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A State-Earned Income Tax Credit Would Help Kentucky's Working Families

Introduction

The federal earned income tax credit (EITC) has a 30-year track record of helping low-income working families. Experts credit it as the federal program that has been most responsible for lifting children out of poverty in the United States. During the last two decades, 22 states and the District of Columbia have established state-level earned income credits to supplement the federal credit and provide additional support to low-income families.

This brief examines the federal EITC and the benefits a state-level EITC would provide to Kentucky's working families if such a credit were implemented in the Commonwealth.

The earned income tax credit is garnering new attention as Kentucky policy makers explore ways to reduce high rates of poverty, increase household income, and make the state's tax system fairer to low-wage earners.

The federal earned income tax credit was instituted in 1975 to offset the effect of federal payroll taxes on low-income families. Research shows that the EITC increases employment among single parents, reduces welfare dependency, and reduces family poverty.¹ Analysis of 2003 Census data finds the federal EITC lifted 4.4 million people out of poverty, including 2.4 million children.² Without the EITC, the poverty rate among American children would be one-fourth higher.³ Families use the refunds on housing, groceries, childcare, transportation and health care costs.⁴ Money spent that goes back into the local economy. In 2004 nearly 350,000 Kentucky taxpayers claimed EITC credits worth \$600 million.

¹ Robert Greenstein, "The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor." Washington, DC, Center on Budget and Policy Priorities, 2005.

² Ibid.

³ Ibid.

⁴ Timothy M. Smeeding, Katherin Ross Phillips, and Michael A. O'Connor, "The Earned Income Tax Credit: Expectation, Knowledge, Use, and Economic and Social Mobility," In Meyer and Holtz-Eakin, *Making Work Pay*, 2002.

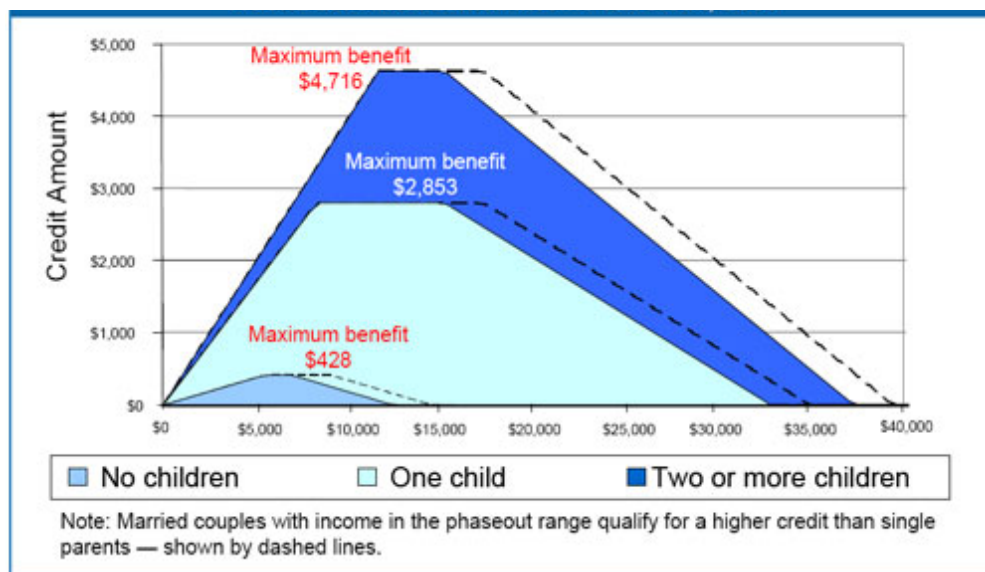
How the Federal Earned Income Tax Credit Works

The federal EITC is a tax credit extended to low-wage workers. Specifically, the tax filer must earn wages in order to qualify for the credit. The credit primarily benefits families with children, and the value of the credit varies depending upon family size. Married couples also qualify for slightly higher credits than single filers. The credit effectively supplements the wages of working individuals and couples. Under a *phase-in provision*, workers qualify for a larger credit as they increase their work effort (see graph below).

