, a state credit equal to 10 percent of what a family receives from the federal credit would cost \$406 million, while a credit equal to 15 percent of the federal credit would cost \$609 million.
- **Family Size.** Should the size of the credit vary directly with family size? The amount of the federal credit varies by whether a family is childless, has one child, or more than one child. California's state tax system provides a dependent credit for each child. Options for a state credit include increasing the size of the credit with each additional child, providing a fixed amount of credit to all taxpayers or to taxpayers with dependents, or following the federal model.

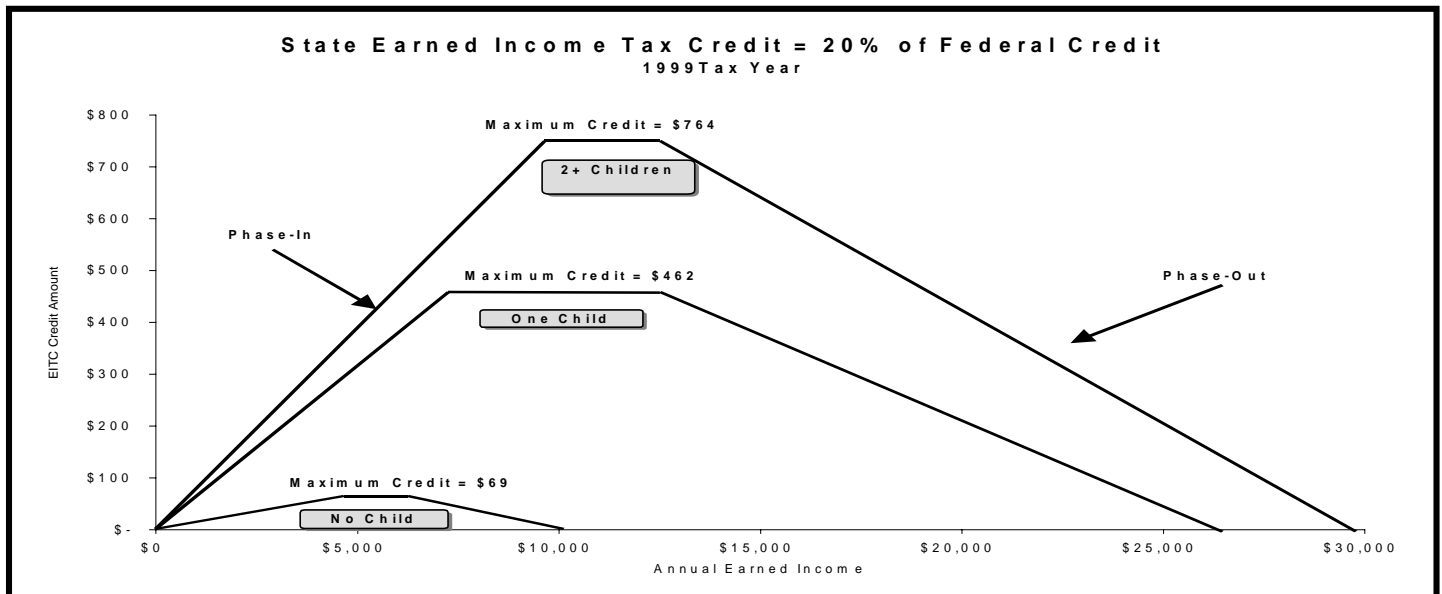
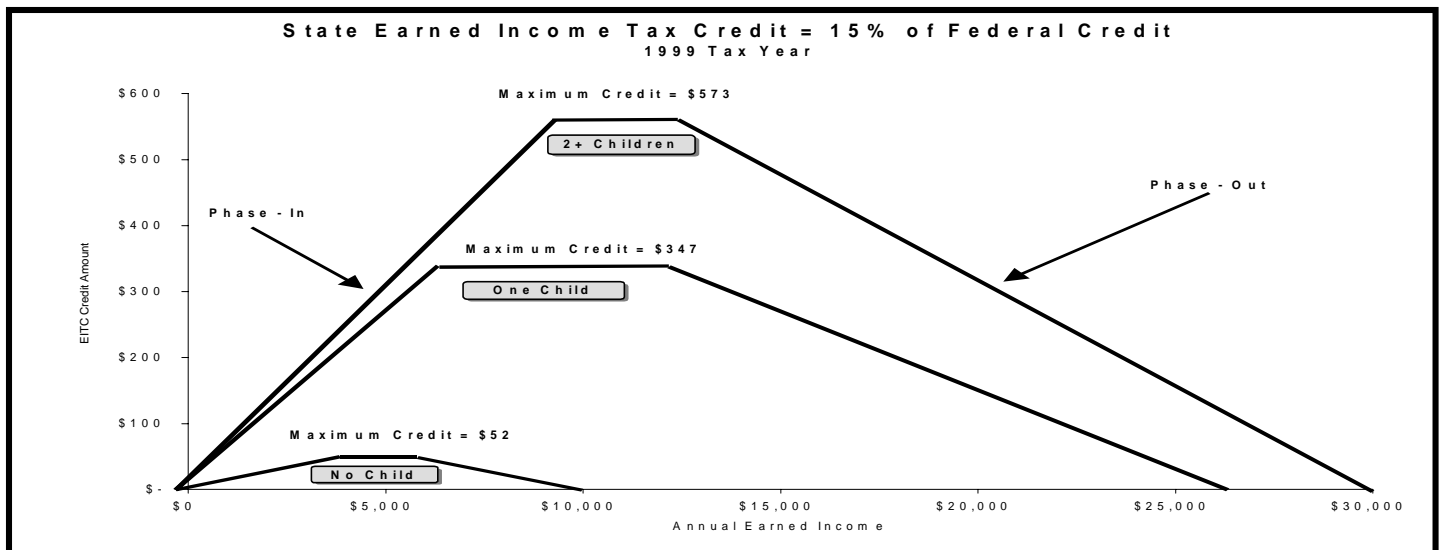
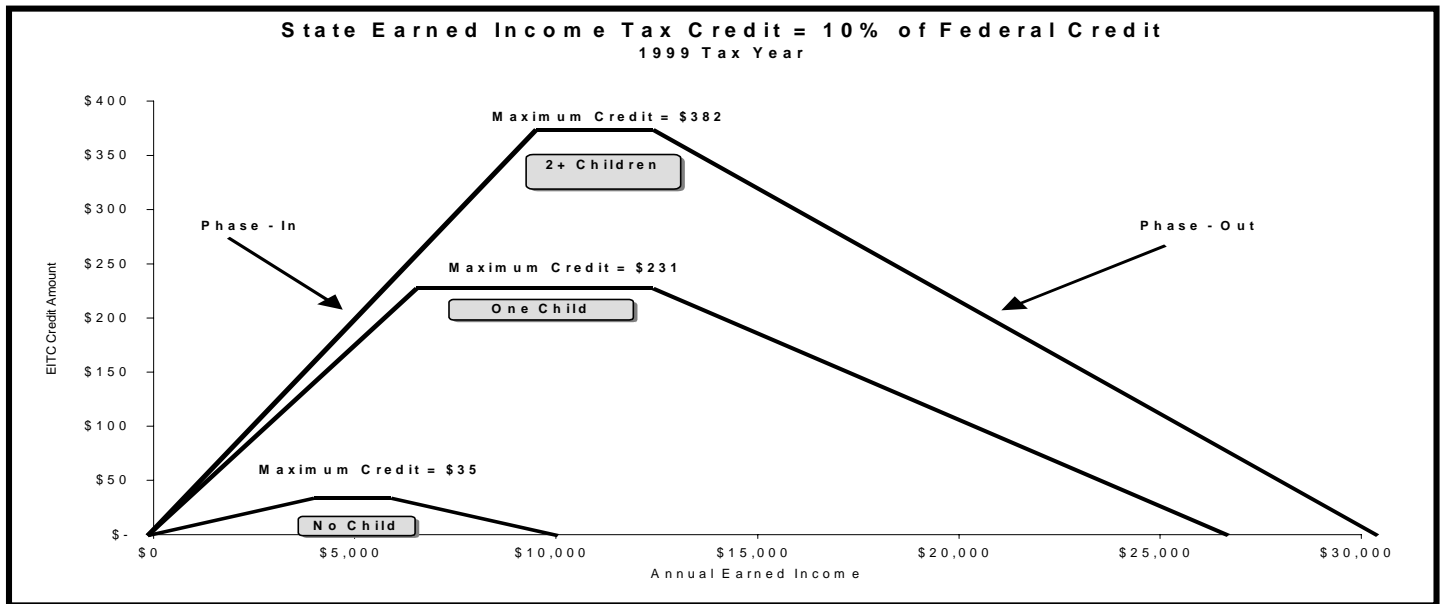
While a state EITC would provide significant assistance to low-income families, a family of four supported by a full-time minimum wage worker would still fall below the federal poverty line (Table 1).<sup>6</sup>

