A STATE EARNED INCOME TAX CREDIT (EITC)
KEY BACKGROUND

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> *When the federal Earned Income Tax Credit was expanded in 1986, President Ronald Reagan called it '…the best anti-poverty, the best pro-family, the best job creation measure to come out of Congress.' I agree and ask your support for a state credit equal to 10 percent of the federal amount for Kansans.*
>
> Gov. Bill Graves (R), State of the State Address, 1998

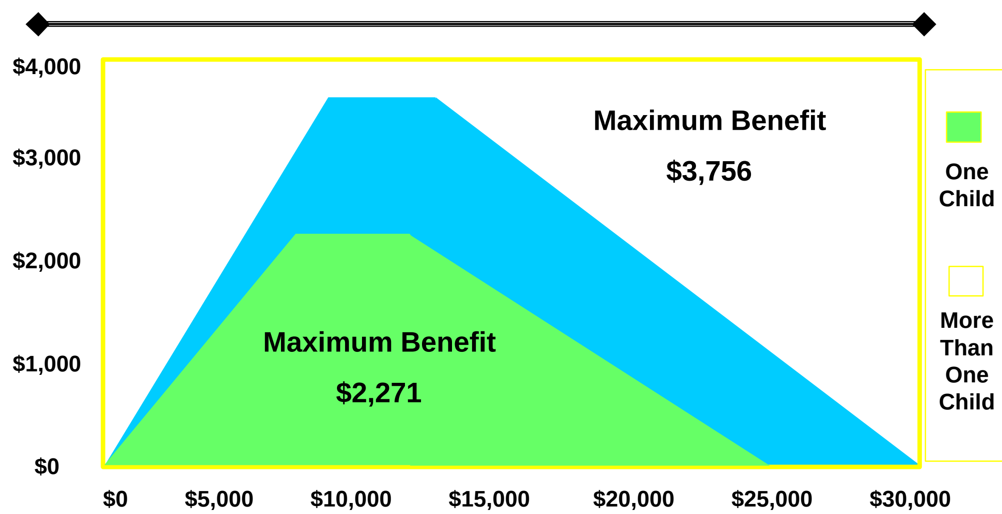
> *The goals of the Earned Income Tax Credit (EITC) are to make work pay, to help ensure that working parents to not have to raise their children in poverty, and to offset the total tax burden of low and moderate income working families.… The EITC is a non-bureaucratic way to reward work effort. There are no middlemen service providers, no long lines at government offices, and there is no need to take time off from work to apply for the credit.*
>
> President's Council of Economic Advisors, December 1998

What is a refundable Earned Income Tax Credit? A refundable Earned Income Credit (EITC) is a well-targeted, administratively-efficient way to "make work pay" by supplementing the incomes of low-wage working families. The federal EITC now helps 4.6 million Americans escape poverty, including 2.4 million children. It provides an incentive to work, because *only* people who work qualify for the credit. The EIC offsets the sudden income loss that families receiving welfare face when they transition off of cash assistance. Perhaps most importantly for Connecticut's long-term economic well-being, the EITC invests in children. It can insure that many fewer Connecticut children have their futures dimmed by poverty's adverse impact on their health and their capacity to learn and achieve in school.

The federal EITC. The federal EITC is a refundable tax credit, meaning that the credit is paid to a family even if the credit exceeds the family's income tax liability. For example, a family whose income tax liability is $1200 and who qualifies for a $2000 credit would pay no federal income tax and receive a $800 refund. The federal EITC varies, based on a family's total income and family size. Workers without children are eligible for a smaller credit than workers with children, and families with two or more children receive a larger credit than families with one child. The credit is adjusted each year for inflation. The credit is claimed on income tax returns, keeping administrative costs very low.

The EITC phases in and out gradually as income increases, unlike many means-tested programs where benefits end completely at a certain income. The following chart illustrates this, showing that the credit for a family with two or more children increases until earnings reach $9,390. Between $9,390 and $12,250, the family receives the maximum credit of $3,756. Then, for each dollar of adjusted gross income above $12,250, the family's EITC is reduced by just over $0.21, phasing out completely when the family's income reaches about $30,100.

