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Options for a State Earned Income Tax Credit

LEGISLATIVE ANALYST'S OFFICE

Presented to:
Assembly Budget Subcommittee No. 1
On Health and Human Services
Hon. Tony Thurmond, Chair

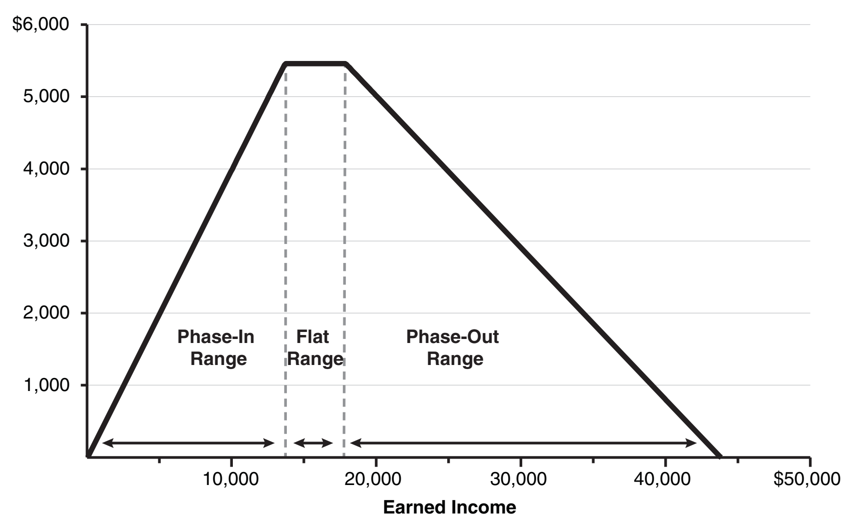
The Federal Earned Income Tax Credit (EITC)

- ☑ ***What Is the Federal EITC?*** The federal EITC is a fully refundable income tax credit that reduces tax liability for filers with earnings. The amount of the federal EITC initially rises with earnings, such that the greater the filer's earnings, the larger the credit. For higher levels of earnings, the federal EITC peaks and then gradually phases out. Because the federal EITC is fully refundable, if the amount of the credit exceeds the filer's tax liability, the filer receives the difference in the form of a refund.

- ☑ ***What Are the Federal EITC's Effects?*** Through providing refunds to low-income tax filers, the federal EITC is estimated to have kept roughly 750,000 Californians above poverty thresholds in 2012, as determined by the Census Bureau's Research Supplemental Poverty Measure (SPM) methodology. Research suggests that the federal EITC increases work participation, particularly among single mothers.

Basic Structure of the Federal EITC

Credit Amount, Single Filer With Two Dependent Children, 2014 Tax Year



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Many States Have Enacted EITCs That Build on the Federal Credit

State EITCs in 2014

State	State EITC as Percent of Federal EITC	Refundable?
District of Columbia	40.0%	Yes
Vermont	32.0	Yes
New York	30.0	Yes
Connecticut	30.0	Yes
Maryland	25.0	Yes[a]
Delaware	20.0	No
New Jersey	20.0	Yes
Virginia	20.0	No
Kansas	17.0	Yes
Massachusetts	15.0	Yes
Iowa	14.0	Yes
Illinois	10.0	Yes
Nebraska	10.0	Yes
New Mexico	10.0	Yes
Ohio	10.0	No
Indiana	9.0	Yes
Oregon	8.0	Yes
Michigan	6.0	Yes
Maine	5.0	No
Oklahoma	5.0	Yes
Rhode Island	3.75	Yes[b]
Louisiana	3.5	Yes
States With Variable EITC Percentages:		
Minnesota	25-37%[c]	Yes
Wisconsin	0-34	Yes
States With EITCs in Law but Not Currently in Effect:		
Colorado	10%	Yes
Washington	10	Yes

[a] Maryland also provides taxpayers the option of a 50 percent nonrefundable credit.
[b] Rhode Island allows up to a 25 percent credit, but just 15 percent of this amount (3.75 percent of the federal credit) is refundable.
[c] Over phase-in and flat ranges.

Policy Considerations for a California EITC

☑ ***Possible Policy Goals.*** The structure of a California EITC would depend on the goals the Legislature wished to achieve by enacting it. Some potential policy goals include:

- ***Encourage Work.*** Providing a state EITC on top of the federal EITC could increase the amount of total credit received for a given amount of earnings, thus increasing incentives to work, potentially leading to increased earnings for eligible filers and reduced poverty.

- ***Supplement Resources of Working Families at Specific Income Levels.*** A state EITC would provide additional cash resources to families that qualify. Depending on the state credit's structure, filers at specific income levels could be targeted, thus increasing resources for such families and reducing poverty.

- ***Fill in Perceived Gaps in the Federal EITC.*** The federal EITC provides a relatively small benefit to filers with no dependent children. Some states have enacted EITCs that provide a much larger credit to filers with no dependents, filling the gap left by the federal EITC.

