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spotlight

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BAD CREDIT

State Earned Income Tax Credit would do little good at great cost

SUMMARY: **The Federal Earned Income Tax Credit (EITC) has helped single mothers escape poverty, but it has penalized married parents and is plagued by misunderstanding and fraud. A state EITC at five percent of the federal level would cost $66 million with the same problems but less impact. State tax credits should address problems in the federal tax code, such as the penalty against middle class parents who do not qualify for means-tested programs or against individuals who do not purchase health insurance through their employer. The state child tax credit addresses the former and a health insurance purchase tax credit would address the latter problem.**

Economists and policy analysts generally agree that the federal earned income tax credit (EITC) is an effective anti-poverty policy tool. It does not price anybody out of the job market, impose additional costs on employers, or cause other distortions in the labor market that the minimum wage does. Research has shown that the federal EITC has been an important factor in single mothers' increased participation in the labor force,[1] although debate continues on the exact magnitude of the EITC relative to other welfare reforms.

Married women are more likely to exit the work force or cut back on working hours, in part because of the high marginal tax rate (up to 41 percent) that exists in the phase-out region of the EITC schedule.[2] Some economists have suggested that means testing the credit imposes a penalty on middle class parents.[3]

In addition to its mixed welfare effect, the federal EITC is extremely complicated (see figure 1), which makes it prone to mistakes and abuse. One IRS publication explaining eligibility is 58 pages.[4] Some of the mistakes include individuals not claiming a credit for which they are eligible. As much as $9 billion of $30 billion claimed in credits for tax year 1999, however, should not have been paid. Misreported income and false statements about residency or family relationships cost up to $5 billion each year.[5] In a question to the GAO in 2006, Sen. Tom Coburn (R-Okla) said, "[I]mproper payments made in the Earned Income Tax Credit makes up the second largest portion of government-wide improper payments for fiscal year 2005, estimating $9.6 to $11.4 billion

200 W. Morgan, #200
Raleigh, NC 27601
phone: 919-828-3876
fax: 919-821-5117
www.johnlocke.org

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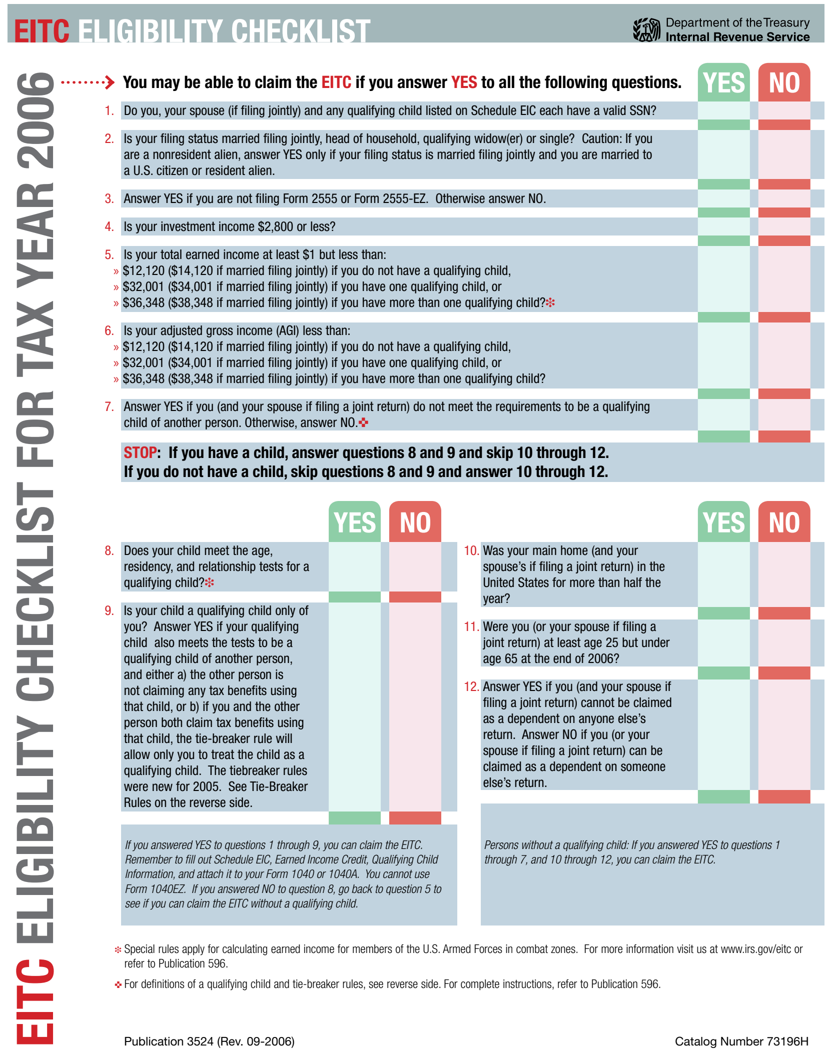
dollars [23 to 28 percent] paid improperly. … This program does not just need help, it needs a complete overhaul, with an improper payment rate that high."[6]

State EITC Proposals

North Carolina politicians,[7] newspaper editorials,[8] and left-leaning policy groups[9] have pushed an earned-income tax credit for the state. Proposals have ranged in value from five percent to ten percent of the federal level. Although many of the same individuals and groups advocated a higher minimum wage in 2006 as a way to help low-income workers, they now argue for the earned-income tax credit because the minimum wage is not efficient at improving the welfare of families.

