

State Law That Supports Working Families Will Expire in 2003



Legislators must preserve and improve the Illinois Earned Income Tax Credit.

Summary

In May 2000, Illinois legislators established a non-refundable state Earned Income Tax Credit (EITC) set at 5% of the federal credit and allocated \$105 million of tobacco settlement funds over the next three years to fund it. In tax year 2000, 542,551 Illinois families took advantage of the state EITC and received an average benefit of \$70. The maximum possible benefit was \$194. Total credits amounted to \$39,980,318.

Despite the fact that Illinois' EITC is an appropriate step for supporting working families, the current structure won't effectively help families achieve self-sufficiency. First, the state EITC is not permanent. Illinois families will lose this critical work support and targeted tax relief unless lawmakers reauthorize the state EITC by the close of the Spring 2003 legislative session. Second, the current law has a limited capacity for enhancing the incomes of low-wage workers. Because the state EITC is non-refundable, the average \$70 benefit only offsets or eliminates tax liability. Additionally, it requires that families still begin paying state taxes at an income level well-below poverty: \$14,000 for a family of four and \$12,500 for a family of three.¹

When structured appropriately, the state-federal EITC combination is one of the most effective strategies available for supporting work and for moving families from poverty to self-sufficiency. Nationwide, about 4.8 million people, including 2.6 million children, are moved from poverty as a result of the federal EITC. Research shows a number of additional benefits associated with the EITC's income enhancement capability that make it a cost effective strategy for supporting families: increased participation in work, positive school outcomes for children, and moves toward family self-sufficiency.

The Illinois EITC Timeline

May 2000	Established the Illinois Earned Income Tax Credit
January-April 2001	Families could use the Illinois EITC to offset their 2000 state tax liability <ul style="list-style-type: none">• 542,551 families took up the state credit• \$70 average benefit• \$39,980,318 total credits
January-April 2002 & 2003	The final two tax seasons in which the Illinois EITC is available to families unless legislative action is taken
January-May 2003	The Illinois EITC must be renewed and expanded by the end of the 2003 legislative session, or families will no longer be able to take advantage of this critical work support

Improve and Expand State EITC to Increase Effectiveness for Working Families

<u>The Illinois EITC Structure</u>	
<i>Current</i>	<i>Expanded and Improved</i>
<ul style="list-style-type: none"> • 5% of the federal credit • Nonrefundable • Sunsets in 2003 	<ul style="list-style-type: none"> • 20% of the federal credit • Refundable • Permanent

Refundable

In its current *non-refundable* form, the Illinois credit cannot lift a family out of poverty, because the credit can only offset the family’s income tax bill. Even if families’ calculated state credit (5% of the federal credit) exceeds their tax liability, they cannot receive refunds for the excess amount.

A *refundable* credit would enable all low-income, working families to share in the benefits of the state EITC by extending the credit to an additional 150,000-200,000 people. These individuals and families currently receive a federal credit, but they are ineligible for the non-refundable state credit because their earned incomes are too low. Families would receive a refund equal to the difference between their tax liability and the total amount of the state credit. In the Chicago region alone, a refundable EITC set at 20% of the federal credit could infuse nearly \$150 million into lower-income neighborhoods. This would not only relieve the tax burden of hundreds of thousands low-income, working Illinois families, but it would increase their ability to invest in both themselves and their communities. A refundable credit would offset other taxes paid by low-income families (sales tax, fuel taxes, property taxes).

Fifteen other states have EITCs, 2/3 of which are refundable.

Permanent

A *permanent* credit would provide families who are working towards self-sufficiency with increased income stability, and it would evidence Illinois’ commitment to supporting families who experience poverty despite the fact that they work.

Illinois has the only state EITC that is not permanent.

Twenty percent of the federal credit

A state EITC set at 20% of the federal credit would allow Illinois to join 22 other states that do not tax families and individuals with incomes below the poverty level. Additionally, it would reduce the tax burden and boost the incomes of low-income, working families.

The current Illinois EITC is the smallest state credit available.

Treating the EITC Like a Tax Expenditure in the Budget

In tax year 2000, Illinois families received a total of about \$40 million in EITC benefits, a small portion of the total tax expenditures that benefit individuals and businesses in Illinois. By making the EITC refundable, total credits would grow. The dollar amounts in Table 3 reflect the total, potential annual benefits of a refundable state EITC.

Table 1. Estimated Total Credits for a Refundable Illinois EITC

	Percent of the Federal Credit			
	5%	10%	15%	20%
Estimated State Cost in Millions Tax Year 2003	\$60	\$120	\$180	\$240

Cost estimates assume full-participation in the state credit among Illinois residents who receive the federal credit. Experiences in other states like New York show actual first-year participation at 83 percent, with 90 percent participation in year two. Because the Illinois EITC is non-refundable, many federal EITC claimants have not been eligible for the state EITC. In consequence, Illinois would probably experience depressed usage rates in the first two years of a refundable credit, despite the fact that a state EITC already exists.