For tax year 2007 (income earned in 2007, returns processed in 2008), the maximum benefit levels were as follows:

- \$4,716 for a family with two or more children with incomes from \$11,750 to \$17,400 (or \$15,400 if single);⁵
- \$2,853 for a family with one child with incomes from \$8,350 to \$17,400 (or \$15,400 if single);⁶ and
- \$428 for a single person or married couple with no children and incomes from \$5,500 to \$9,000.⁷

Federal Earned Income Tax Credit, 2007



Source: Center on Budget and Policy Priorities

⁵ IRS, Earned Income Credit (EIC) Table, 2006 1040 Instructions, pp. 53-59.

<http://www.irs.gov/pub/irs-pdf/i1040.pdf>

⁶ Ibid.

⁷ Ibid.

Under the *phase-out provision*, the value of the EITC falls off as earnings increase. Under both the phase-in and phase-out provisions of the EITC schedule, workers keep every additional dollar they earn, along with the EITC's benefit. The income levels at which the EITC benefit end are above the poverty level for families with children. These income levels exceed official poverty thresholds, but still fall below the actual income levels families require to meet their basic needs.

The federal EITC is a refundable tax credit, meaning that if the value of the credit exceeds the tax filer's tax liability, the taxpayer receives the difference between the two amounts. The refundable nature of the credit helps offset other taxes that low-income workers pay, such as payroll or sales taxes. Often, the tax bill for low-income workers represents a higher percentage of their income than that of high-income individuals.

Federal EITC Returns Over \$600 Million to Kentucky Taxpayers

The EITC returns money directly to low-income Kentuckians, supplementing low wages and offsetting taxes. Preliminary figures for the total value of federal EITC claims by Kentucky taxpayers are \$600 million for tax year 2004 and \$635 million for tax year 2005.⁸ The average EITC value for a Kentucky tax payer was \$1,731 in tax year 2003, \$1,775 in tax year 2004, and \$1,821 in tax year 2005. The average and total value of the federal EITC in Kentucky continues to increase each year.

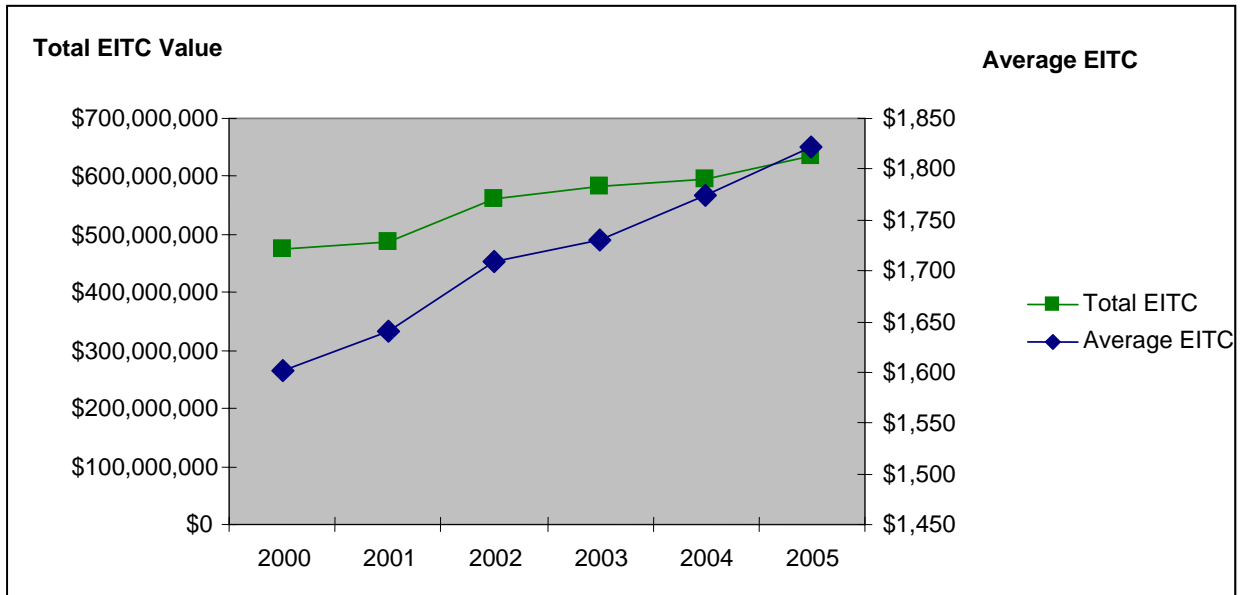
Several factors contribute to the increased value of the federal EITC. First, it is purposely structured to increase each year to account for inflation. Second, outreach efforts to inform taxpayers of their eligibility for the EITC have been stepped up, both by community organizations providing services to this population and by private-sector tax preparers.

