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Is it Time for an Arkansas Earned Income Tax Credit?

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Summary Points

President Reagan called the Earned Income Tax Credit the "best anti-poverty, the best pro-family, the best job creation measure to come out of Congress."

The federal EITC rewards work by adding almost $2 per hour to the pay of low income working families with children.

Eighteen states have their own EITCs. Eleven states have adopted EITCs since 1997.

An Arkansas state earned income tax credit, or EITC, would be easy to administer, would stimulate the state economy, and would help our families make ends meet.

A state EITC would increase the fairness of the Arkansas tax system. The current Arkansas tax system taxes our low-income working families at twice the rate of our richest citizens.

The EITC puts money in the pocketbooks of working Arkansans who in turn put it to work in the local Arkansas economy. A conservative estimate is that each dollar spent equals three dollars to the state's economy.

A state EITC equal to 20 percent of the federal EITC would provide a maximum benefit of $850 per family and cost Arkansas $98 million annually.

Introduction

Arkansans are a hard-working group. More than 1 million people are employed in the state in diverse jobs ranging from flipping hamburgers in fast food restaurants to farming to financial services.

Many of these workers, however, have not fared well during the recent recession. According to the U.S. Bureau of the Census, the state median household income fell to $32,535, substantially lower than the national average of $43,349; more than one in four children under age five live in poverty, and one in two children live in families with incomes below 200 percent of the poverty line.[1]

At a time when many low- and middle-income families are struggling, tax changes recently enacted by the Arkansas General Assembly have hurt the pocketbooks of families with children. While the legislature deserves credit for having the political will to raise taxes to pay for education reform and improve the economic prospects of our children, these changes have had bad consequences for the state's families.

Low- and middle-income families have borne the brunt of recent tax increases and now bear the heaviest burden of the Arkansas tax system. A recent study by Arkansas Advocates for Children and Families (AACF) found that families in the lowest income group pay more than twice as much of their income in state and local taxes (12.4 percent) than the top 1percent (6.1percent).[2]

Arkansas needs to find a way to make work pay better and the tax system fairer for families. One option is a state earned income tax credit (EITC). State EITCs are based on the federal earned income tax credit, which dates back to 1975 and has enjoyed bi-partisan support for almost three decades.

Presidents Ronald Reagan, George H. W. Bush, and Bill Clinton all signed significant expansions of the EITC into law. President Reagan called the EITC the "best anti-poverty, the best pro-family, the best job creation measure to come out of Congress."[3]

The federal EITC has been so effective that 18 of the 42 states with personal income taxes have adopted an earned income credit based on the federal EITC.

How Does the Federal EITC Work?

First established in 1975, the federal EITC is an income tax credit for low and moderate-income workers with families to support. To qualify, the wage earner must have worked at least a portion of the year and have children that can be claimed as dependents on the family's federal income tax return.

Administratively, the EITC is simple to administer. The family must have a working parent and file a federal income tax return. The Internal Revenue Service automatically calculates the credit. If the amount of the EITC exceeds the tax liability, a refund check for the balance is sent to the taxpayer. This "refundable" feature is very important as a means of rewarding work at or slightly above minimum wage.

The federal EITC combines two values in setting the value of the credit for families. The first is the effort families make to be self-supporting; the family must earn at least $13,000 to qualify for the maximum benefit of $4,247. The second is need; the payments distinguish between those families that have one child and those that have two or more.

The EITC is graduated until the earnings of a family reach a specified level and then the credit gradually declines. The amounts vary based on the number of children, marital status, and income.

- For a family with one child, the EITC provides an additional $340 for each $1,000 of income up to $7,500 for a maximum credit of $2,604. These families continue to receive the maximum benefit until annual income reaches almost $15,000. As income increases, the credit decreases until it is phased out at $30,338 ($31,338 if married).

- For a family with two or more children, the EITC adds $400 for every $1,000 of family income to $10,000 with a maximum credit of $4,300. These families receive the maximum benefit until their income reaches almost $15,000. The credit then begins to decrease until it is phased out at $34,458 ($35,458 if married).

