DC Fiscal Policy Institute

An Affiliate of the
Center on Budget and Policy Priorities
820 First Street NE, Suite 460
Washington, DC 20002
(202) 408-1080 Fax (202) 408-8173
www.dcfpi.org

December 12, 2013

Changes to DC's Income Tax Could Boost the Effectiveness of DC's Earned Income Tax Credit

By Wes Rivers

The District's Earned Income Tax Credit (EITC) is a key tool to increase the take-home pay of low-income working residents. By boosting incomes and reducing tax liabilities, the EITC has become one of the most effective anti-poverty programs for low-income working families. The DC EITC, modeled after the federal EITC, is the second largest state level EITC in the nation, and can provide significant tax relief to residents with very low incomes.

However, the DC EITC is less effective than other states' EITCs at providing relief — even though the vast majority of them are far lower that the District's. Other than working families in extreme poverty, low-income families in DC end up owing *more* income tax – or getting smaller EITC refunds — than similar households in other states with an EITC. This is because the basic income taxes the District levies — before the EITC is factored — are far higher for moderate-income households than in other states. Two things contribute to this:

- **The District does not exclude as much income from tax as other states with state-level EITCs.** The combination of DC's standard deduction and personal exemptions is far lower than the federal income tax and in the majority of states that have an income tax. This means more of DC residents' income is taxable.

- **The District's marginal tax rate for moderate-income filers is high.** In the District, single households with taxable incomes above $10,000 and two-earner couples with incomes above $20,000 face a 6 percent marginal tax rate. This is significantly above the average of tax rates in other EITC states that have a refundable state-level credit.[1]

The District's EITC could be more effective at providing tax relief and income support for working poor households. For example, raising the DC personal exemption and standard deduction to match the federal income tax would make the District's EITC one of the most robust in the country — providing the maximum refund to more residents and reducing liabilities of more moderate income households.

---

[1] Source: 2011 Filing Forms and Instructions for DC and 41 states with income tax. Refundable EITC states include: CT, DC, IL, IN, IA, KS, LA, MD, MA, MI MN, NE, NJ, NM, NY, NC, OK, OR, RI, VT, and WI.

How the District's Earned Income Tax Credit Works

Twenty states and the District of Columbia offer a refundable Earned Income Tax Credit (EITC) in their state's income tax -- similar to the federal EITC that is applied to federal income tax. These state EITCs are refundable, meaning that if the credit amount exceeds the income taxes owed, the difference is given as a tax refund.[2] In most cases, states base their credit on the federal EITC and set it as a certain percentage of the federal credit. DC has the second largest state EITC benefit on a percentage basis, at 40 percent of the federal benefit. (See **Table 1.**)

Table 1

DC Has One of the Largest State EITCs as a Percentage of the Federal Credit

Connecticut	30%
DC	40%
Illinois	5%
Indiana	9%
Iowa	7%
Kansas	18%
Louisiana	3.5%
Maryland	25%
Massachusetts	15%
Michigan	20%
Minnesota**	Varies
Nebraska	10%
New Jersey	20%
New Mexico	10%
New York	30%
North Carolina	5%
Oklahoma	5%
Oregon	6%
Rhode Island***	25%
Vermont	32%
Wisconsin****	11%

Source: 2011 Filing Forms and Instructions for DC and 41 states with income tax.

*Five State Refundable EITCs (CT, IL, IA, MI, NC) have changed since 2011, but this analysis uses other parts of the 2011 state tax codes, so those changes are not reflected here. Colorado was the only state to add a refundable EITC, at 10 percent.

**Minnesota's credit percentage fluctuates with income. For the incomes presented in this analysis, the credit ranged from 22 percent to 48 percent.

***Rhode Island's credit is a non-refundable credit plus 15 percent of the state credit, if the credit exceeds tax liability.

****Wisconsin's credit is based on the number of children. Two children households in this analysis have a credit of 11 percent.