A state EITC would expand the power of the federal credit and help working families in Kentucky meet basic needs and give them a better opportunity to build assets.⁹ For Kentuckians working but still within the grasp of poverty, the EITC helps them pay for basic necessities. EITC recipients with higher incomes are more likely to apply their EITC toward longer-term investments that help them build assets, including education, housing improvements, or savings. Individual development accounts offered by community-based organizations in Kentucky offer matched savings programs to encourage individuals to save at least a portion of their EITC.

⁸ Center on Budget and Policy Priorities, EITC Participation for Tax Year 2005 and 2004. http://www.cbpp.org/eic2007/EIC_Participation.pdf

⁹ Timothy M. Smeeding, Katherin Ross Phillips, and Michael A. O'Connor, "The Earned Income Tax Credit: Expectation, Knowledge, Use, and Economic and Social Mobility," In Meyer and Holtz-Eakin, *Making Work Pay*, 2002.

Total and Average Federal EITC Dollars in Kentucky



Data Source: Center on Budget and Policy Priorities and Brookings Institution. Calculations made by Kentucky Youth Advocates.

How Would a State EITC Work in Kentucky?

Policymakers in Kentucky must consider several key elements of a state EITC, including the amount of a credit, whether to make the credit refundable, and how marital status and family size would affect the size of the credit.

In most of the states that have enacted state-level earned income tax credits, the credit is set as a percentage of the federal EITC. State credits range from 3.5 percent to 35 percent of the federal credit, with most falling in the 10 percent to 20 percent range.

In 20 of the 23 states offering an EITC, the credit is refundable, allowing a family to receive money back when the credit amount is greater than the tax liability. Though the state incurs a greater expense in providing a refundable credit, such a credit provides working families with greater tax relief and a potential wage supplement. Most filers who receive a credit payment spend their refunds in their local communities, producing economic activity and spurring local development.¹⁰

Most states with an EITC follow federal provisions in establishing how large a credit each type of family receives. That is, families with no children, one child, or two or more children receive

¹⁰ Alan Berube, "Using the Earned Income Tax Credit to Stimulate Local Economies," The Brookings Institution, <http://www3.brookings.edu/metro/pubs/berube20061101eitc.pdf>

a certain credit amount. Only two states, Minnesota and Wisconsin, go beyond the federal provisions to offer larger credits to families with more than two children.¹¹

One compelling reason to base a state EITC on the federal credit is its modest administration costs. By having a state credit “piggyback” on the federal credit, state tax agencies often need to add only one new line to a state tax form. In addition, many tax filers are already familiar with the federal EITC, and many community-based outreach efforts are already in place to assure that all eligible families take advantage of the federal EITC. Such efforts will help make sure tax filers know about a state tax credit and take advantage of it.

States with an Earned Income Tax Credit

State	Refundable vs. Non-Refundable	Rates and Structure
Delaware	Non-Refundable	20% of Federal EITC
DC	Refundable	35% of Federal EITC
Illinois	Refundable	5% of Federal EITC
Indiana	Refundable	6% of Federal EITC
Iowa	Refundable	7% of Federal EITC
Kansas	Refundable	17% of Federal EITC
Louisiana	Refundable	3.5% of Federal EITC (effective 2008)
Maine	Non-Refundable	5% of Federal EITC
Maryland	Refundable OR Non-Refundable	Refundable - 20% of Federal EITC, increase to 25% in 2008 Non-Refundable - 50% of Federal EITC
Massachusetts	Refundable	15% of Federal EITC
Michigan	Refundable	10% of Federal EITC (effective 2008) 20% in 2009
Minnesota	Refundable	Contingent on Income, # of Children Average of 33% of Federal EITC
Nebraska	Refundable	8% of Federal EITC (10% in 2008)
New Jersey	Refundable	20% of Federal EITC, ¹² (22.5% in 2008, 25% in 2009)
New Mexico	Refundable	8% of Federal EITC
New York	Refundable	30% of Federal EITC
North Carolina	Refundable	3.5% of Federal EITC (effective in 2008)
Oklahoma	Refundable	5% of Federal EITC
Oregon	Refundable	5% (6% in 2008) of Federal EITC
Rhode Island	Refundable	10% Refundable, 25% Refundable of Federal EITC
Vermont	Refundable	32% of Federal EITC
Virginia	Non-Refundable	20% of Federal EITC
Wisconsin	Refundable	4% of Federal EITC if 1 child, 14% if 2 children, 43% if 3 or more children