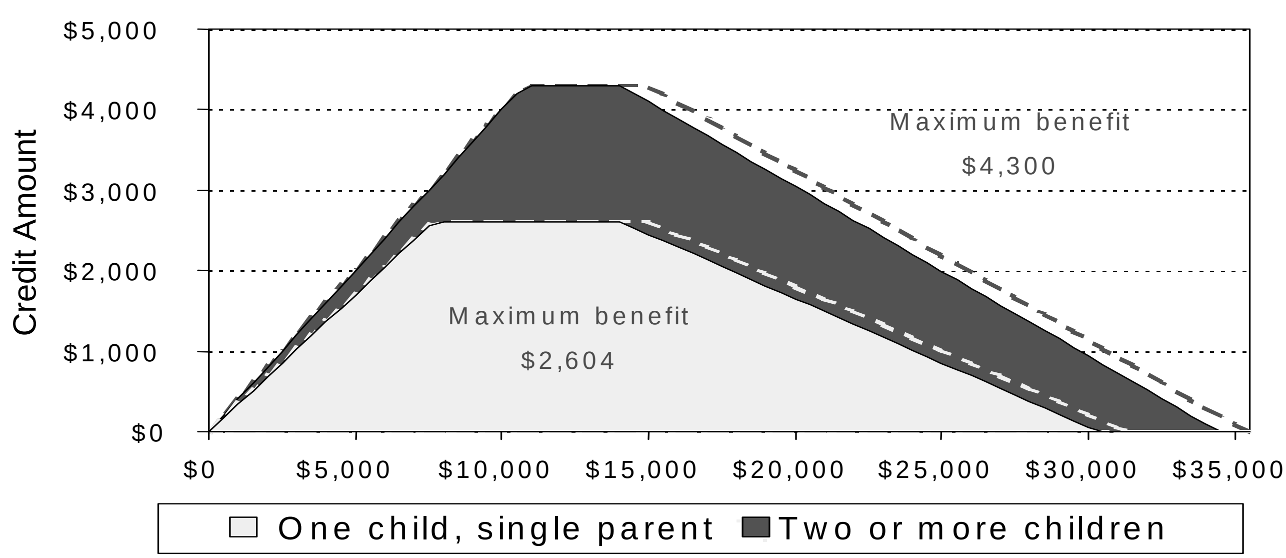
Impact of the Federal EITC

Originally, the EITC was designed to relieve the burden of federal payroll taxes for Social Security and Medicare on low- and middle-income families. Today, the federal EITC has other major goals. First, it is an incentive to work and make work pay; the beneficiaries must be employed for at least part of the year to qualify. The very lowest income workers are encouraged to work more hours because the EITC increases as income rises towards the federal poverty level. It also rewards those heads of household who leave the welfare roles for a job, albeit usually a low-wage job. Secondly, the supplemental income provided by the EITC reduces poverty among low-income working families. Thirdly, it supports families who are working hard, playing by the rules, and struggling to meet their children's basic needs.

The federal EITC has had a major impact on working families, their children, and state and regional economies.

The EITC has reduced poverty. According to the Center for Budget and Policy Priorities, the federal EITC now lifts more children out of poverty than any other government program. Some 4.9 million people, including 2.7 million children, were removed from poverty in 2002 nationwide as a result of the federal EITC.[4] Research shows that it has been very effective in encouraging work among single mothers and welfare recipients.

The Federal Earned Income Tax Credit in Tax Year 2004



Note: Married couples with incomes in the phaseout range qualify for a higher credit than single parents as shown by dashed lines.
Source: Center on Budget & Policy Priorities

The EITC has boosted the wages of working families. Robert S. McIntyre, the director of Citizens for Tax Justice, recently summarized the impact of the $45 billion federal EITC has in the nation's $12 trillion economy. "On average, it adds about $2 an hour to the wages of 10 million low-income families with children and about a buck and a half an hour to the wages of 6 million slightly better off families."[5]

The EITC has improved tax fairness. In 2002, more than one million Arkansas households filed federal income tax returns. Of these, nearly 260,000 Arkansas families (25.9 percent of filers) received the federal EITC. The average credit was $1,909. Altogether the federal EITC payments added $494,823,529 to the state's income.[6]

This represents half a billion dollars that were returned to the state's economy. Phillips County had the highest participation and the highest average credit among the state's 75 counties: almost half of those filing federal returns (49.7 percent) got an average of $2,325. Saline County had the lowest participation (15.6 percent) and the lowest average credit ($1,725).

