

# MONEY MATTERS...\$...\$...\$

FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal Policy Research Brief  
By Kentucky Youth Advocates

No.2  
October 1999

## An Earned Income Tax Credit for Kentucky

### Introduction

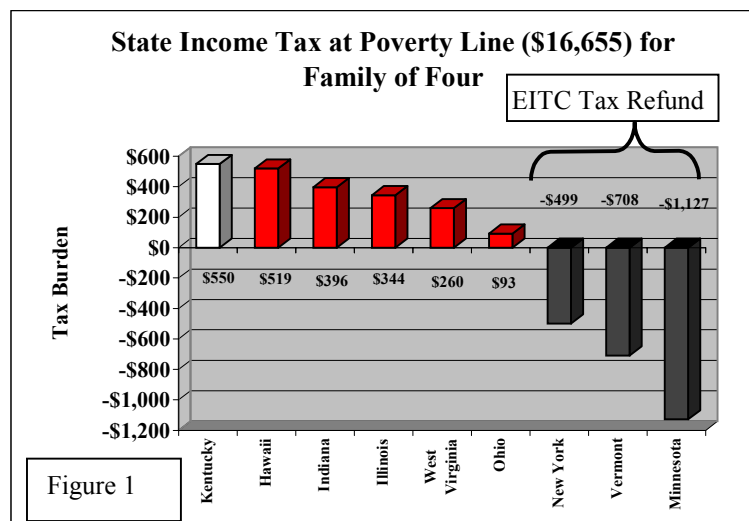
Kentucky has been sharing in America's recent economic prosperity – unemployment is low, and welfare caseloads are down. Yet too many low-income working families continue to live in poverty. For these people, the good times are passing them by. Implementing a state earned income tax credit is one way to provide some relief to these financially strapped Kentucky families.

### What is an Earned Income Tax Credit?

An earned income tax credit (EITC) provides tax relief to families who are working to lift themselves out of a state of poverty or near-poverty. An EITC can be used both to offset taxes that reduce “take home” pay and to supplement earned wages through a refundable credit. Currently eleven states offer EITCs (eight of which are refundable credits). For moderate and low income workers, the EITC acts as a wage supplement. The amount of this supplement depends on income: poor workers receive a substantial bonus while those with moderate incomes receive less as their incomes rise. The earned income tax credit has a proven track record for lifting families out of poverty.

### Why do we need an EITC in Kentucky?

Kentucky places one of the highest tax burdens in the country on its poorest citizens. There are 80,000 families, including 138,000 children, living in poverty in Kentucky despite the presence of a working parent. Yet, Kentucky's poor families start paying taxes at only \$5,000, less than half the poverty level for a family of three,



Source: Center on Budget and Policy Priorities

*This KYA report is funded through the Annie E. Casey Foundation, the Open Society Institute, and the generous support of local benefactors. The contents of this report are the sole responsibility of Kentucky Youth Advocates.*

and less than one third the poverty level for a family of four (see Figures 1 and 2).

Poverty exists where incomes are inadequate to meet needs. Those living in poverty need to either increase their income, or decrease their expenses. An EITC does both for those living in poverty. The EITC would reduce the tax burden on the working poor, even providing a refund amount for working Kentuckians with the lowest incomes. In short, the EITC rewards those who are working hard to lift themselves out of poverty.