Source: <http://www.stateeitc.com/>

¹¹ Ibid.

¹² New Jersey lifted the income threshold, and will increase the percentage of the federal credit to 22.5 percent in 2008 and 25 percent in 2009.

A State EITC for Kentucky

Kentucky's General Assembly is considering several proposals for a state EITC during the 2008 Regular Session. All involve setting a refundable rate as a percentage of the federal EITC. During the 2007 legislative session, legislation was proposed to establish a refundable state EITC at 15 percent of the federal credit. At this level, an additional \$90 million in tax credits would be made available to approximately 350,000 Kentucky tax filers. The chart below shows the average size of a credit under eight credit rates, as well as the total cost of each credit.

Proposed State Refundable EITC		
<u>% of Federal Deduction</u> <u>Allowed</u>	<u>Average EITC per</u> <u>Return</u>	<u>Estimated State EITC</u>
3%	\$53.29	\$17,986,256
5%	\$88.82	\$29,977,093
10%	\$177.65	\$59,954,187
13%	\$230.94	\$77,940,443
15%	\$266.47	\$89,931,280
20%	\$355.29	\$119,908,373
50%	\$888.23	\$299,770,934
75%	\$1,332.35	\$449,656,400

Data Source: Brookings Institution, 2004 tax year data from Internal Revenue Service. Calculations made by Kentucky Youth Advocates.

Analysis of IRS data for tax year 2004 shows that out of 1.7 million federal tax returns filed by Kentuckians, 20 percent included an EITC claim. In all, 337,968 Kentucky tax filers received the EITC. Given that many EITC recipients are married couples – many with children – the actual number of Kentuckians benefiting from the credit is much larger.

In 2005, Kentucky established a nonrefundable, family size tax credit (FSTC), which provides income tax relief for individuals and married couples earning less than 133 percent of established thresholds.

While the FSTC has been valuable to many working families, it does not carry all of the benefits of a state EITC. First, because it is not refundable, the FSTC doesn't supplement wages as a refundable EITC would. In addition, a refundable state EITC would provide tax relief to low-income working families who earn slightly more than the current income cutoffs under the FSTC. For example, a family of four with two children with earnings of \$14,000 receives a family size tax credit equal to its income tax liability. If a refundable state EITC of 15 percent were implemented, the family would receive a credit of \$680.¹³

¹³ Erica Meade and James P. Ziliak, "A State Earned Income Tax Credit," University of Kentucky Center for Poverty Research, Fall 2007.

While about 20 percent of federal tax filers in Kentucky received the federal EITC, the proportion of EITC recipients varied from county to county. In 22 Kentucky counties, the percentage of filers receiving the EITC exceeded 30 percent, with a high of 39 percent in McCreary County. The rate of EITC returns was less than 15 percent in just 7 counties. Even in Oldham County, the state's wealthiest, nearly one in ten filers filed for the federal EITC.

**Kentucky Counties With Highest Percentage
of 2004 Tax Filers Claiming Federal EITC**

County	# of Filers Claiming Federal EITC	County	# of Filers Claiming Federal EITC
McCreary	39%	Whitley	32%
Owsley	37%	Jackson	32%
Clay	35%	Harlan	31%
Wolfe	35%	Leslie	31%
Clinton	33%	Martin	31%
Knox	33%	Menifee	31%
Breathitt	33%	Wayne	31%
Bell	33%	Elliott	30%
Lee	32%	Casey	30%
Magoffin	32%	Powell	30%
Lewis	32%	Cumberland	30%

Data Source: Brookings Institution, 2004 tax year data from Internal Revenue Service. . Calculations made by Kentucky Youth Advocates.