The EITC has supported local economies in tough economic times. The EITC goes to low-income families who have to spend all of their income to meet basic needs. In turn, the vast majority of this money was returned immediately to the state's economy through local purchases of food, clothing, housing, and transportation. For some recipients, the refundable EITC meant they could put some money aside for future needs including education, home ownership, and capital investment in a small business.

The refundable EITC also had a major impact on the local economy. Economic studies have shown that such local spending will generate three to 10 times more economic activity in the area as the money moves through utility companies, grocery stores, and other local merchants. Let's be conservative and say that this half a billion EITC will turn over three times. That means that in 2003 the federal EITC payments were worth at least $2 billion to the state's economy.

State EITCs

Many states have adopted their own EITC to help working families. In 1986, Rhode Island became the first state to adopt an EITC. Vermont followed in 1988, and Maryland and Wisconsin a year later. Virginia became the latest state to adopt the EITC, enacted in 2004.

Today 18 states have an EITC. Thirteen of those make the EITC fully refundable. Four states have non-refundable EITC's. Maryland has a total credit of 50 percent of the federal EITC but only 20 percent of the state EITC is refundable.

States With Earned Income Tax Credits

State	Year Adopted	Refundable	Percent of Federal EITC
Colorado	1999	Yes	10%
D.C.	2000	Yes	25%
Illinois	2000	Yes	5%
Indiana	1999	Yes	6%
Iowa	1992	No	6%
Kansas	1998	Yes	15%
Maine	2000	No	4.92%
Maryland	1989	Yes/No	20%/50%
Massachusetts	1997	Yes	15%
Minnesota	1991-1992	Yes	varies
New Jersey	2000	Yes	20%
New York	1994	Yes	30%
Oklahoma	2002	Yes	5%
Oregon	1997	Yes	5%
Rhode Island	1986	No	25%
Vermot	1988	Yes	32%
Virginia	2004	No	20%
Wisconsin	1989	Yes	varies

Source: www.StateEITC.com

All 18 states use the same eligibility standards as those for the federal EITC. While individuals without children are eligible for the credit, it is targeted to individuals or couples with earned income and at least one child in the home who can be claimed as a deduction on the federal income tax form.

Fifteen of the 18 states express their credit as a straight percentage of the federal EITC. Maryland has a mixed approach with a portion of the credit refundable. Minnesota has a different formula for determining the state EITC. It is similar to the federal EITC except it starts to increase again when the federal EITC is phasing out. Expressed as a percentage of the federal EITC, it averages 33 percent, but the range is between 25 percent and 45 percent. Wisconsin varies the EITC based on the number of children in the family. A family with one child gets 4 percent; with two children it rises to 14 percent, and with three or more it climbs to 43 percent.

Should Arkansas Establish a State Earned Income Tax Credit?

Research on the federal EITC is very clear: it's good for working families. A state EITC would build on the success of the federal EITC and benefit Arkansas working families in several important ways:

1. A state EITC would make the state and local tax system fairer for working families. Previous work by AACF has shown the unequal burden that state and local taxes place on Arkansans in 2002.[7] In essence, 60 percent of the households earn less than $33,000 and have a tax burden of 11.8 to 12.4 percent. By contrast, the top 1 percent of Arkansas taxpayers enjoyed incomes in excess of $242,000 and paid 6.1 percent in taxes.

2. A state EITC would support working families who are struggling to meet basic needs. In 2003, according to a recent Bureau of the Census report, the median household income in Arkansas was $32,565, down 3.9 percent from the previous year. The U.S. median household income, by contrast, was $43,349, fully one-third higher than in Arkansas. It should come as no surprise, that Arkansas has the highest poverty rate in the nation at 18.8 percent, more than 50 percent higher than the national rate of 12.3 percent.