The state EITC is one of many Illinois tax breaks targeted at a specific group. Overall, fiscal year 2000 tax breaks (also called tax expenditures) totaled approximately \$5 billion.² Individual tax breaks, which include things such as personal exemptions and sales tax rate reductions on food, drugs and medical appliances, reached \$2.6 billion. Tax breaks for businesses reached \$1.2 billion and charities received \$673 million.

Because of its value to Illinois families, the state budget should guarantee the stability of the EITC by accounting for it in the same manner as other tax breaks. Currently, Illinois statutes and the budgeting process treat the EITC differently than other tax expenditures. This credit is the one of the only tax breaks that has its own line-item in the budget (\$35 million from tobacco settlement dollars each year for three years). Most other tax breaks are simply considered an adjustment in revenues during the budgeting process. Because some of those breaks result in refunds (e.g., personal and corporate income tax deductions, education expense credit), a statutory formula determines how much will be needed to pay for those refunds during a fiscal year; as income tax revenues come to state coffers, the amount determined by the formula is sent to the refund fund.

By funding the EITC in the same manner as other tax breaks, Illinois would ensure the stability of a tax expenditure that both provides critical tax relief to low-income working families and that is known to achieve its intended purpose—helping families achieve self-sufficiency.

Who does the EITC Reach?

The EITC reaches families throughout Illinois.

An extremely attractive element of an expanded and improved state EITC is that if it would reach over 750,000 families throughout Illinois. In its first year, approximately 540,000 families took up the non-refundable credit. Table 2 shows a subset of the Illinois regions that benefited from the federal EITC in tax year 1998 (most recent data available).

Table 2. Federal EITC Take Up Rate In Illinois Metropolitan Areas³

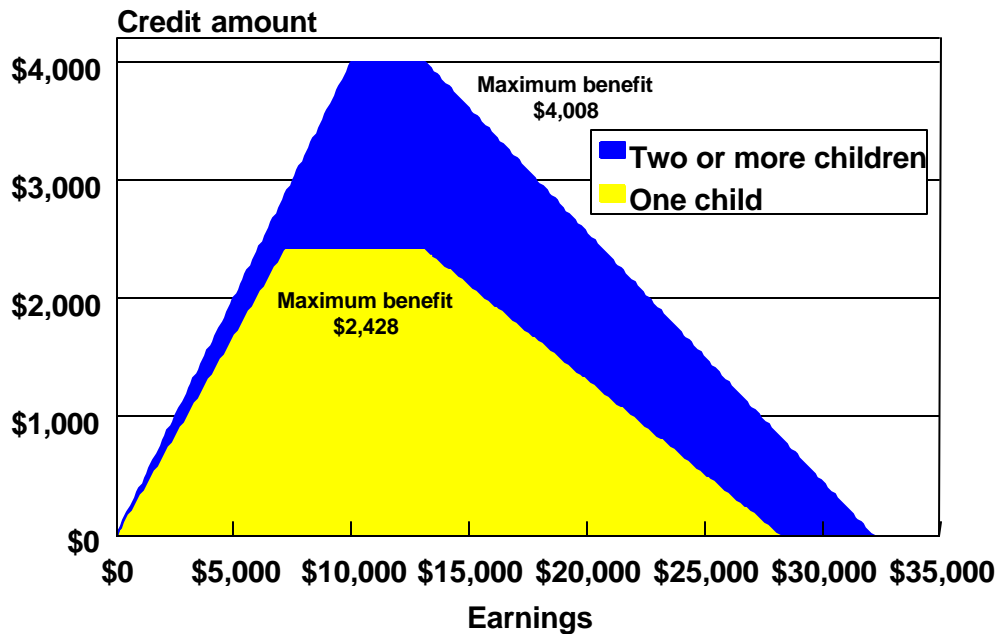
Region	% of Taxpayers Filing for EITC	Number of EITCs Claimed
Champaign-Urbana	12.6%	9,646
Chicago Region	12.9%	469,529
Quad Cities	15.3%	8,125
Decatur	15.3%	8,125
Kankakee	16.1%	7,286
Peoria-Pekin	12.5%	20,233
Rockford	12.6%	21,365
Springfield	12.5%	12,434

The EITC works for families within a broad income range.

The actual EITC benefit that an eligible family receives depends on the family's income; benefits go to families whose incomes range from far below the poverty line to approximately double the poverty line. Because it is refundable, the federal credit kicks in with the first dollar of earned income. In Illinois, the non-refundable credit requires that four-person families earn over \$8,000 before benefits begin.