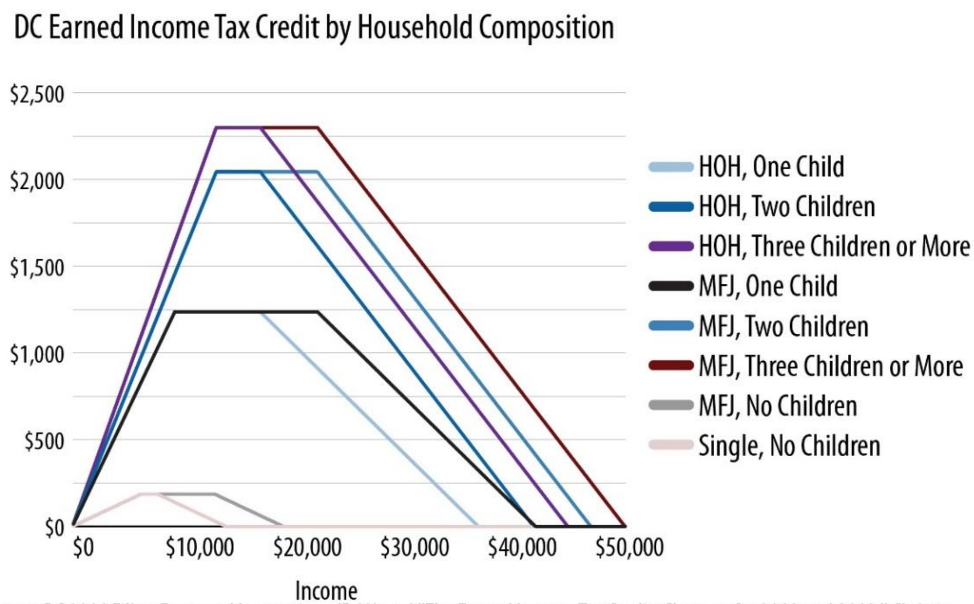
The District EITC, like the federal credit, is based on income and the number of children in the household. For very low-income workers, the EITC equals a percentage of earnings, which means the benefit amount rises as income rises, until it reaches the maximum credit amount. Workers qualify for the maximum credit over a specified range above the phase-in point, and then then the credit steadily declines as income rises further. For example, the EITC benefit for a single person with two qualifying children increases as income rises from $0 to $12,500, plateaus at a maximum benefit between incomes of $12,500 and $17,000, and then begins to decrease – phasing out completely at about $41,000.[3] Households with no children receive the smallest benefit, while households with three or more children receive the largest. **Figure 1** illustrates relationship between income and the benefits for multiple household types.

[2] Some states have EITCs that are non-refundable, meaning the credit can be used to eliminate a family's tax liability but cannot result in a refund. Those state EITCs are not reflected in this analysis.

[3] Source: 2011 Internal Revenue Service Form 1040 and Filing Instructions and 2011 DC Form D40 and Filing Instructions.

Figure 1

A District Family with Three Children Can Receive an EITC as Large as $2,300



Source: DC 2011 Filing Form and Instructions (D40) and "The Earned Income Tax Credit: Changes for 2012 and 2013," Christine Scott, Congressional Research Service, January 31, 2013.

HOH: Head of Household
MFJ: Married Filing Jointly

The EITC is one of the most effective anti-poverty tools, having lifted 9.4 million people — with 4.9 million of those being children — out of poverty across the nation in 2011.[4] The credit helps to incentivize work by subsidizing low-wages through refunds and tax relief, and the EITC gradually phases out, allowing families to earn more income without a dramatic loss of benefit — known as a "cliff."

The District's Earned Income Tax Credit Could Do More for Working Families

The District's EITC – set to equal 40 percent of a family's federal EITC — is larger than those in every state with a refundable EITC other than Minnesota.[5] This creates the potential for DC's EITC to provide substantial support to low-income workers and their families. Yet while very low-income DC families claim among the highest tax refunds in the country, DC's EITC is less effective at reducing net tax liability at moderately low-income levels. At these income levels, District

---

[4] Center on Budget and Policy Priorities, Policy Basics: The Earned Income Tax Credit, February 1, 2013, available at: http://www.cbpp.org/cms/index.cfm?fa=view&id=2505