☑ ***Key Decision Points in Designing a California EITC.***

- ***Relationship to the Federal EITC.*** A state EITC can "piggyback" on the federal EITC, meaning that the state EITC has the same eligibility requirements as the federal EITC and is calculated as a simple percentage of the federal credit. Alternatively, a state EITC could have its own benefit schedule that is distinct from the federal EITC and that could target specific populations.

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Policy Considerations for a California EITC

(Continued)

- ***Refundability.*** A state EITC could be refundable, like the federal EITC, or it could be nonrefundable, meaning that the benefit of the credit would be limited to the amount of each filer's state income tax liability. Because filers that qualify for the federal EITC generally have very small state income tax liabilities, the effect of a nonrefundable state EITC would be limited.
- ***Total Level of Funding.*** Different state EITC structures could be adjusted to fit within a target funding amount (personal income tax revenue loss resulting from the EITC) that is consistent with available resources in the state budget.

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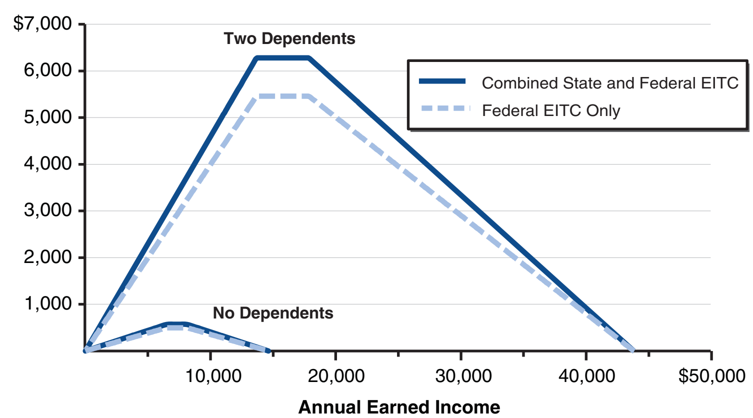
Option 1: Piggyback on Federal Credit

Option 1 would piggyback on the federal EITC, and would have a value equal to 15 percent of the federal credit.

Option 1: Piggyback on Federal Credit

Combined State and Federal Credit Amount for Single Filers, 2014 Tax Year



☑ ***Could Move Roughly 120,000 Individuals Above Poverty Threshold.*** We estimate that roughly 10 million individuals were in households that would have benefitted from option 1 if it had been available in 2012. Of these, roughly 120,000 would have been moved above the SPM poverty threshold.

☑ ***Would Generally Increase Incentives to Work.*** Option 1 would increase the incentive both to move from no work to part- or full-time work and to move from part-time to full-time work.

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Option 1: Piggyback on Federal Credit *(Continued)*

- ***Roughly $20 Million in Annual Administrative Costs.*** The Franchise Tax Board (FTB) estimates that administering option 1 would be less costly than the other options we present *on a per-filer basis*, but would likely be more costly overall—at roughly $20 million annually—because of a greater number of potential filers than under the other options.

- ***Roughly $1 Billion in Lost Revenue.*** Had option 1 been available in 2012, we estimate that state personal income tax revenue would have been reduced by roughly $1 billion.

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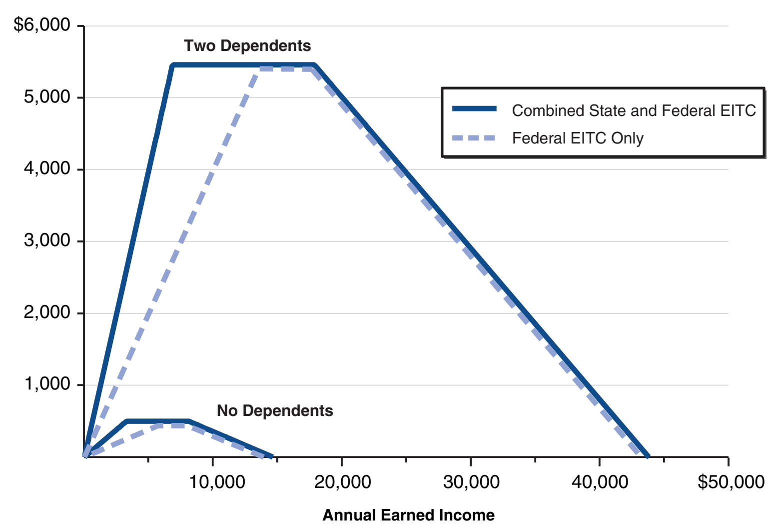
Option 2: Focus on Working Families With Lowest Incomes

Option 2 would match the federal EITC for filers with very low incomes (generally less than 70 percent of the federal poverty level) up to a certain level of earnings and then phase out before the earnings level at which the maximum federal EITC is reached.

Option 2: Focus on Working Families With Lowest Incomes

Combined State and Federal Credit Amount for Single Filers, 2014 Tax Year



☑ ***Could Move Roughly 45,000 Individuals Above Poverty Threshold.*** We estimate that roughly 2.7 million individuals were in households that would have benefitted from option 2 if it had been available in 2012. Of these, roughly 45,000 would have been moved above the SPM poverty threshold.