Funding a State EITC

Most states with a state earned income tax credit rely heavily on general funds to cover the costs. But several options have been forwarded for financing a Kentucky EITC. One would be to expand the sales tax to apply to luxury and discretionary services. Another option that has been discussed is reinstating Kentucky's estate tax. A third option would be recalibrating the income tax to impose slightly higher rates on the wealthiest 20 percent of Kentuckians. By taxing income above \$75,000 at a 7 percent rate and incomes above \$90,000 at 8 percent, an additional \$300 million in new revenue would be generated.

Some states have used surplus Temporary Assistance for Needy Families (TANF) funds to pay for a state EITC. This has been feasible only for states that have seen significant drops in the number of TANF participants in the last decade. In Kentucky, however, all \$181 million of the TANF block grant was used for basic cash assistance, the Child Care Development Fund,

or other child care and work programs.¹⁴ However, it is important to note that using TANF funds to establish a state refundable EITC would help the state meet its “maintenance of effort” requirement for receiving federal TANF funds.¹⁵

Kentucky Would Benefit from Building on Success of Federal EITC

A refundable state EITC would begin paying benefits quickly – with little administrative cost and without requiring the creation of more governmental infrastructure. By implementing an EITC in Kentucky, thousands of low-income working families would have additional funds to address their immediate needs and, in some cases, a few extra dollars to save for achieving long-term economic success.

¹⁴ CRS Report for Congress, January 23, 2007, Appendix B: Table B2, Table B4.
<http://www.nationalaglawcenter.org/assets/crs/RL32760.pdf>

¹⁵ Ibid. A state EITC must be refundable to meet the maintenance of effort requirements.

**Kentucky Tax Filers Claiming the Federal EITC
Tax Year 2004**

County	Total # of Returns	# of EITC Returns	% of EITC Returns	Total \$ - EITC Received	Average \$/EITC Return
Adair	6,350	1,832	29%	\$3,366,500	\$1,837.61
Allen	6,992	1,534	22%	\$2,725,156	\$1,776.50
Anderson	8,835	1,331	15%	\$2,294,336	\$1,723.77
Ballard	3,491	652	19%	\$1,143,767	\$1,754.24
Barren	16,372	3,591	22%	\$6,445,327	\$1,794.86
Bath	4,408	1,169	27%	\$2,058,778	\$1,761.14
Bell	9,435	3,084	33%	\$5,811,914	\$1,884.54
Boone	47,369	5,109	11%	\$8,706,096	\$1,704.07
Bourbon	8,256	1,581	19%	\$2,744,055	\$1,735.65
Boyd	19,932	3,867	19%	\$6,745,934	\$1,744.49
Boyle	11,474	2,200	19%	\$3,840,551	\$1,745.71
Bracken	3,669	812	22%	\$1,402,787	\$1,727.57
Breathitt	4,553	1,494	33%	\$2,693,086	\$1,802.60
Breckinridge	8,165	1,751	21%	\$3,116,437	\$1,779.80
Bullitt	30,282	4,666	15%	\$8,049,957	\$1,725.24
Butler	4,869	1,131	23%	\$2,069,588	\$1,829.87
Caldwell	5,469	1,047	19%	\$1,800,861	\$1,720.02
Calloway	13,669	2,514	18%	\$4,202,300	\$1,671.56
Campbell	39,644	5,243	13%	\$8,836,144	\$1,685.32
Carlisle	2,131	444	21%	\$813,085	\$1,831.27
Carroll	4,501	944	21%	\$1,656,328	\$1,754.58
Carter	10,869	3,053	28%	\$5,695,873	\$1,865.66
Casey	5,871	1,781	30%	\$3,219,212	\$1,807.53
Christian	30,545	7,907	26%	\$15,750,176	\$1,991.93
Clark	14,675	2,585	18%	\$4,459,356	\$1,725.09
Clay	6,330	2,240	35%	\$4,314,530	\$1,926.13
Clinton	3,627	1,215	33%	\$2,155,711	\$1,774.25
Crittenden	3,532	678	19%	\$1,119,992	\$1,651.91
Cumberland	2,419	717	30%	\$1,268,250	\$1,768.83
Daviess	40,710	7,001	17%	\$12,460,243	\$1,779.78
Edmonson	4,697	1,116	24%	\$2,014,395	\$1,805.01
Elliott	1,550	472	30%	\$901,848	\$1,910.69
Estill	5,384	1,489	28%	\$2,714,954	\$1,823.34
Fayette	118,645	17,240	15%	\$28,700,142	\$1,664.74
Fleming	5,890	1,504	26%	\$2,622,969	\$1,744.00
Floyd	13,902	3,944	28%	\$7,329,329	\$1,858.35
Franklin	22,556	3,599	16%	\$5,932,143	\$1,648.28

