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TAX FAIRNESS FOR LOW-INCOME WORKING FAMILIES

The Importance of Expanding the State Earned Income Tax Credit

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The General Assembly is considering legislation that would expand the state earned income tax credit (EITC), which is targeted to low-income working families with children. The Illinois EITC — enacted in 2000 and made permanent and strengthened in 2003 — is currently set at only 5 percent of the federal EITC. Increasing the state EITC to at least 10 percent of the federal credit would improve tax fairness for low-income families, alleviate child poverty during a deep recession, and stimulate economic activity in local communities.

Earned Income Tax Credit: Federal and State Policies

The federal EITC is a targeted tax credit for low-income working households.[1] The primary beneficiaries are families with children. (Low-income households without children are also eligible for the EITC, but the amount of the credit is quite small.) Income eligibility limits and tax credit amounts are adjusted annually for inflation.

The EITC is structured to encourage and reward work by allowing low-income families to keep more of what they earn. For tax year 2011, a single parent with two children receives a credit equal to 40 percent of earnings, up to a maximum credit of $5,112. The family remains eligible for the maximum credit within the earnings "plateau" range of $12,750-$16,700 — between 70 percent and 90 percent of the federal poverty level (FPL). The credit is then gradually reduced and phases out when earnings reach about $41,000 (see Exhibit 1). In 2011, more than a million Illinois residents received the federal EITC, with an average credit of $2,250.

A substantial body of research shows that the EITC encourages labor force participation of single parents by "making work pay." For those with very low earnings, additional hours of work yield both more wages and a larger EITC. Those on the earnings plateau continue to receive the maximum credit. Some critics of the EITC contend that the declining credit discourages work among those in the phase-out range of earnings. However, this claim is not supported by the extensive and rigorous body of empirical research on the EITC.[2]

The federal EITC is widely recognized as one of the nation's most effective anti-poverty tools. The the EITC is not counted as income in calculations of the official federal poverty rate, but alternative, after-tax measures of poverty show that the EITC is especially effective in alleviating child poverty. The Internal Revenue Service estimates that in 2011, the EITC moved 6.6 million people above the poverty level, including 3.3 million children.

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[1] Low-income households are typically defined as households below 200 percent of the federal poverty level.

[2] Bruce D. Meyer, "The Effects of the Earned Income Tax Credit and Recent Reforms," in Jeffrey R. Brown, ed., *Tax Policy and the Economy*, Vol. 24 (National Bureau of Economic Research, 2o10).

Exhibit 1: Income Eligibility Thresholds for Earned Income Tax Credit, Tax Year 2011

	Single-parent households			Married-couple households		
	One child	Two children	3 or more children	One child	Two children	3 or more children
Plateau begins	$9,100	$12,750	$12,750	$9,100	$12,750	$12,750
As pct. of FPL	62%	69%	57%	49%	57%	49%
Phase-out begins	$16,700	$16,700	$16,700	$21,800	$21,800	$21,800
As pct. of FPL	114%	90%	75%	118%	98%	83%
Eligibility ends	$36,050	$40,964	$43,998	$41,132	$46,044	$49,078
As pct. of FPL	245%	221%	197%	222%	206%	188%

More than 20 states have built on the success of the federal EITC by adopting their own targeted tax credits. In most cases, these state EITCs are set as a percentage of the federal credit — with the same income eligibility thresholds. A majority of state EITCs are at least 15 percent of the federal EITC. Examples include Massachusetts (15%), Kansas (18%), Virginia (20%), Rhode Island (25%), and Vermont (32%). Illinois is one of only four states with an EITC as low as 5 percent of the federal credit.[3] For tax year 2011, the maximum credit in Illinois is only $155 for a family with one child, $256 for a family with two children, and $288 for a family with three or more children.

State Income Taxes and Low-Income Families

Among the 42 states that have income taxes, most use some combination of policy tools to reduce the tax liabilities of low-income households. These tax fairness measures include standard deductions, personal exemptions, and targeted tax credits. The Illinois income tax has no standard deduction and a small personal exemption ($2,000 per household member), as well as a small EITC. Consequently, even before the income tax increase enacted last January, tax liabilities for low-income families in Illinois were among the highest in the nation. In 2010, only five states imposed higher taxes on a single-parent family of three at the federal poverty level, which was about $17,500. For a two-parent family of four at poverty level (about $22,000), only six states had higher taxes than Illinois.[4]

The income tax increase was an essential step toward resolving the state's prolonged fiscal crisis. The new revenue — together with significant spending cuts — has substantially reduced the cumulative budget deficit.[5] However, the revenue legislation included no provisions to improve tax fairness. As a result, *low-income families were disproportionately affected by the higher tax rate.* Income tax liabilities more than tripled for single parents with two children at poverty level and jumped by more than 150 percent for comparable married couples with two children.

[3] Nicholas Johnson and Erica Williams, "A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2011" (Center on Budget and Policy Priorities, April 2011).