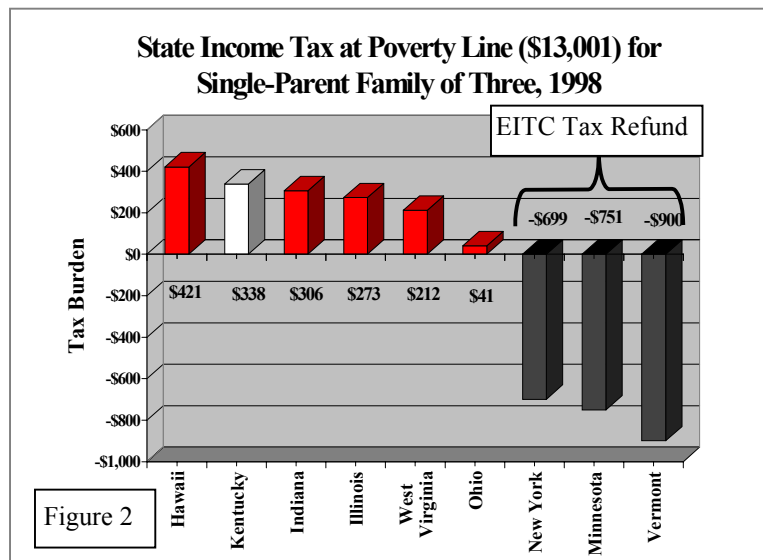


Figure 2 Source: Center on Budget and Policy Priorities

## What has been the federal experience with an EITC?

States have patterned their earned income tax credits on the federal EITC because of its success as an anti-poverty initiative. The federal General Accounting Office (GAO) has praised the effectiveness of the federal EITC. “The EITC works. It...provides a positive work incentive to the lowest income group.”<sup>1</sup> Economist Rebecca Blank states that “the EITC provides real income protection to working poor families...Its expansion [in 1993] may be the single most important antipoverty policy implemented during this decade.”<sup>2</sup> Blank further notes that “more than any other program, the EITC directly responds to the economic changes of the past few decades...”<sup>3</sup> Although EITC benefits target low income Americans – disproportionately supporters of the Democratic party – the federal EITC initiative has traditionally enjoyed support spanning the political spectrum. Successive administrations – both Republican and Democratic – have lent their support to the EITC. Liberals, moderates, and conservatives have supported an EITC that increases the fairness of the federal tax code and is tied to work effort.

The federal EITC has a proven track record of lifting people out of poverty. In 1997, for example, the EITC lifted 2.3 million children out of poverty<sup>4</sup>, making it the “largest single program exiting children from poverty.”<sup>5</sup> Because the EITC is particularly effective at helping parents who work, it fits nicely with recent welfare reform efforts.

## What are the pros and cons of an Earned Income Tax Credit?

### Highly targeted relief

Tax relief provided by a state EITC is highly targeted and can be implemented without creating additional state bureaucracy. Those claiming a federal EITC simply claim their state EITC through the state income tax return. The 308,909 Kentucky tax filers who already claim the federal EITC would simply claim a pre-determined percentage of that on their state income tax return. Only one line would need to be added to the return.

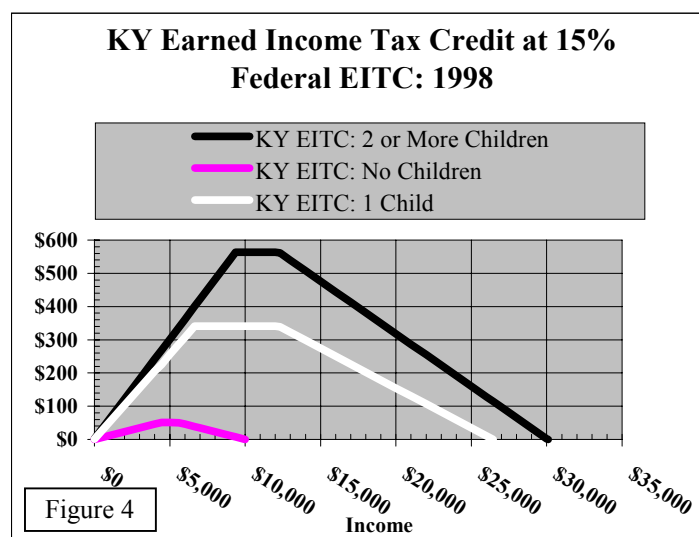
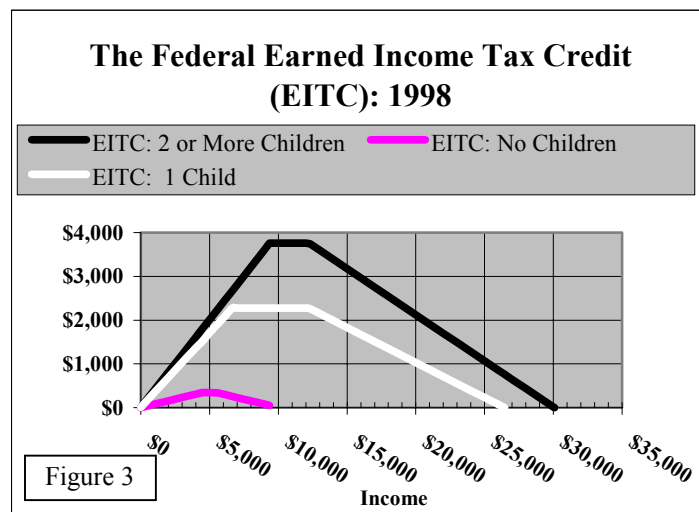
## EITC and Welfare Reform