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Option 2: Focus on Working Families With Lowest Incomes *(Continued)*

- ☑ ***Greatly Increased Incentives for Part-Time Work.*** Option 2 would greatly increase the incentive to move from no work to part-time work, but would reduce incentives to move from part-time work to full-time work. Option 2 would not affect incentives to move from no work to full-time work.

- ☑ ***Roughly $7 Million in Annual Administrative Costs.*** The FTB estimates that administering option 2 would be more costly than option 1 *on a per-filer basis*, but would likely be less costly overall—at roughly $7 million annually—because of a smaller number of potential filers than under option 1.

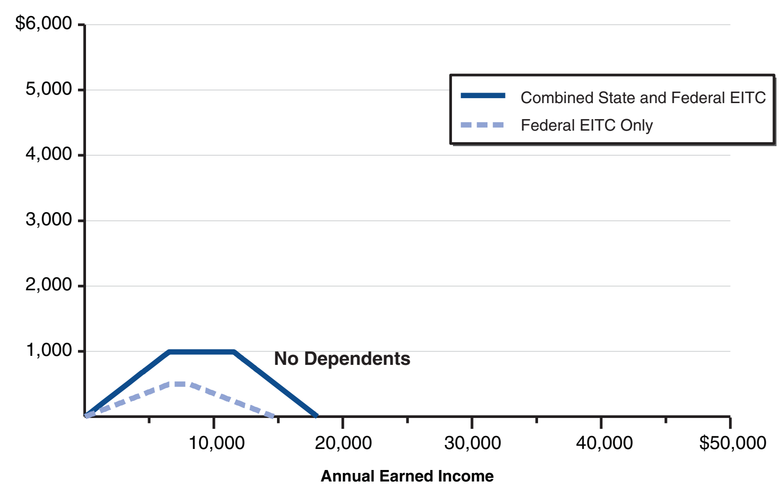
- ☑ ***Roughly $450 Million in Lost Revenue.*** Had option 2 been available in 2012, we estimate that personal income tax revenue would have been reduced by roughly $450 million.

Option 3: Supplement Federal Credit for Childless Adults

Option 3 would match the amount of the federal EITC for filers with no dependents such that the combined state and federal EITC would be double the federal EITC and the range of income over which such filers could claim the state credit would be extended. Filers with dependents would not be eligible for Option 3.

Option 3: Supplement Federal Credit for Childless Adults

Combined State and Federal Credit Amount for Single Filers, 2014 Tax Year



☑ ***Could Move Roughly 21,000 Individuals Above Poverty Threshold.*** We estimate that roughly 3.2 million individuals were in households that would have benefitted from option 3 if it had been available in 2012. Of these, roughly 21,000 would have been moved above the SPM poverty threshold.

☑ ***Increased Incentives for Part-Time Work.*** Option 3 would increase the incentive to move from no work to part-time work, but would reduce incentives to move from part-time work to full-time work. Option 3 would not affect incentives to move from no work to full-time work.

Option 3: Supplement Federal Credit for Childless Adults *(Continued)*

- ☑ ***Roughly $14 Million in Annual Administrative Costs.*** The FTB estimates that administering option 3 would also be more costly than option 1 *on a per-filer basis*, but would likely be less costly overall—at roughly $14 million annually—because of a smaller number of potential filers than under option 1.

- ☑ ***Roughly $400 Million in Lost Revenue.*** Had option 3 been available in 2012, we estimate that personal income tax revenue would have been reduced by roughly $400 million.

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Implementation Issues

- ☑ ***Options Could Be Mixed and Matched.*** While each of the options discussed above could be implemented as described, the Legislature could combine elements from the different options to meet its policy objectives. For example, one additional alternative state EITC structure could provide a significant credit for filers with very low incomes, consistent with option 2, while also somewhat increasing the maximum credit for all filers, consistent with option 1.

- ☑ ***Addressing Improper Payment Concerns.*** It is well documented that the federal EITC has significant issues with improper payments, meaning filers claiming a larger (or in some cases smaller) federal EITC than they are eligible for. Numerous factors lead to improper payments, ranging from honest mistakes due to the complexity of the federal EITC to deliberate misrepresentation on the part of filers and paid tax preparers. If the state enacts an EITC, it should consider measures to reduce the likelihood of improper payments, including strategies to (1) verify information provided by filers against available data sources and (2) target enforcement resources to tax returns with a high risk of improper payment (specifically those with self-employment income).

- ☑ ***Considering Outreach to Maximize Take-up.*** As of 2010, the Internal Revenue Service estimates that only 71 percent of California tax filers who qualified for the federal EITC claimed it. The state has pursued some efforts in the past to increase participation in the federal EITC. If a state EITC is enacted, the Legislature could consider whether additional activities are warranted to increase participation and maximize the effects of both federal and state EITCs.