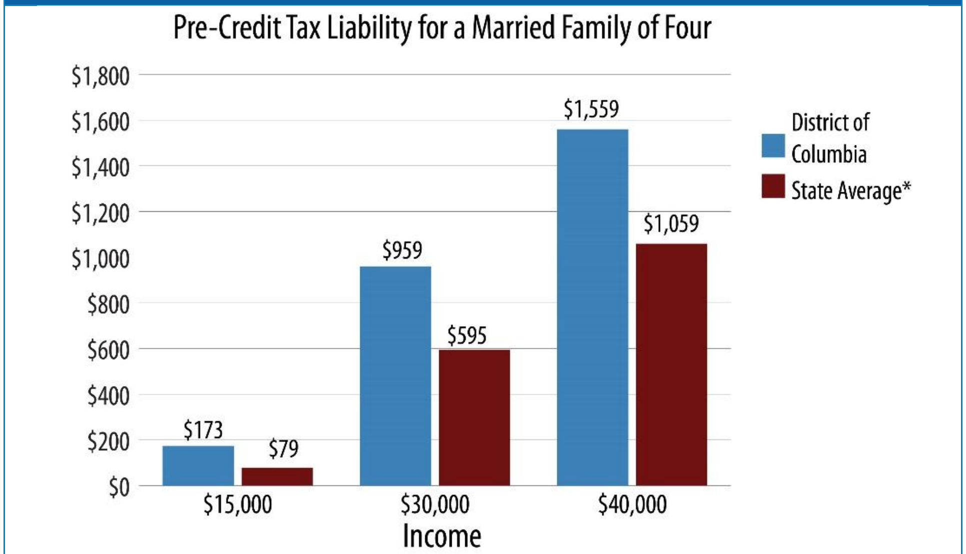
[5] Minnesota's credit fluctuates as a percentage of the federal credit, depending on income. At incomes between $30,000 and $40,000 (those used in this analysis), the state credit equals 43 to 48 percent of the federal credit.

households receive a lower refund or owe more tax than similar households in many states with a refundable EITC.

- At an annual income of $15,000, for example, a parent with two children receives a tax refund of $1,872 as a result of the EITC. This refund is larger than in every state other than New York.
- By contrast, a single parent with two dependents and an annual income of $30,000 would owe about $40 in DC income tax, even after the EITC. That same family would receive a refund in 7 other states — up to $595.
- If that family had $40,000 in annual income, they would owe $1,478 in DC, more than similar families in 15 of the 20 other states with a state-level EITC.

Figure 2

DC Has One of the Largest Pre-Credit Tax Liabilities in the Country



*State average includes the 21 states that offer a state earned income tax credit.
Source: 20 states and the District of Columbia's 2011 filing instructions and forms

DC's inability to convert a high EITC benefit into low net taxes results from the District's relatively high tax liability before credits are factored in. This means that before District households apply the EITC, they face sizeable income tax.[6] (See **Figure 2**.) District married couples have the fourth highest pre-credit tax when compared to 20 other states with refundable credits.[7] A married family with two children and income of $40,000 owes nearly $1,600 in DC before counting credits, compared with $1,100 in the 20 states with a refundable EITC.

The District's high pre-credit tax liability is attributable to two factors: higher levels of taxable income (income after the application of personal exemptions and standard deductions) and high marginal tax rates for households in these income ranges.

[6] DC's high pre-refundable tax and net tax liabilities compared to other states applies true both with and without the application of other states' nonrefundable personal and low income credits. The application of nonrefundable credits does not make a significant difference to the analysis. When referring to pre-credit tax, the analysis refers to tax before the application of both nonrefundable and refundable credits. When referring to net tax liability, the analysis refers to tax post the application of both nonrefundable and refundable credits.

[7] Holds true for the $15,000; $30,000; and $40,000 income levels.

The District Exempts Less Income From Tax than Other States with EITCS

States exclude different amounts of income from tax by applying personal exemptions and standard deductions to total income. The level or amount of a personal exemption or standard deduction varies from state to state by household size, and in some cases, income. The larger a personal exemption or standard deduction is, the smaller the share of a household's income that is subject to tax. While important to all filers, personal exemptions and — in particular – standard deductions are especially important to low income individuals, because they can remove a significant share of income from taxation. In DC for example, some 75 percent of filers with incomes below $75,000 claim the standard deduction.[8]

The combination of DC's standard deduction and personal exemption is far lower than the federal personal exemptions and standard deduction and similar deductions in many other states. For example, the combined standard deduction and personal exemption for a single parent with two children reduces taxable income by $10,700 in DC, compared with $15,300 in the average state and $19,600 at the federal level. The low value of these exclusions means that District households end up having more income subject to tax than they would in other states.

The District's Low-Income Credit

Some states have a nonrefundable credit that they use as a tool to provide tax relief to very low-income households. For very low income households, 5 states have nonrefundable credits, based on income, that work in tandem with their EITC. These credits allow more families to receive a refund through the refundable EITC. Maryland and the District also have a nonrefundable credit for low income families, but in each state, households cannot claim both the nonrefundable low income credit and the EITC.