**Kentucky Tax Filers Claiming the Federal EITC
Tax Year 2004**

County	Total # of Returns	# of EITC Returns	% of EITC Returns	Total \$ - EITC Received	Average \$/EITC Return
Fulton	2,701	758	28%	\$1,469,079	\$1,938.10
Gallatin	3,372	683	20%	\$1,234,604	\$1,807.62
Garrard	6,533	1,385	21%	\$2,390,348	\$1,725.88
Grant	10,140	2,081	21%	\$3,738,118	\$1,796.31
Graves	14,962	3,097	21%	\$5,535,993	\$1,787.53
Grayson	9,299	2,360	25%	\$4,208,073	\$1,783.08
Green	4,337	1,093	25%	\$1,949,449	\$1,783.58
Greenup	14,358	3,043	21%	\$5,449,273	\$1,790.76
Hancock	3,566	502	14%	\$902,984	\$1,798.77
Hardin	41,342	8,115	20%	\$14,772,904	\$1,820.44
Harlan	9,609	3,005	31%	\$5,751,549	\$1,913.99
Harrison	7,917	1,438	18%	\$2,584,064	\$1,796.98
Hart	6,754	1,791	27%	\$3,267,016	\$1,824.13
Henderson	19,838	3,526	18%	\$6,221,221	\$1,764.38
Henry	6,566	1,207	18%	\$2,072,270	\$1,716.88
Hickman	1,849	406	22%	\$689,154	\$1,697.42
Hopkins	19,059	3,897	20%	\$6,927,543	\$1,777.66
Jackson	4,628	1,458	32%	\$2,667,435	\$1,829.52
Jefferson	325,833	57,570	18%	\$100,877,616	\$1,752.26
Jessamine	17,858	3,254	18%	\$5,760,901	\$1,770.41
Johnson	7,889	2,117	27%	\$3,874,595	\$1,830.23
Kenton	70,368	9,949	14%	\$16,866,437	\$1,695.29
Knott	4,809	1,346	28%	\$2,381,429	\$1,769.26
Knox	11,599	3,820	33%	\$7,564,941	\$1,980.35
Larue	5,628	1,167	21%	\$2,146,670	\$1,839.48
Laurel	21,072	5,456	26%	\$10,068,444	\$1,845.39
Lawrence	5,283	1,435	27%	\$2,619,756	\$1,825.61
Lee	2,237	726	32%	\$1,279,786	\$1,762.79
Leslie	3,719	1,162	31%	\$2,151,491	\$1,851.54
Letcher	8,026	2,157	27%	\$3,736,677	\$1,732.35
Lewis	4,773	1,528	32%	\$2,913,298	\$1,906.61
Lincoln	9,276	2,402	26%	\$4,350,683	\$1,811.28
Livingston	4,083	828	20%	\$1,436,370	\$1,734.75
Logan	10,809	2,263	21%	\$3,936,643	\$1,739.57
Lyon	3,131	493	16%	\$793,251	\$1,609.03
Madison	30,287	5,601	18%	\$9,407,776	\$1,679.66
Magoffin	4,056	1,312	32%	\$2,451,076	\$1,868.20