A state credit equal to 15 percent of the federal credit, for example, would provide a maximum of \$573 per year to a family with more than one child and up to \$347 per year for a family with one child (Table 2).

<sup>5</sup> Franchise Tax Board, *Analysis of AB 1854*.

<sup>6</sup> Assumes a state EITC equal to 15 percent of the federal EITC.

**Figure 4**  
**How Would A State EITC Work?**



	<b>\$5.75 Minimum Wage</b>	<b>State EITC &amp; \$5.75 Minimum Wage</b>
<b>Earnings</b>	\$11,960	\$11,960
<b>Payroll Taxes</b>	(\$975)	(\$975)
<b>Federal EITC</b>	\$3,816	\$3,816
<b>State EITC Equal to 15% of Federal EITC</b>		\$573
<b>Disposable Income</b>	\$14,801	\$15,374
<b>Disposable Income as a Percent of 2000 Poverty Line for a Family of Four</b>	87%	90%

<b>Size of State Credit (% of Federal EITC)</b>	<b>Cost of Credit (In millions)</b>	<b>Average Credit</b>	<b>Maximum Credit One Child</b>	<b>Maximum Credit More Than One Child</b>
10%	\$406	\$127	\$231	\$382
15%	\$609	\$191	\$347	\$573
20%	\$812	\$254	\$462	\$764

## 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 approximately \$609 million in the 2000 tax year. 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). Restricting a credit to families with children would reduce the cost of a state credit by just two percent.<sup>7</sup>

One frequently raised concern with respect to measures that reduce state tax revenues is the potential impact on funding for education. In some years, the level of funding for K - 14 education guaranteed by Proposition 98 of 1988 depends on state General Fund revenues.<sup>8</sup> In these years, tax credits that reduce General Fund revenues reduce schools' minimum funding guarantee. However, based on the precedent established for previous refundable credits, the amount returned to families with no tax liability would be treated as a spending program and does not reduce the level of the Proposition 98 guarantee. Thus, while a refundable EITC would compete against other General Fund priorities, it would have an extremely minimal impact on the school spending guarantee since nearly all (99 percent) of the benefits of a state EITC mirroring the federal credit would be paid in the form of a refund, rather than a tax decrease.

## 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

<sup>7</sup> Based on an estimated \$13 million reduction in the cost of a credit equal to 15 percent of the federal credit from 608.5 to \$595.3 million.

<sup>8</sup> This is the case in "Test 3" years.

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 \$655 million in unspent CalWORKs funds from the 1998-99 budget to 1999-00.<sup>9</sup> While some of these funds may be needed to meet basic program needs in the event of an economic downturn, policymakers may wish to consider allocating a portion of the unspent balance to 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.<sup>10</sup> California's Franchise Tax Board previously administered a refundable renters' tax credit. Administrative costs attributable to the added workload of the renters' tax credit were less than one percent of the total cost of the credit.<sup>11</sup>

Recent changes to the federal EITC have helped insure 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 in excess of \$38,475 in 1999 -- 226 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.

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<sup>9</sup> Legislative Analyst's Office, *California Spending Plan 1999-00* (August 1999), p. 29.

<sup>10</sup> Robert Greenstein, *The Earned Income Tax Credit: A Target for Budget Cuts?* (Washington DC: Center on Budget and Policy Priorities, 1995), p. 19.

<sup>11</sup> 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.

## CONCLUSION

The most significant argument against a state EITC is cost. The fiscal impact of a state EITC could be minimized by balancing the cost of a new credit with revenues raised by limiting existing tax expenditures or by increasing some other state tax. Alternately, a state EITC could be phased in over time to minimize the immediate impact on the state budget. 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 patterned after a federal program that has a history of strong bipartisan support.

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