The Federal Earned Income Credit in Tax Year 1998



Source: Center on Budget and Policy Priorities

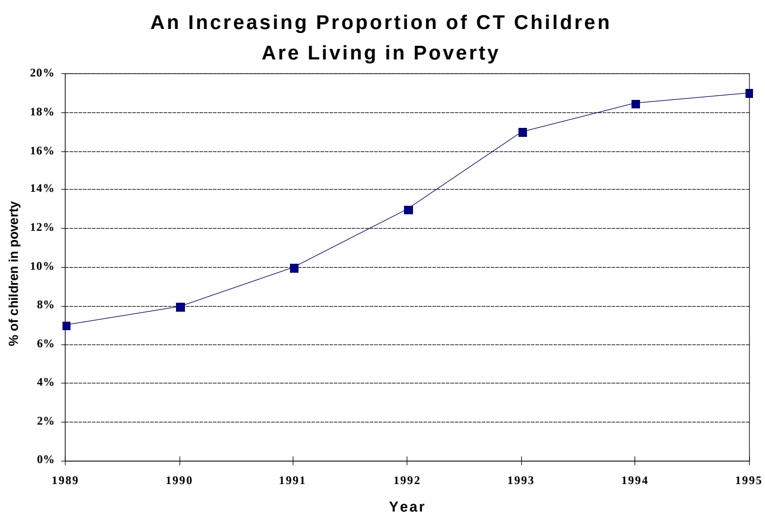
The federal EIC has enjoyed broad bi-partisan support since its adoption in 1975, and has been expanded three times, twice during Republican administrations, and in 1993 at the height of deficit-reduction efforts.

State EICs. Ten states, including Connecticut's neighboring states of New York, Massachusetts, Rhode Island, and Vermont, have state EITCs. Generally, state EICs use federal eligibility rules, and credits are set at a percentage of the federal credit. For example, Vermont has a refundable EIC that is set at 25% of the federal credit, and New York has a refundable 20% EIC. In 1997-98, Massachusetts and Kansas enacted new refundable credits, Minnesota expanded its existing refundable credit by about two-thirds, and Maryland added a refundable component to its existing non-refundable credit. Additionally, at least

13 states besides Connecticut are presently considering EIC bills: Alabama, Arkansas, Colorado, Illinois, Kentucky, Maine, Michigan, Missouri, New Jersey, North Carolina, Oregon, Utah and Washington.

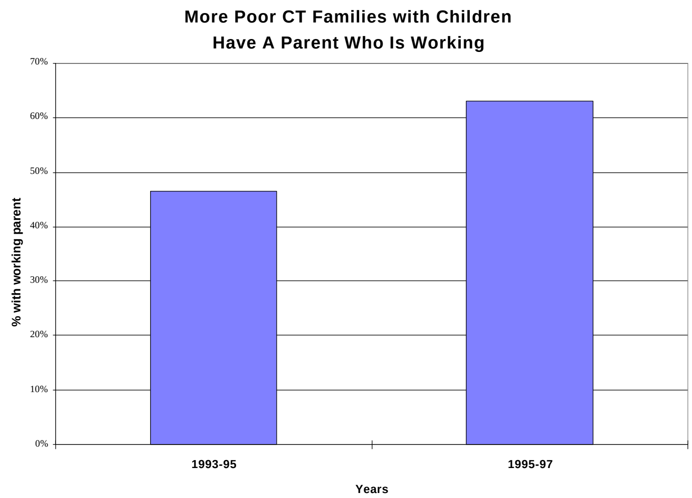
What are some of the reasons that Connecticut might consider adopting an EITC?

1. **The EITC can markedly reduce the number of Connecticut children living in poverty.** Despite Connecticut's currently robust economy, child poverty has increased dramatically over the last decade. In 1989, when Connecticut's unemployment rate low as it is today, Connecticut's child poverty rate was just 7%. Now, nearly one in five Connecticut children live in poverty ($16,450/year for a family of four). Since 1991, Connecticut has slipped from having the second lowest rate of child poverty in the nation to 29th place.