3. A state ETIC would reward and encourage work. According to a 1998 report by President Clinton's Council of Economic Advisors, "the EITC is a non-bureaucratic way to reward work effort. There are no middlemen [sic] service providers, no long lines at government offices, there is no need to take time off from work to apply for the credit."[8]

The National Center for Children in Poverty has argued that the potential impact of state EITCs should also be considered in light of recent evaluations of the New Hope program and the Minnesota Family Investment Project.[9] This research suggests that when states provide the right type of fiscal incentives to parents for low-wage work, not only do welfare rolls fall, but family incomes rise, poverty rates fall, and young children's academic achievement and social behavioral development improve."

What Would an Arkansas EITC Look Like?

Two features would be critical to a successful Arkansas EITC.

(1) It should be refundable so that any credit over the state income tax owed is returned to the family as a reward for working at low-paying jobs.

(2) It should be set at a percentage of the federal EITC for ease of administration. State EITCs are usually in the range of 10 to 50 percent of the federal credit.

What would an Arkansas EITC cost?

According to the Center on Budget and Policy Priorities, less than we might think. If the state credit were set at 20 percent of the federal EITC, the maximum benefit would be $850. The state would have a revenue loss of $98 million.[10]

Funds from the welfare reform block grant (TANF) could be used to underwrite the cost of the state EITC. Any savings accruing to the Transitional Employment Assistance (TEA) Program, Arkansas' version of TANF, have come about because former welfare recipients have taken jobs. Those initial jobs, almost without exception, will qualify the household for the federal EITC so it is only logical that the savings be used to support those families willing to work rather than remain on the welfare rolls.

An Arkansas EITC would have a major economic impact on the state's local economies, especially in areas such as the Delta. If 90 percent of the families receiving the federal EITC in 2002 would also receive the state EITC in 2006, an estimated 234,000 families would receive and spend the state credit of $98 million. If that turns over only three times in the economy, it will mean an addition of $300 million to the state gross domestic product and the state will capture a significant amount of that through sales tax and state income tax.

A state EITC makes sense for Arkansas' working families. It would be directly linked to work and would resonate well with the general public. It would reward parents who are working and trying to provide for their children. It will help to lift a number of those families out of poverty. A state EITC could be a key element in moving back toward tax fairness. It will ease the impact of the sales tax increase. It will stimulate further growth in the state economy. And it could be done economically and without an increase in the state bureaucracy. The bottom line is that a state EITC would be a winner for all of us.

Notes:

1.U.S. Census Bureau, Income. Poverty, and Health Insurance Coverage in the United States; U.S. Census Bureau, the 2003 American Community Survey, August 2004; and unpublished estimates by the Economic Policy Institute using data from the Current Population Survey, various years.

2. Arkansas Advocates for Children & Families, "The Impact of 2003-2004 Legislative Changes on Arkansas Families," *Paychecks and Politics*, Number 25, November 2004.

3.President Ronald Reagan, "Sweeping Tax Overhaul Now the Law," *Chicago Tribune*, October 23, 1986.

4.Joseph Llobrera and Bob Zahrandik "A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2004," Center on Budget and Policy Priorities, May 14, 2004.

5.Robert S. McIntrye, "A Payday Bonus," *The American Prospect*, September 2004.

6.AACF calculations of IRS data found at WWW.StateEITC.com.

7. Arkansas Advocates for Children & Families, "The Impact of 2003-2004 Legislative Changes on Arkansas Families," *Paychecks and Politics*, Number 25, November 2004.

8.Report from President Clinton's Council of Economic Advisors, December 1998.

9. National Center for Children in Poverty, "Untapped Potential: State Earned Income Credits and Child Poverty Reduction," Research Brief 3, 2001.