[4] See Phil Oliff and Nicholas Johnson, "The Impact of State Income Taxes on Low-Income Families in 2010" (Center on Budget and Policy Priorities, November 2011).

[5] See "Update on the Impact of New Income Tax Revenue" (Budget & Tax Policy Initiative, Voices for Illinois Children, October 2011).

Effects of Expanding the State EITC

The regressive impact of the income tax increase on families with children could be significantly mitigated by expanding the state EITC. Consider the case of a single mother with two children at 100 percent of the federal poverty level — about $17,500. When the individual income tax rose from 3 percent to 5 percent, the tax liability for this single mother jumped from $107 to $332. However, if the state EITC were increased from 5 percent to 10 percent of the federal credit, her taxes would be reduced to only $85, more than offsetting the rate increase (see Exhibits 2 and 3).

For a married couple with two children at 100 percent of poverty level, household income would be about $22,000. This family's state income tax liability rose from $178 in 2010 to $454 in 2011. Doubling the EITC would reduce their taxes to $202, which would offset nearly all of the rate increase (see Exhibits 2 and 3).

Exhibit 2: Estimated State Income Tax Liability for Families at 100% of Poverty Level

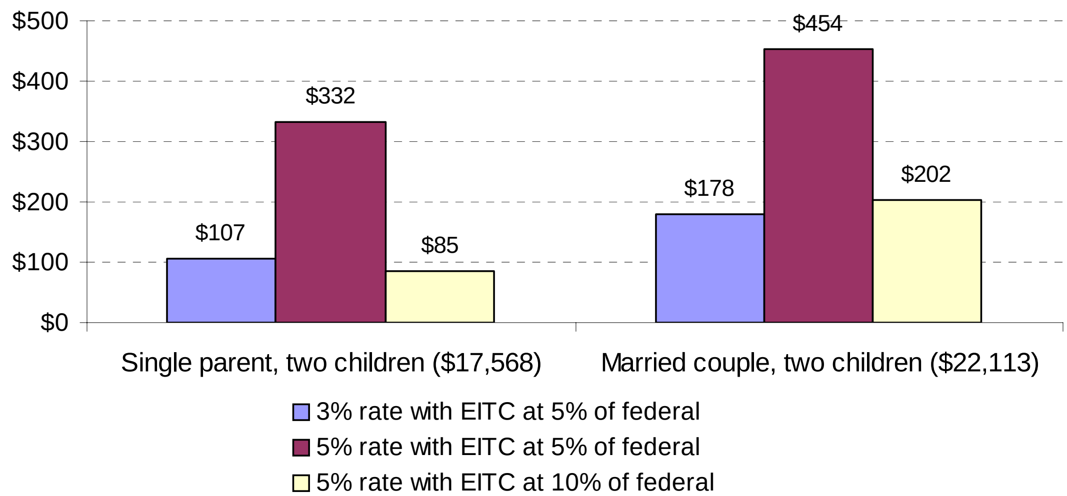

Exhibit 3: Calculation of State Income Tax Liability for Families at 100% of Poverty Level

	Single parent with two children	Married couple with two children
Earned income	$17,568	$22,113
Exemptions	-6,000	-8,000
Taxable income	11,568	14,113
Tax rate at 3% (2010)	347	423
State EITC at 5% of federal (2010)	-240	-245
Tax liability	**107**	**178**
Tax rate at 5% (2011)	578	706
State EITC at 5% of federal	-246	-252
Tax liability	**332**	**454**
Tax rate at 5%	578	706
State EITC at 10% of federal	-493	-504
Tax liability	**85**	**202**

Note: Poverty thresholds are at 2010 levels.

Conclusion

The General Assembly should increase the state EITC to *at least* 10 percent of the federal credit. Expanding the state EITC would improve tax fairness for low-income families, especially the working poor. It would also alleviate child poverty in Illinois, which rose from 16.6 percent in 2007 to 19.4 percent in 2010. Moreover, by boosting the after-tax income of working families and stimulating consumer spending, a stronger EITC would have positive economic effects on local communities. Studies indicate that most federal EITC recipients use the additional income to meet short-term and medium-term needs such as children's clothing, household goods, and car repairs. These types of consumer spending have important "ripple effects" on local economic activity.[6] Expanding the EITC would benefit children, families, and communities across the state of Illinois.

About the Budget & Tax Policy Initiative

The Budget & Tax Policy Initiative (BTPI) at Voices for Illinois Children provides timely, credible, and accessible information and analysis on fiscal issues that affect children, families, and communities in Illinois. BTPI is a member of the State Fiscal Analysis Initiative (SFAI), a network of nonprofit organizations in more than 35 states. SFAI is coordinated by the Center on Budget and Policy Priorities, a Washington, D.C.-based research organization and strategic policy institute that works on a range of federal and state issues.

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[6] See Alan Berube, "Using the Earned Income Tax Credit to Simulate Local Economies" (Living Cities Policy Series, November 2006).