If the Illinois EITC were to mimic the federal structure seen in figure 1 (next page), state benefits would begin with the first dollar earned. The phasing-in/phasing-out of benefits over a \$0-\$32,000 income range matches benefits with working families' changing income needs, and it avoids work disincentives commonly associated with benefits that abruptly begin or end.

The Refundable EITC : Aligning Benefits with Working Families' Income Needs



Center on Budget and Policy Priorities

Figure 1. The structure of the EITC encourages work by matching the credit to families' income needs. The credit gradually increases with rising earned-income, and then plateaus for a certain range of earned-income. Once past that range, the credit begins to phase-out.

For families with very low earnings, the value of the EITC increases as earnings rise. In tax year 2001, families with two or more children will receive a federal EITC equal to 40 cents for each dollar up to \$10,050, for a maximum benefit of \$4,008. Families with one child will receive an EITC equal to 34 cents for each dollar earned up to \$7,150 of earnings, for a maximum benefit of \$2,428. Both types of families continue to be eligible for the maximum credit until income reaches \$13,100.

For families with incomes above \$13,100 in tax year 2001, the EITC phases out as earnings rise. Families with two or more children are eligible for some EITC benefit until income exceeds \$32,121, and families with one child remain eligible for some EITC benefit until income exceeds \$28,250.

The Dollar Benefits for Illinois Families

Both the federal and state credits depend upon families’ gross earnings. The Illinois credit “piggybacks” on the federal credit; the amount of the state EITC is equal to a percentage of the federal EITC. Table 3 shows the benefits at different levels of earned income for both a 20% refundable state credit and a 5% non-refundable state credit.

Table 3. EITC Benefit Levels by Family Income, Tax Year 2001

	Gross Earnings	Federal EITC	State Income Tax	FICA Payroll Tax	20% refundable state EITC	5% non-refundable state EITC
Family of four with two children						
Full-time minimum wage	\$10,700	\$4008	\$81	\$819	\$802	\$81
Wages equal to federal poverty line	\$17,650	\$3042	\$289	\$1350	\$608	\$152
Wages equal to 125% of poverty line	\$22,062	\$2116	\$422	\$1688	\$423	\$106
Wages equal to 150% of poverty line	\$26,475	\$1189	\$554	\$2025	\$238	\$59
Wages equal to 200% of poverty line	\$35,300	\$0	\$819	\$2700	\$0	\$0
Single parent with one child						
Full-time minimum wage	\$10,700	\$2428	\$201	\$819	\$487	\$121
Wages equal to federal poverty line	\$11,610	\$2428	\$228	\$888	\$487	\$121
Wages equal to 125% of poverty line	\$14,512	\$2262	\$315	\$1110	\$452	\$113
Wages equal to 150% of poverty line	\$17,415	\$1735	\$402	\$1332	\$347	\$87
Wages equal to 200% of poverty line	\$23,220	\$960	\$577	\$1776	\$192	\$48
Single parent with two children						
Full-time minimum wage	\$10,700	\$4008	\$141	\$819	\$802	\$141
Wages equal to federal poverty line	\$14,630	\$3685	\$258	\$1119	\$737	\$184
Wages equal to 125% of poverty line	\$18,287	\$2916	\$369	\$1399	\$583	\$146
Wages equal to 150% of poverty line	\$21,945	\$2147	\$478	\$1656	\$429	\$107
Wages equal to 200% of poverty line	\$29,260	\$599	\$698	\$2238	\$120	\$30

The 20%, refundable credit will offset state tax liability and, in many cases, enable families to receive a refund. The amount of the refund equals the state credit total minus the state income tax total. For a family of four with two children and an income of \$17,650, the refund would equal \$608 - \$289, or \$319.

The federal EITC will offset FICA Payroll Taxes and any federal income taxes owed by the family. A family of four with two children and wages equal to the federal poverty line would receive a federal refund equal to \$3042. Once payroll taxes are taken into account (\$1350), this translates into a net benefit of \$1692.

Beginning in Tax Year 2002, the benefit phase-out range will differ for married families that file jointly and unmarried families.

A Support for Working Families that Pays for Itself

The primary appeal of the Illinois Earned Income Tax Credit is the ability of the EITC to pay for itself over the long run. Research on both the federal EITC and on the value that extra income has for families shows us how.

The EITC encourages employment.

- Research suggests that the increase in labor force participation among single mothers is strongly linked the EITC,⁴ with one study suggesting a 63% rise in the labor force between 1984 and 1996.⁵
- One recent study concludes that the EITC has been the foremost explanation for increased hours worked by former welfare mothers over the 1993-1996 period.
- Research on earnings supplements like the EITC that are restricted to families with earned income shows that the supplements improve employment stability.⁶

The EITC helps families attain and sustain self-sufficiency.

A refundable EITC enhances families' income through targeted tax relief. The additional purchasing power that results from the EITC not only brings income into the community, but it helps families begin the process of asset building.