**Kentucky Tax Filers Claiming the Federal EITC
Tax Year 2004**

County	Total # of Returns	# of EITC Returns	% of EITC Returns	Total \$ - EITC Received	Average \$/EITC Return
Marion	7,343	1,644	22%	\$2,858,161	\$1,738.54
Marshall	13,254	2,117	16%	\$3,659,728	\$1,728.73
Martin	3,484	1,081	31%	\$2,012,503	\$1,861.70
Mason	6,913	1,511	22%	\$2,649,050	\$1,753.18
McCracken	28,597	5,427	19%	\$9,859,427	\$1,816.74
McCreary	5,088	1,978	39%	\$4,036,352	\$2,040.62
McLean	3,958	767	19%	\$1,351,152	\$1,761.61
Meade	11,379	2,290	20%	\$4,111,114	\$1,795.25
Menifee	2,239	691	31%	\$1,311,087	\$1,897.38
Mercer	9,266	1,709	18%	\$2,910,135	\$1,702.83
Metcalfe	3,964	1,120	28%	\$2,079,675	\$1,856.85
Monroe	4,255	1,189	28%	\$2,197,373	\$1,848.08
Montgomery	10,100	2,297	23%	\$4,135,820	\$1,800.53
Morgan	4,433	1,297	29%	\$2,357,827	\$1,817.91
Muhlenberg	12,171	2,832	23%	\$5,034,110	\$1,777.58
Nelson	18,166	3,254	18%	\$5,637,362	\$1,732.44
Nicholas	2,721	591	22%	\$1,011,260	\$1,711.10
Ohio	9,029	2,099	23%	\$3,785,028	\$1,803.25
Oldham	21,825	1,917	9%	\$3,065,552	\$1,599.14
Owen	3,627	779	21%	\$1,416,993	\$1,818.99
Owsley	1,344	496	37%	\$908,134	\$1,830.92
Pendleton	6,307	1,164	18%	\$2,028,349	\$1,742.57
Perry	10,737	3,161	29%	\$5,649,283	\$1,787.18
Pike	21,836	5,373	25%	\$9,539,918	\$1,775.53
Powell	5,032	1,497	30%	\$2,800,727	\$1,870.89
Pulaski	23,470	5,694	24%	\$10,239,030	\$1,798.21
Robertson	751	166	22%	\$281,897	\$1,698.17
Rockcastle	6,073	1,618	27%	\$2,944,997	\$1,820.15
Rowan	7,735	1,780	23%	\$2,900,968	\$1,629.76
Russell	6,095	1,767	29%	\$3,165,410	\$1,791.40
Scott	16,686	2,505	15%	\$4,434,852	\$1,770.40
Shelby	15,577	2,275	15%	\$4,044,137	\$1,777.64
Simpson	7,279	1,501	21%	\$2,738,612	\$1,824.52
Spencer	5,874	778	13%	\$1,295,630	\$1,665.33
Taylor	9,561	2,128	22%	\$3,629,091	\$1,705.40
Todd	4,605	1,016	22%	\$1,812,884	\$1,784.33
Trigg	5,564	1,013	18%	\$1,747,249	\$1,724.83

**Kentucky Tax Filers Claiming the Federal EITC
Tax Year 2004**

County	Total # of Returns	# of EITC Returns	% of EITC Returns	Total \$ - EITC Received	Average \$ per EITC Return
Trimble	3,800	699	18%	\$1,219,069	\$1,744.02
Union	6,121	1,151	19%	\$1,986,377	\$1,725.78
Warren	41,619	7,795	19%	\$13,707,543	\$1,758.50
Washington	4,573	926	20%	\$1,553,069	\$1,677.18
Wayne	7,540	2,313	31%	\$4,387,394	\$1,896.84
Webster	5,795	1,105	19%	\$1,920,128	\$1,737.67
Whitley	12,022	3,821	32%	\$7,736,761	\$2,024.80
Wolfe	2,286	806	35%	\$1,470,094	\$1,823.94
Woodford	10,673	1,386	13%	\$2,289,528	\$1,651.90
TOTAL	1,719,401	337,492	20%	\$599,541,867	\$1,776.46

Source: Brookings Institution, 2004 tax year data from Internal Revenue Service,

Kentucky Youth Advocates
Commonwealth Business Center
11001 Bluegrass Parkway, Suite 100
Jeffersontown, Kentucky 40299
(502) 895-8167
Fax: (502) 895-8225
<http://kyyouth.org/>

Contact:
Tracy Goff Herman
Deputy Director
therman@kyyouth.org

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