The EITC complements welfare reform efforts, rewarding those who make the transition to work. For every dollar earned, an additional financial incentive is provided. This not only encourages people to work, it also sets them that much further along the road to economic self-sufficiency. The EITC helps overcome some of the additional costs associated with working, such as transportation and child care, which can act as formidable employment barriers for the poor.

The final regulations for the federal law creating the Transitional Assistance to Needy Families (TANF) block grant clearly indicate that welfare reform and an EITC are complementary. Federal TANF dollars can be used towards the refundable portion of an EITC [the portion that exceeds the state income tax bill]. For those coming off welfare, an EITC eases the transition. A recent study states “there is little doubt that the EITC [has] played a large role in reducing the welfare rolls.”<sup>6</sup>

## EITC as wage supplement

The EITC effectively supplements the hourly wage of the working poor. As demonstrated in Figures 3 and 4, for each family type, the effect of the EITC changes as income increases. Each portion of the graph represents a different effect. In the *phase-in portion* [where the graph slopes up], recipients gain the most for their work effort. For example, in 1998, families with two or more children received 40¢ for every dollar earned as a federal EITC, up to an income of \$9,350 (with a Federal EITC of \$3,756). Throughout the income range represented by the *flat portion* of the graph (between \$9,351 and \$12,300), workers receive maximum EITC benefits. Incomes between \$12,300 and \$30,095 continue to receive EITC benefits, but at a reduced rate. During this *phase-out portion* [the downward slope on the graph], EITC credits decline by 21¢ for each additional dollar earned. The *phase-in rate* in Kentucky, based on 15% of the Federal EITC, would be an additional 6¢, while the state phase-out would be 3.15¢ for every dollar earned. This does not, however, mean that workers are losing money – for every



dollar earned, they still keep the dollar, as well as some EITC.

Like the federal EITC, a Kentucky EITC would provide maximum benefit between annual incomes of \$9,350 and \$12,300. If the Kentucky EITC were set at 15% of the federal credit, the maximum benefit to Kentucky taxpayers (with two children) would be \$563. (See Figure 4). Note that although there is some provision for an EITC for families with no children, both the credit amount and the income levels are set **very** low (maximum credit of \$341 federally, \$51 in Kentucky, for those with incomes between \$4,450 and \$5,600; complete phase-out at income of \$10,000). The Federal EITC is essentially, then, a credit aiming to help families. A Kentucky EITC would share this focus.

### Potential EITC Uses

#### Making Ends Meet

- Rent
- Utility bills
- Other bills
- Purchase groceries
- Purchase clothing for self or family
- Purchase household appliance
- Purchase household furniture
- Other personal or household expenses

#### Improving Social Mobility

- Savings
- Bank loan
- Car payment
- Credit card bills
- Medical bills
- Purchase or repair of car
- Share money with family
- Fix up home
- Moving expenses
- Tuition/school expenses
- Child care bills
- Payoff personal loans

Source: Smeeding et al, 1999.