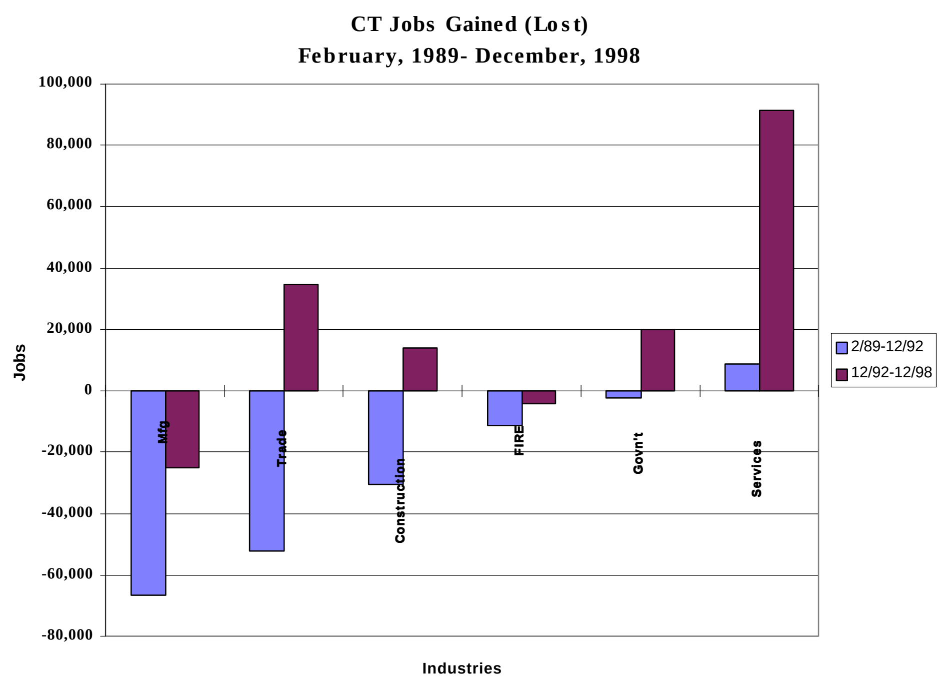


Research consistently demonstrates that poverty harms children's cognitive, emotional, and social development, independent of factors such as parents' ages, educational levels, and family structure. The EITC is an efficient and expeditious way to reduce child poverty and increase the likelihood that *all* Connecticut children become self-sufficient, competent, caring adults.

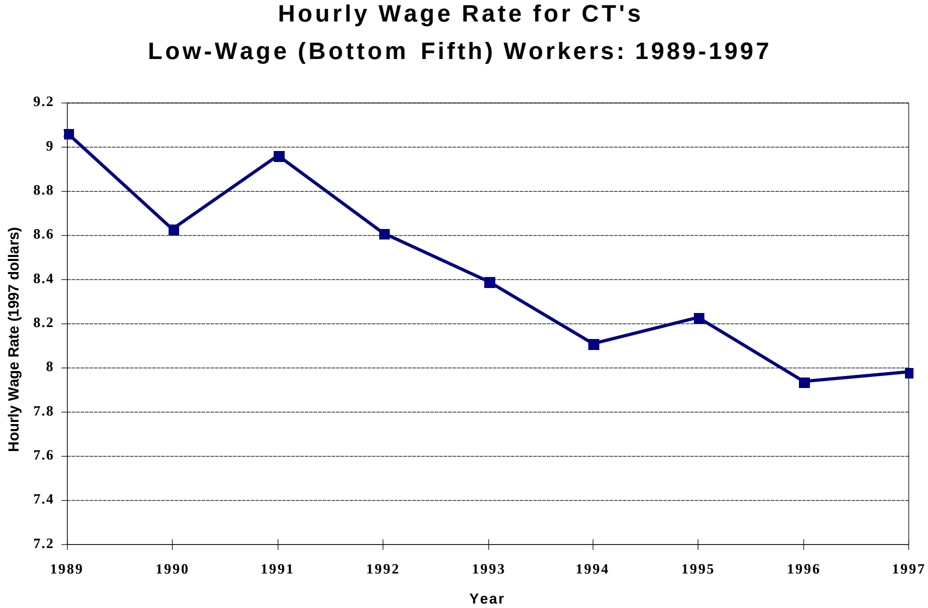
2. **An EITC rewards work, and is a well-targeted investment in Connecticut's poorest working families.** Most Connecticut families living in poverty (63%) now have a working parent.



However, having a working parent no longer ensures a life free of poverty for about 33,000 Connecticut families raising children. Full-time, year-round work at a minimum wage job in Connecticut provides $11,752/year in income, only 71% of the federal poverty line for a family of four. Also, Connecticut's significant loss of manufacturing jobs since 1989 has resulted in income losses for many Connecticut parents who were laid-off, and could only find employment in lower-paying service sector jobs.



In addition, Connecticut's high cost of living (estimated by the Census Bureau to be 120% of the national average) adds to the challenge facing our lowest income families with children, whose wages (adjusted for inflation) have declined since 1989, and are, only now, beginning to regain the value lost over the last decade.



3. **The EITC complements welfare reform.** Families transitioning off of Connecticut's cash assistance program experience a sharp and sudden decline in family income when benefits end. The EITC is carefully tailored to provide the *greatest* economic support to families precisely when their earned income moves them off of cash assistance. An EITC will promote the transition to a family's complete reliance on earnings, while buffering the children in the family against the harmful effects of poverty. Because it often takes some time for parents' earnings capacity to increase, the EITC can assure that children will not suffer.