Nineteen states and the District of Columbia have enacted earned-income tax credits ranging from five percent of the federal credit to 35 percent. (see figure 2) In North Carolina, a state EITC set at five percent of the federal credit would cost $66 million[10] and provide benefits up to $227, though the average amount would be $94.[11] At ten percent of the federal credit, a state EITC would cost $133 million with maximum benefits of $450 and average benefits of $187. Whether $94 or $187, this will not make an impact on the poverty status of many people.

Figure 1: IRS Guide to EITC Eligibility



EITC ELIGIBILITY CHECKLIST

Department of the Treasury
Internal Revenue Service

EITC ELIGIBILITY CHECKLIST FOR TAX YEAR 2006

You may be able to claim the EITC if you answer YES to all the following questions. YES NO

1. Do you, your spouse (if filing jointly) and any qualifying child listed on Schedule EIC each have a valid SSN?
2. Is your filing status married filing jointly, head of household, qualifying widow(er) or single? Caution: If you are a nonresident alien, answer YES only if your filing status is married filing jointly and you are married to a U.S. citizen or resident alien.
3. Answer YES if you are not filing Form 2555 or Form 2555-EZ. Otherwise answer NO.
4. Is your investment income $2,800 or less?
5. Is your total earned income at least $1 but less than:
   » $12,120 ($14,120 if married filing jointly) if you do not have a qualifying child,
   » $32,001 ($34,001 if married filing jointly) if you have one qualifying child, or
   » $36,348 ($38,348 if married filing jointly) if you have more than one qualifying child?❈
6. Is your adjusted gross income (AGI) less than:
   » $12,120 ($14,120 if married filing jointly) if you do not have a qualifying child,
   » $32,001 ($34,001 if married filing jointly) if you have one qualifying child, or
   » $36,348 ($38,348 if married filing jointly) if you have more than one qualifying child?
7. Answer YES if you (and your spouse if filing a joint return) do not meet the requirements to be a qualifying child of another person. Otherwise, answer NO.❖

STOP: If you have a child, answer questions 8 and 9 and skip 10 through 12.
If you do not have a child, skip questions 8 and 9 and answer 10 through 12.

YES NO

8. Does your child meet the age, residency, and relationship tests for a qualifying child?❈
9. Is your child a qualifying child only of you? Answer YES if your qualifying child also meets the tests to be a qualifying child of another person, and either a) the other person is not claiming any tax benefits using that child, or b) if you and the other person both claim tax benefits using that child, the tie-breaker rule will allow only you to treat the child as a qualifying child. The tiebreaker rules were new for 2005. See Tie-Breaker Rules on the reverse side.

If you answered YES to questions 1 through 9, you can claim the EITC. Remember to fill out Schedule EIC, Earned Income Credit, Qualifying Child Information, and attach it to your Form 1040 or 1040A. You cannot use Form 1040EZ. If you answered NO to question 8, go back to question 5 to see if you can claim the EITC without a qualifying child.

YES NO

10. Was your main home (and your spouse's if filing a joint return) in the United States for more than half the year?
11. Were you (or your spouse if filing a joint return) at least age 25 but under age 65 at the end of 2006?
12. Answer YES if you (and your spouse if filing a joint return) cannot be claimed as a dependent on anyone else's return. Answer NO if you (or your spouse if filing a joint return) can be claimed as a dependent on someone else's return.

Persons without a qualifying child: If you answered YES to questions 1 through 7, and 10 through 12, you can claim the EITC.

❈ Special rules apply for calculating earned income for members of the U.S. Armed Forces in combat zones. For more information visit us at www.irs.gov/eitc or refer to Publication 596.

❖ For definitions of a qualifying child and tie-breaker rules, see reverse side. For complete instructions, refer to Publication 596.

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If a state EITC ever made sense, it would have been as a substitute for the minimum wage increase passed in 2006, for all of the reasons EITC advocates now say it makes sense as a complement to the minimum wage increase. The two policies are not complementary, even at the federal level. The EITC provides welfare benefits through the tax code to parents who earn up to $38,000. The minimum wage makes it more difficult for low-skilled workers to find a job. A person with no children working full time at the state minimum wage would earn too much ($12,300) to qualify for the earned income tax credit.

