

# STATE EARNED INCOME TAX CREDIT

## OVERVIEW

In 2007, 12.3% of the population had incomes below the federal poverty level, and 22.5% were asset poor – meaning they could not survive at the poverty level for three months if their incomes were interrupted. One of the largest and most effective wage support programs for low- and moderate-income families is the federal Earned Income Tax Credit (EITC). The EITC supplements the earnings of workers by reducing their tax burdens. If the EITC is greater than the amount of taxes owed, the taxpayer receives a refund.

The EITC lifts more than 5.1 million Americans out of poverty every year, including 2.6 million children.<sup>1</sup> The EITC is also a means to reducing asset poverty. Studies have shown that some families use EITC payments for significant purchases such as a house or to pay off debts.<sup>2</sup> Families can also use the credit they receive each year to start saving for the future.

As a result of its success, the federal credit has been dramatically expanded (from \$1.25 billion in 1975 – the year the EITC was created – to \$48.7 billion in 2007),<sup>3</sup> and many states have enacted EITCs that piggyback on the federal credit.

## WHAT STATES CAN DO

States can enact their own EITCs that build on the federal credit. Each state can determine the amount of the credit, its coverage and family size adjustments, as well as whether it will be refundable.<sup>4</sup> States also can provide incentives for families to save all or part of their refunds in a product such as an Individual Development Account (IDA), Individual Retirement Account or 529 college savings account. This flexibility gives states the opportunity to design the credit according to their individual populations' needs and available resources. It also gives states the opportunity to improve upon an already effective federal program.

## ELEMENTS OF A STRONG POLICY

CFED considers a state's EITC policy strong if it meets the following criteria:

- 1. Has the state enacted an EITC policy?** A first step that states should take is to get a state EITC – no matter how small – on the books. Even a relatively small credit will benefit low-income families and can lay the groundwork for subsequent expansion.
- 2. Is the credit refundable?** Refundability is the single most important component of the EITC. Because families with low earnings are likely

<sup>1</sup> Sherman, A. (2009, July 6). *Safety Net Effective at Fighting Poverty But Has Weakened for the Very Poorest*. Washington, DC: Center on Budget and Policy Priorities. Retrieved August 26, 2009 from [www.cbpp.org/cms/index.cfm?fa=view&id=2859](http://www.cbpp.org/cms/index.cfm?fa=view&id=2859).

<sup>2</sup> Holt. (2006, February). *The Earned Income Tax Credit at 30: What We Know*. Washington, DC: The Brookings Institution, p.17. Retrieved November 18, 2006 from [www.brook.edu/metro/pubs/20060209\\_Holt.pdf](http://www.brook.edu/metro/pubs/20060209_Holt.pdf).

<sup>3</sup> IRS, Statistics of Income Division, Individual Master File System. May 2009. Retrieved August 18, 2009 from [www.irs.gov/pub/irs-soi/07in54us.xls](http://www.irs.gov/pub/irs-soi/07in54us.xls).

<sup>4</sup> Nagle & Johnson, p. 21.

<sup>5</sup> Nagle & Johnson, p. 25.

to have little or no state income tax liability, only a refundable credit reaches them effectively, giving them an added incentive to work and helping to offset the other state taxes they pay.

3. **Is the credit at least 15% of federal EITC?** Credit levels should be large enough to ensure that working poor families receive adequate support to benefit from the program. Primary considerations in setting a state credit level include the affordability of the program for the state, the level of tax relief desired and the size of the desired income boost for poor families.
4. **Is there a bonus if EITC funds are deposited into a savings or investment account?** The majority of EITC refunds are used to meet immediate needs.<sup>6</sup> However, refund checks are often the largest lump-sum, discretionary funds that low-income taxpayers receive all year. Their potential to further long-term asset development is significant. Providing an incentive that encourages savings, either through IDAs or other savings instruments, can improve the asset development prospects of many working families.<sup>7</sup>

## WHAT STATES HAVE DONE

To date, 24 states (counting the District of Columbia) have enacted EITCs. Four states have enacted EITCs since the release of the *2007-2008 Assets & Opportunity Scorecard*: Washington, North Carolina, Louisiana and New Mexico. With these additional states and a number of recent expansions, state EITCs will collectively provide more than \$2 billion per year to low-income families.<sup>8</sup> Twenty-two of the 24 state EITCs are refundable.<sup>9</sup> Existing state EITCs range from 3.5% to 40% of the federal credit. In 2008, Washington became the first of the nine states without a broad-based income tax to enact a state EITC, setting an important precedent.<sup>10</sup>

<sup>6</sup> Holt, p. 16.

<sup>7</sup> Holt, pp. 16-17

<sup>8</sup> *Policy Basics: State Earned Income Tax Credits*. (June 25, 2009). Washington, DC: Center on Budget and Policy Priorities. Retrieved from [www.cbpp.org/files/policybasics-seitc.pdf](http://www.cbpp.org/files/policybasics-seitc.pdf).

<sup>9</sup> This includes Maine's, Maryland's and Rhode Island's EITCs, which are partially refundable. Only Delaware and Virginia have completely nonrefundable EITCs.

<sup>10</sup> *Rising Number of States Offer EITCs*. (2009). Washington, DC: Center on Budget and Policy Priorities. Retrieved June 6, 2009 from [www.cbpp.org/cms/index.cfm?fa=view&id=462](http://www.cbpp.org/cms/index.cfm?fa=view&id=462).

For more information on this policy measure, State Earned Income Tax Credit, and more, go to <http://scorecard.cfed.org>.

In the *2009-2010 Assets & Opportunity Scorecard*, the 50 states and the District of Columbia were rated on their tax-related policies. The ratings were based on all four criteria described above.