10. Unpublished estimates from the Center on Budget and Policy Priorities, August 2004.

For more information:

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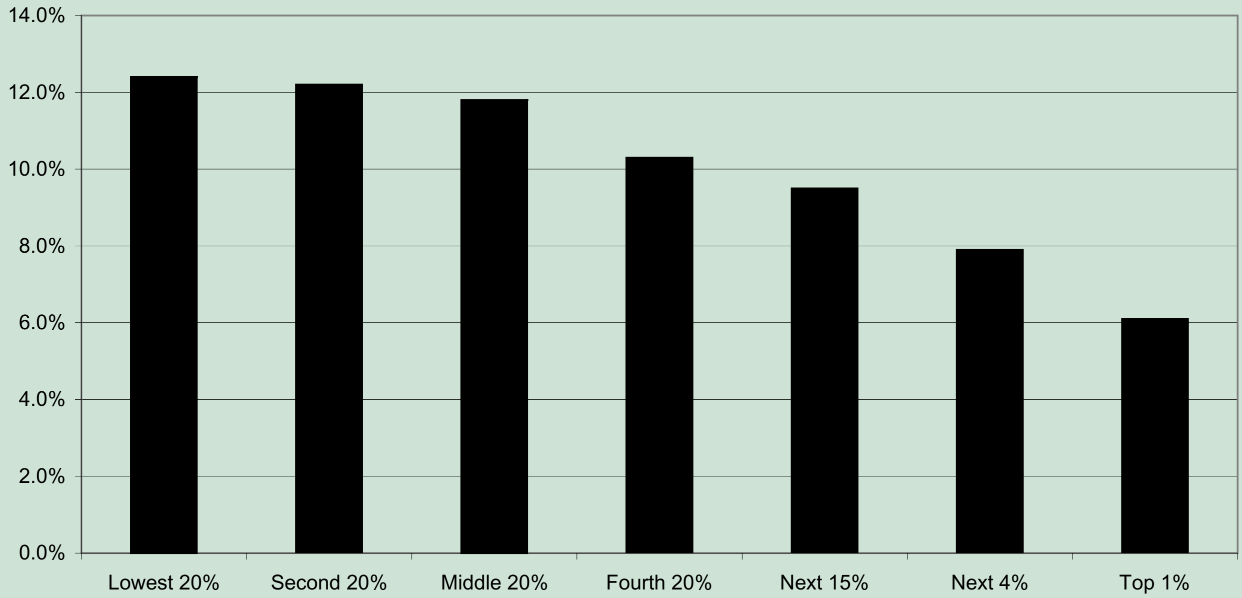
Arkansas State and Local Taxes After 2003-04 Legislative Changes As Shares of Family Income for Non-Elderly Taxpayers



Source: Institue on Taxation & Economic Policy, August 2004

Federal EITC Usage by Arkansas Counties - 2002

County	Number Returns	EITC Returns	Percent EITC	Amount EITC	Average EITC
Arkansas	8,211	2,231	27.2%	$4,108,066	$1,841
Ashley	8,691	2,622	30.2%	$5,220,063	$1,991
Baxter	15,199	2,736	18.0%	$4,791,075	$1,751
Benton	62,277	11,136	17.9%	$20,383,719	$1,830
Boone	13,596	3,101	22.8%	$5,576,791	$1,798
Bradley	4,264	1,385	32.5%	$2,718,992	$1,963
Calhoun	1,617	489	30.2%	$970,591	$1,985
Carroll	9,250	2,422	26.2%	$4,474,831	$1,848
Chicot	4,631	2,038	44.0%	$4,486,601	$2,201
Clark	8,557	2,246	26.2%	$4,163,295	$1,854
Clay	6,372	1,577	24.7%	$2,896,314	$1,837
Cleburne	8,820	1,883	21.3%	$3,390,567	$1,801
Cleveland	2,956	782	26.5%	$1,457,179	$1,863
Columbia	9,268	2,759	29.8%	$5,373,970	$1,948
Conway	7,351	1,925	26.2%	$3,616,196	$1,879
Craighead	31,233	7,163	22.9%	$13,213,332	$1,845
Crawford	20,747	5,153	24.8%	$9,649,427	$1,873
Crittenden	18,810	7,679	40.8%	$16,385,283	$2,134
Cross	6,980	2,361	33.8%	$4,860,382	$2,059
Dallas	3,173	1,097	34.6%	$2,218,858	$2,023
Desha	5,662	2,276	40.2%	$4,710,241	$2,070
Drew	6,084	1,905	31.3%	$3,791,897	$1,990
Faulkner	22,438	5,132	22.9%	$9,314,295	$1,815
Franklin	6,311	1,463	23.2%	$2,726,694	$1,864
Fulton	3,489	942	27.0%	$1,644,055	$1,745
Garland	37,496	8,047	21.5%	$14,497,955	$1,802
Grant	5,861	1,198	20.4%	$2,072,279	$1,730
Greene	13,749	3,118	22.7%	$5,493,103	$1,762