### EITC as a lump sum payment

Because the EITC works through the income tax system, payment is likely to occur as a lump-sum. One study shows that less than 5% of federal EITC recipients exercise the option to receive a portion of their EITC benefits in weekly or monthly increments. This has both positive and negative implications. Because many EITC recipients live “day to day,” or “month to month,” the “forced savings” aspect of the EITC may be beneficial over the long run. Rather than having the credit absorbed by weekly expenses, a lump sum can be used effectively for relatively high-end expenditures – refrigerators, debt payment, even down payments on a “starter house.” Because the EITC provides benefits to families with such a wide range of annual income (\$1-\$30,095), the types of things people use their EITC credits for varies considerably.

It is useful to think of two main types of expenditure EITCs are applied towards: those used to *make ends meet*, and those used to *improve social mobility* (see accompanying sidebar).<sup>7</sup> Those with lower incomes (corresponding to the *phase-in* or *flat* regions of the EITC credit), are more likely to use their EITCs to make ends meet. For the working poor, outstanding bills and urgent consumption needs must get priority. Those with incomes in the *phase-out* region are more likely to apply money from their EITC credits towards relatively long-term investments, including education, child care, or even savings. The flexible nature of the EITC allows recipients to tailor the benefits of an income tax credit to *their needs*, rather than having their needs predetermined by state bureaucrats.

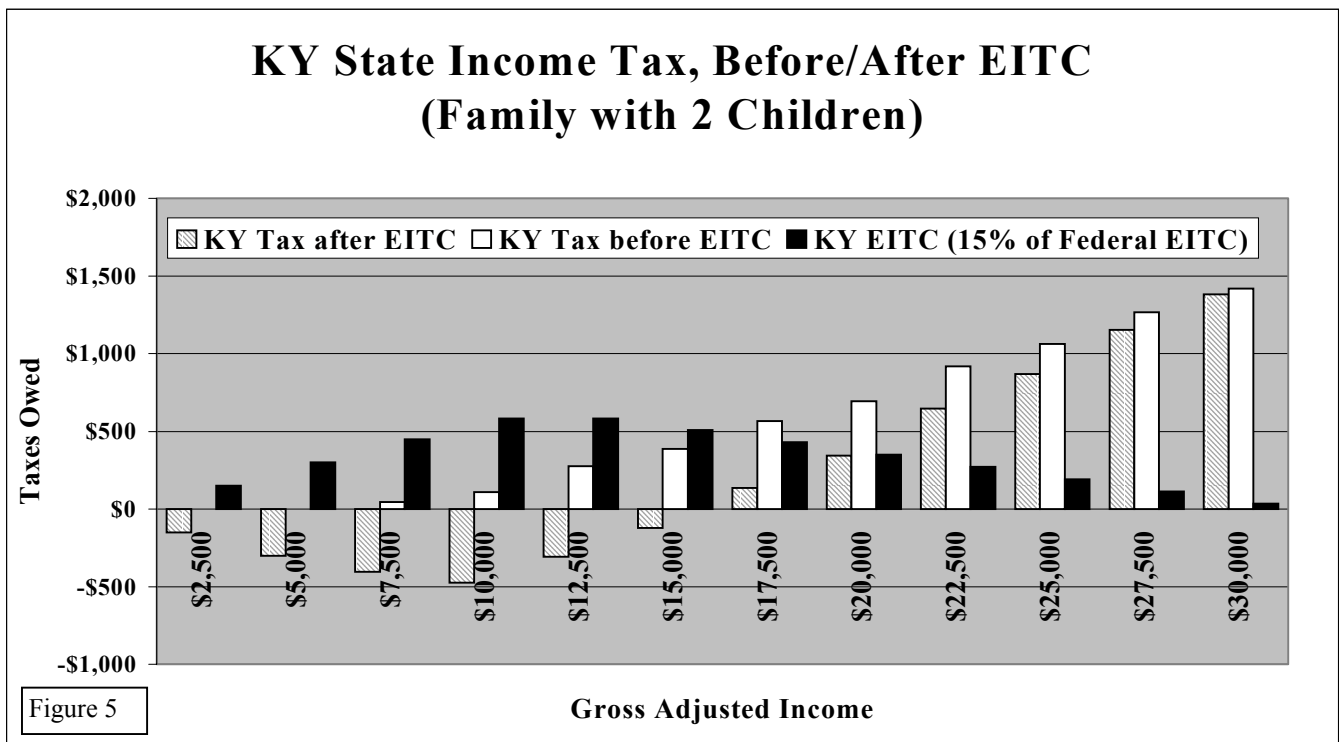
The disadvantage of the typical lump sum payment is that it makes it a little more difficult for recipients to see