- A study that interviewed low-income workers who received tax assistance at Tax Counseling Project⁷ sites in Chicago found that:
 - Sixty-one percent planned to use some of their refund for investment purposes, like paying for education; fixing, buying or financing a car; or paying for a move.
 - Twenty-eight percent said they were saving some of the EITC for future use.
 - The lowest-income families said they used the EITC to meet immediate needs such as utilities and rent.⁸
- Families use their refunds to purchase larger-item goods, accumulate assets, and create savings.⁹

The EITC works as an anti-poverty and welfare prevention strategy.

- In 1999, the EITC lifted some 4.8 million individuals—including 2.6 million children—out of poverty.
- According to the National Center for Children in Poverty, a refundable state EITC set at half of the federal EITC could lift over 37,000 children out of poverty.
- The EITC helps correct for the fact that the earnings of low-wage workers have not kept up with inflation over the last thirty years, while incomes at the higher end of the distribution have grown by 26%.¹⁰

Wage supplements support child well-being.

- In two-parent families, the EITC enables parents to spend more time with their children.¹¹
- EITC-like programs that offered generous earnings supplements improved children's school achievement and social behavior.¹²

- A recent study showed that increases in family income were associated with better cognitive and social functioning of children as young or younger than three-years-old.¹³

Conclusion

A refundable, permanent state EITC set at 20% of the federal credit would provide support for working families struggling to move up the economic ladder. A state EITC would also provide additional incentive for those moving from welfare to work. The federal EITC and state-level counterpart are an effective and proven method to reward work and reduce the tax burden on low- and moderate-income families. If appropriately structured, an Illinois EITC would support families by making employment a pathway out of poverty leading to self-sufficiency.

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¹ The 2000 tax thresholds are a combination of \$2000 personal exemptions plus the effect of the state EITC. According to the 2001 federal poverty guidelines, these families remain in poverty until their incomes exceed \$17,560 and \$14,630, respectively.

² Comptroller Daniel W. Hynes. *State of Illinois Tax Expenditure Report; Fiscal Year 2000*. April 2001. Available at www.ioc.state.il.us.

³ Berube, A. & Forman, B. *Rewarding Work: The Impact of the Earned Income Tax Credit in Greater Chicago*. Center on Urban & Metropolitan Policy at the Brookings Institution, Washington D.C., November 2001. Data source: Internal Revenue Service. Tax year 1998.

⁴ Meyer, B.D. *The Earned Income Tax Credit and Work, Marriage, Income Distribution, Child-Well Being and Tax Compliance*. Presentation to a Joint Center for Poverty Research Illinois Legislative Research Briefing on the Earned Income Tax Credit. February 2, 2001.

⁵ Hotz, J.V., Mullin, C., & Scholz, J.K. *The EITC and Labor Market Participation of Families on Welfare*. JCPR Policy Briefs, Vol. 3, No. 7. Available at <http://www.jcpr.org>.

⁶ Bloom, D. & Michalopoulos, C. *How Welfare and Work Policies Affect Employment and Income: A Synthesis of Research*. Manpower Demonstration Research Corporation, May 2001. Available at <http://www.mdrc.org/Reports2001/NG-AdultSynthesis/NG-AdultResearchSyn-May2001.pdf>.

⁷ The Tax Counseling Project is one of the nation's largest community-based programs providing free tax preparation and tax counseling for low-income workers. In 2001, the Project's 464 volunteers prepared 19,586 income tax returns at 21 sites in Illinois. For more information, contact the Center for Law and Human Services, 312-252-0280, www.centerforlaw.org.

⁸ Smeeding, T.M., Phillips, K.R., & O'Connor, M. (2000). *The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility*. Center for Policy Research, Working Paper Series, No. 13. Available at <http://www-cpr.maxwell.syr.edu/cprwps/wps13abs.htm>.

⁹ Romich, J.L. & Weisner, T. (2001) "How Families View and Use the EITC: The Case for Lump-sum Delivery." *National Tax Journal* 53(4) (part 2): 1107-1134. For more information see www.ntanet.org.

¹⁰ Jeffrey B. Liebman (1998). "The Impact of the Earned Income Credit on Incentives and Income Distribution." From *Tax Policy and the Economy, Volume 12*, (James Poterba, Editor), MIT Press. Available at www.ksg.harvard.edu/jeffreyliebman/tpaeetic.pdf.

¹¹ Eissa, N. & Hoynes, H.W. (August 1999) *The Earned Income Tax Credit and the Labor Supply of Married Couples*. Institute for Research on Poverty Discussion Paper no 1194-99. Available at www.ssc.wisc.edu.

¹² *Ibid.*, 2.

¹³ Dearing, E., McCartney, K., & Taylor, B.A. (In press). "Change in family income-to-needs matters more for children with less." *Child Development*.