4. **The EITC enhances the equity of Connecticut's state and local taxes.** Notwithstanding the high income threshold set for Connecticut's state income tax, Connecticut's poorest families still pay a much greater proportion of their incomes in state and local taxes than do Connecticut's wealthiest families. The progressivity of our state income tax is not sufficient to offset the greater burden placed on our lower income families by Connecticut's sales/use and property taxes. The EITC would reduce the tax burden on our lowest income families, creating a more equitable tax code.[1]

[1] Values in this table would change slightly based changes to Connecticut's tax code since 1995, including the new property tax credit against the state income tax.

Connecticut State and Local Tax Burden

Lowest 20% - Average income:$26,800	
Sales/excise tax	4.9%
Property tax	6.0%
Income tax	0.6%
Total Tax	**11.5%**

Top 5%- Average income:$326,000	
Sales/excise tax	1.1%
Property tax	2.2%
Income tax	4.3%
Total Tax	**7.6%**

Middle 20%-Average income:$64,700	
Sales/excise tax	3.2%
Property tax	4.1%
Income tax	3.4%
Total Tax	**10.7%**

Top 1% - Average income: $1,705,000	
Sales/excise tax	0.8%
Property tax	1.6%
Income tax	4.4%
Total Tax	**6.8%**

* By income group as % of gross income for non-elderly married couples in 1995

Source: Citizens for Tax Justice and The Institute for Taxation and Economic Policy

5. **The EITC helps Connecticut business.** A refundable EITC will give Connecticut's poorest families more income. This income is certain to be quickly funneled back into the economy as the families are better able to pay their bills – for utilities, rent, health care and other essentials.

How many Connecticut families would benefit from a state EITC? In 1998, 143,551 Connecticut families, from every part of the state, claimed the *federal* EITC, bringing $193 million in additional federal dollars into the households of Connecticut's lowest income families. The average credit claimed by Connecticut families was $1,344.

What are the essential elements of a Connecticut's EIC? Key elements of an EITC include:

1. **The credit should be refundable.** Because Connecticut's poorest families have no state income tax liability, only a refundable credit would provide financial benefit to our poorest working families. A refundable credit also provides an administratively-efficient way to improve the equity of our state and local taxes, by offsetting the financial burden of Connecticut's more regressive sales and property taxes through existing tax refund mechanisms.

2. **The credit should be set at a level that lifts as many families out of poverty as possible.** States with refundable EITCs have credits that range from 10% to

43% of the federal credit. A state EITC equal to 25% of the federal EIC, in conjunction with Connecticut's higher state minimum wage of $5.65 per hour and the federal EIC, would lift a family of four with a parent working at minimum wage to *just below* the federal poverty level.

A March 1, 1999 analysis by the National Center for Children in Poverty at Columbia University School of Public Health found that a refundable EITC in Connecticut that is set at 25-50% of the federal EITC would lift 7,000-18,000 poor Connecticut children out of poverty.

3. **The credit should consider family size.** Children are currently invisible in Connecticut's income tax code -- exemptions, tax rates, and the low-income credit are not adjusted for the number of children that a family is raising. Although families with two children receive a larger federal EITC than families with one child (reflecting the higher costs of raising more children), no additional credit is offered to larger families.

   Wisconsin has a refundable EITC that reflects the increased economic strain on larger families. Wisconsin families with a single child receive 4% of the federal ETIC, 14% of the credit if raising two children, and 43% of the credit if there are three or more children. The Minnesota EITC for families with children ranges from 20% to 42% of the federal credit, depending on income and household size. Enhancing the credit for larger families can help prevent many children from falling further into poverty.

What would a state EITC cost? A 10% state EITC would cost approximately $20.6 million in 1999 (assuming that all taxpayers who claimed the federal EITC also claimed the state EITC, which is unlikely in the first several years). Administrative costs are nominal. In New York, the administrative cost was $2.78 per return filed in the first year of its EITC; these costs included start-up costs such as changes to computer systems. Cost per return fell after the first year.

Importantly, the federal Department of Health and Human Services' proposed TANF regulations allow states to apply that part of state EITC that is refundable and is paid to TANF-eligible families toward the state maintenance of effort (MOE) spending requirements. Funds that Connecticut currently is saving from declining welfare caseloads could be effectively "re-invested" in these now-working families to help ensure that the families achieve and maintain a level of economic security.

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