County	Number Returns	EITC Returns	Percent EITC	Amount EITC	Average EITC
Hempstead	7,732	2,908	37.6%	$5,923,782	$2,037
Hot Spring	10,689	2,609	24.4%	$4,803,996	$1,841
Howard	6,076	1,878	30.9%	$3,652,104	$1,945
Independence	12,612	2,914	23.1%	$5,227,408	$1,794
Izard	4,498	1,076	23.9%	$1,885,435	$1,752
Jackson	5,503	1,731	31.5%	$3,262,096	$1,885
Jefferson	30,395	10,504	34.6%	$21,360,109	$2,034
Johnson	8,011	2,292	28.6%	$4,221,720	$1,842
Lafayette	2,741	1,062	38.7%	$2,103,584	$1,981
Lawrence	6,669	1,854	27.8%	$3,618,647	$1,952
Lee	3,099	1,492	48.1%	$3,290,667	$2,206
Lincoln	3,770	1,261	33.4%	$2,526,267	$2,003
Little River	4,910	1,438	29.3%	$2,909,895	$2,024
Logan	8,289	2,153	26.0%	$3,979,241	$1,848
Lonoke	21,760	4,534	20.8%	$8,184,366	$1,805
Madison	5,033	1,220	24.2%	$2,172,249	$1,781
Marion	5,198	1,247	24.0%	$2,342,982	$1,879
Miller	14,878	4,421	29.7%	$8,891,178	$2,011
Mississippi	17,638	6,849	38.8%	$14,094,128	$2,058
Monroe	3,547	1,424	40.1%	$2,913,013	$2,046
Montgomery	2,609	651	25.0%	$1,236,782	$1,900
Nevada	3,678	1,164	31.6%	$2,211,160	$1,900
Newton	2,689	813	30.2%	$1,486,871	$1,829
Ouachita	10,674	3,446	32.3%	$6,782,609	$1,968
Perry	3,975	957	24.1%	$1,758,050	$1,837
Phillips	8,538	4,247	49.7%	$9,875,614	$2,325
Pike	3,778	1,014	26.8%	$1,883,403	$1,857
Poinsett	9,013	2,878	31.9%	$5,444,366	$1,892
Polk	6,986	2,012	28.8%	$3,928,785	$1,953
Pope	20,550	4,815	23.4%	$8,813,793	$1,830
Prairie	3,082	881	28.6%	$1,652,432	$1,876
Pulaski	161,206	38,093	23.6%	$72,038,028	$1,891
Randolph	6,095	1,619	26.6%	$2,945,683	$1,819
Saint Francis	10,010	4,442	44.4%	$9,604,606	$2,162
Saline	22,589	3,534	15.6%	$6,097,775	$1,725
Scott	3,928	1,126	28.7%	$2,265,348	$2,012
Searcy	2,636	796	30.2%	$1,549,331	$1,946
Sebastian	44,784	10,934	24.4%	$19,805,516	$1,811
Sevier	5,239	1,697	32.4%	$3,525,937	$2,078
Sharp	6,836	1,805	26.4%	$3,454,727	$1,914
Stone	3,701	989	26.7%	$1,907,438	$1,929
Union	17,723	5,466	30.8%	$10,820,985	$1,980
Van Buren	5,416	1,310	24.2%	$2,433,332	$1,858
Washington	64,639	13,306	20.6%	$23,548,862	$1,770
White	25,448	6,055	23.8%	$11,203,909	$1,850
Woodruff	3,128	1,183	37.8%	$2,454,093	$2,074
Yell	7,601	2,286	30.1%	$4,525,176	$1,980
Totals	**1,002,692**	**259,252**	**25.9%**	**$494,823,529**	**$1,909**