When Tax Credits Make Sense

Previous John Locke Foundation papers have recognized some of the problems with North Carolina's reliance on income and sales tax revenues to fund state government and have suggested ways to improve the system, such as moving to a consumed-income tax[12] and eliminating tax biases.[13]

State governments should create tax credits to offset problems in the federal tax code. Because a state EITC would simply piggyback on the existing federal credit, it would have the same problems as the federal credit without any compensating strengths. Fraudulent or mistaken federal claims would carry over to state taxes. Even if the net dollar value of such claims is small, they undermine the policy argument for a state EITC.

The existing child tax credit, on the other hand, does ease the burden on middle class parents created by the federal EITC and other aspects of the federal tax code. Doubling this credit to $200 per child would cost the state about as much as the 10 percent EITC, but would help all families and be less subject to fraud.

Figure 2: State Earned Income Tax Credits Based on the Federal EITC
Tax Year 2006

	Percentage of Federal Credit	Refundable?	Workers Without Qualifying Children Eligible?	Average Amount of State Credit (Most Recent Year)
Colorado	10%	Yes	Yes	Suspended 2006
Delaware	20%	No	Yes	N/A
District of Columbia	35%	Yes	Yes	$467
Illinois	5%	Yes	Yes	$91
Indiana[a]	6%	Yes	Yes	$105
Iowa	6.5%	No	Yes	$83
Kansas	15%	Yes	Yes	$249
Maine	5%	No	Yes	$60
Maryland[b]	20%	Yes	No	$313
Massachusetts	15%	Yes	Yes	$231
Michigan	10% (effective in 2008; to 20% in 2009)	Yes	Yes	N/A
Minnesota[c]	Average 33%	Yes	Yes	$516
Nebraska	8%	Yes	Yes	N/A
New Jersey[d]	20%	Yes	No	$373
New York[e,f]	30%	Yes	Yes	$452
Oklahoma	5%	Yes	Yes	$95
Oregon	5% (to 6% in 2008)	Yes	Yes	$70
Rhode Island	25%	Partially[g]	Yes	N/A
Vermont	32%	Yes	Yes	$493
Virginia	20%	No	Yes	N/A
Wisconsin	4% - one child 14% - two children 43% - three children	4% - one child 14% - two children 43% - three children	No	$326

Notes: From 1999 to 2001, Colorado offered a 10% refundable EITC financed from required rebates under the state's "TABOR" amendment. Those rebates, and hence the ETIC, were suspended beginning in 2002 due to a lack of funds and again in 2005 as a result of a voter-approved five-year suspension of TABOR. Under current law, the EITC is projected to resume in 2010.

[a] Presently scheduled to expire in TY 2011.

[b] Maryland also offers a non-refundable EITC set at 50 percent of the federal credit. Taxpayers in effect may claim either the refundable credit or the non-refundable credit, but not both.

[c] Minnesota's credit for familes 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 for families with children may range from 25 percent to 45 percent of the federal credit; taxpayers without any children may receive a 25 percent credit.

[d] The New Jersey credit is available only to families with incomes below $20,000.

[e] The New York credit would be reduced automatically to the 1999 level of 20 percent should the federal government reduce New York's share of the TANF block grant.

[f] Beginning in 2006, New York also allows certain non-custodial parents who are making child support payments to claim an EITC that is the greater of 20 percent of the federal EITC that they would be eligible for with one qualifying child as a custodial parent or 250 percent of the federal EITC for taxpayers without qualifying children.

[g] Rhode Island made a very small portion of its EITC refundable effective in TY 2003. In 2006, the refundable portion was increased from 10 percent ot 15 percent of the nonrefundable credit (i.e. 3.75 percent of the federal EITC).

Sources: Ifie Okwuje and Nicholas Johnson, "A Rising Number of State Earned Income Tax Credits Are Helping Working Families Escape Poverty," Center on Budget and Policy Priorities (October 20, 2006). Internal Revenue Service

Another worthwhile state tax credit would compensate for the tax penalty imposed on individuals who do not receive insurance through their employers. A refundable credit of $1,000 per person and up to $4,000 per family would make it possible to purchase a high deductible policy and set aside some money in a health savings account (HSA) with the tax savings. The cost of such a credit would be up to $500 million, which could be paid in part by repealing the fiscal year 2005-06 expansions of Medicaid and Health Choice for children in families with incomes up to $40,000, and reducing the number of optional Medicaid benefits.

Conclusion

The federal earned income tax credit (EITC) has been an effective tool in helping low-income families headed by single women, but has been less effective at improving work incentives for married women. Middle class parents face a tax penalty because of the EITC. The program has also been prone to mistakes and fraud.

A state EITC would do nothing to alleviate the problems of the federal program, but would carry them through into the state tax code. Welfare improvements would be small at a cost of $66 million per year.

State tax credits make sense when they address a flaw in the federal or state tax code. A state EITC would not. Expanding the state child tax credit or creating a health insurance tax credit would accomplish this. Legislators should consider one or both of these alternatives to improve the welfare of North Carolinians.

Joseph Coletti is Fiscal Policy Analyst for the John Locke Foundation.

NOTES

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