the direct linkage between their work effort and the credit received. The EITC nonetheless has a strong effect as a work incentive.

## What Would an EITC in Kentucky Accomplish?

Figure 5 demonstrates the effect that a Kentucky earned income tax credit would have on a family with two or more children. Based on a Kentucky EITC set at 15% of the federal EITC, the maximum state EITC of \$563 would be received by those earning between \$9,350 and \$12,300. Critics of a state EITC point out that \$563 is not a great deal of money. This point is not in question here. For a family of four struggling to get by on an income of \$12,000, this **is** a lot of money. Whether applied towards basic needs items such as food and clothing, or for purposes of improving social mobility, a lump sum receipt of \$563 would be a welcome addition to the annual budget of the working poor family.

For the 1997 tax year, 308,909 Kentucky tax filers received federal earned income tax credits. These people – the working poor and near poor – have worked hard to better themselves and to achieve, and sustain, a level of economic self-sufficiency. A Kentucky EITC would build on the success of the federal credit, lifting even more Kentuckians out of poverty.



## Concluding Thoughts: Kentucky Needs an EITC

Too many Kentucky families are living in poverty today. This view is widely shared. Building a consensus around ways to address this situation is more problematic. Everybody seems to have a different perspective on what the exact nature of the problem is. An earned income tax credit cannot, on its own, solve the problems faced by Kentucky's working poor. Do we need to focus on the importance of lifelong learning, including education and training? Yes. Do we need to pursue creative opportunities for economic development? Yes. These are important pieces of the puzzle required to lift Kentuckians out of poverty permanently. The beauty of an earned income tax credit is that its effects are achievable in a very short time frame, with virtually no administrative cost, and without requiring the creation of additional

bureaucratic infrastructure. By implementing an EITC in Kentucky, thousands more can be lifted out of poverty. Expanding the most successful anti-poverty initiative of our time to help Kentuckians today is not just a good idea. It is an important step in building Kentucky's common wealth.

---

<sup>1</sup> U.S. General Accounting Office, testimony before the Subcommittees on Select Revenue Measures and Human Resources, House Ways and Means Committee, March 30, 1993.

<sup>2</sup> Rebecca M. Blank, 1998. *It Takes a Nation: A New Agenda For Fighting Poverty*, New York: Russell Sage, 113.

<sup>3</sup> Blank, 1998, 111.

<sup>4</sup> Counsel of Economic Advisors, 1999.

<sup>5</sup> Robert Greenstein and Isaac Shapiro, 1998. "New Research Findings on the Effects of the EITC," Washington, D.C. Center on Budget and Policy Priorities.

<sup>6</sup> Timothy M. Smeeding et al, 1999 (draft) "The Economic Impact of the Earned Income Tax Credit (EITC)," The Maxwell School, Syracuse University.

<sup>7</sup> Smeeding, Table A-2.



This research brief is produced by Kentucky Youth Advocates, through the State Fiscal Analysis Initiative. Any questions, or requests for further information about an EITC in Kentucky, should be directed to Douglas Hall, Senior Analyst, at (502) 875-4865.

Non. Profit Org.  
U.S. Postage  
**Paid**  
Louisville, KY  
Permit No. 397