DC could allow families to claim both the nonrefundable low income credit and the refundable EITC. However, the District's non-refundable credit is very small and applies only to extremely low income households -- so allowing residents to claim both the EITC and the low income credit would not expand the efficacy of the EITC for moderately low-income households.

By raising the standard deduction and personal exemption to the federal levels, the District could eliminate the need for the DC Low Income Credit which only applies to residents whose District exemptions are less than their federal exemptions. This could also help to simplify the tax code.

The District's Marginal Tax Rates for Lower-Income Filers Are High Compared to States with EITCS

On top of greater amounts of taxable income, low-income District households are subject to higher marginal tax rates than they would be in other states. Between $30,000 and $40,000 of income, for example, District households face a marginal tax rate of 6 percent. The average for EITC states is between 4 and 5 percent, depending on household size.

[8] DC Fiscal Policy Institute. "Increasing the District's Personal Exemption and Standard Deduction Would Help Provide Greater Tax Relief to Low- and Moderate-Income DC Residents." June 25, 2013.

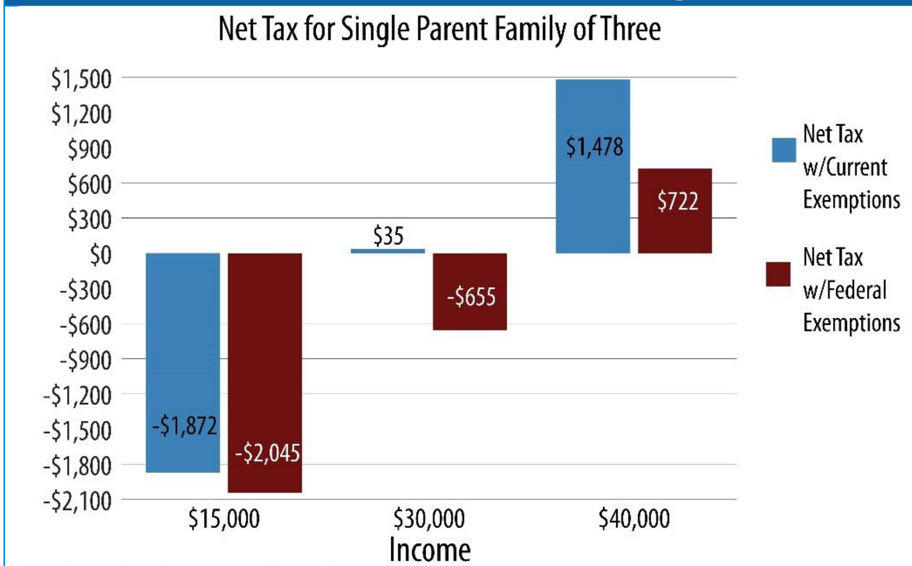
The combination of greater amounts of taxable income and that income facing higher marginal tax rates leads to DC having large pre-credit tax liabilities.

Reducing The Tax Liability That Low-Income Households Face Can Make the District's EITC a More Effective Poverty Reduction Tool

In order for the EITC to provide greater tax relief and income support for low-income families, the District could lower the pre-credit tax on low-income households.

Figure 3

Raising the Personal Exemption and Standard Deduction Would Increase the Effectiveness of DC's EITC at Lowering Net Tax



DC (D40) and Federal Filing Forms and Instructions (1040) for 2011
Note: DC Refund with federal exemptions maintains the DC provision that Head of Households receive an extra exemption

Raising the standard deduction and personal exemption and lowering marginal tax rates on low-income households would be the most effective ways at boosting the impact of the EITC and providing some tax relief to middle-income households.

- Expanding the personal exemption and standard deduction would reduce the amount of income subject to tax and lower pre-credit tax liability. (See **Figure 3**.) If the District raised the personal exemption and standard deduction to the federal exemption and deduction levels, a single parent family of three with income of $30,000 would get a refund of $655 rather than owing $35. Households at lower income levels would be able to receive the EITC benefit entirely as a refund.

- The District's marginal income tax rates are higher on low-to-moderate income households that they are in other states. By lowering marginal rates on low- and moderate-income households, the District could lower the tax liability of these households, which would boost the effectiveness of the DC EITC.

A more robust EITC could further incentivize workforce participation and help lift more DC families out of poverty. By reducing the amount of income subject to tax and tax rates on extremely and moderately low-income households, the District could allow the EITC to more effectively boost the take-home income of the working poor and provide tax relief for those who need it most.